Financial Reform and the Enforcement Problem

Gillian Garcia

The title of Walker Todd's paper, "The Evolving Legal Framework for Financial Services," gives the writer ample leeway to cover a wide range of related topics. A book on this subject, for example, might reflect on: the historical evolution of the current financial system; the different political philosophies current at the time the system was set up and later reformed; the political structure and its modus operandi, whether the financial system is centralized or "dual" as in the United States; the extent to which the contemporary financial structure efficiently and equitably meets the economy's structure and needs, both domestic and international.

The discussion would cover banks and other financial firms and would examine the customs, laws, and regulations that govern their operations. In addition, it would examine the enforcement of these laws. It would investigate the ability of the financial structure to take advantage of technological progress. In determining the extent to which the financial system is divided into separate compartments, it would comment on the degree of competition within and among the different segments. That examination would inevitably involve discussion of the powers that different segments possess, whether banks are regarded as "special" or whether "universal banking" prevails.

That, of course, is far too big an agenda for a single paper. In his paper, Todd carefully focuses on one small, but vitally important element in this structure—the legal framework for supervising and

Cato Journal, Vol. 13, No. 2 (Fall 1993).

The author is a Distinguished Professorial Lecturer in Finance at Georgetown University and Senior Economist with the International Monetary Fund. She was on the staff of the Senate Banking Committee when the article was written. She thanks Catherine England and Walker Todd for their constructive comments. The usual disclaimer applies.

regulating financial services firms in the United States.[1] Todd discusses supervisors' preclosure enforcement activities, but pays particular attention to the criteria for closing failed banks and the changes that were made in them by the Competitive Equality Banking Act (CEBA) of 1987, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, and the FDIC Improvement Act (FDICIA) of 1991. This comment picks up the enforcement theme, presents and analyzes some new interagency data on enforcement actions, and draws attention to the lack of criteria for evaluating enforcement activity.

Tinkering With The U.S. Financial System

It is interesting to ask why the United States has not achieved a greater degree of financial reform than it has. Early in the 1980s, the administration was set on a path toward expanding bank and thrift powers (that culminated in the Senate's repeal of the Glass Steagall Act in 1988) and deregulating the financial service industries. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 and the Garn-St Germain Act of 1982 took steps in that direction (Cargill and Garcia 1982, 1985).

At the latest count, however, Congress and the administration have tightened control over the banking and thrift industries and limited their powers to those permissible for national banks. Why did this happen at a time when Western European countries and Japan were liberalizing their financial systems?

Part of the answer, I believe, lies in the success, until the 1980s, of the system set in place in the United States during the Great Depression. Deposit insurance was credited with stabilizing the financial system and aiding the economy; so, other countries began to adopt similar systems. The very success of the U.S. system caused many analysts to overlook the fundamental agency problem inherent in the system of deposit insurance. The large number of bank and thrift failures revealed this flaw and modern finance theory has analyzed it. Deposit guarantees allowed owners of publicly owned banks and thrifts to incur more risk than debt-holders would have permitted if they had not been insured by the government.[2] This problem blossomed into full scale moral hazard and adverse selection when inflation and consequent high interest rates virtually bankrupted the thrift industry

[1]Other people in this conference and elsewhere have dealt with other aspects of this broad topic.

[2]Conversions from mutual to stock charters were common for savings banks and S&Ls in the 1980s.

at the beginning of the 80s. Weak and bankrupt thrifts gambled at taxpayer expense. Taxpayers lost $200 billion plus interest. And today weak banks can gamble in the derivative products market.

Ignoring these fundamental problems led the United States to apply a marginal approach to financial reform.[3] More fundamental changes that would have allowed interstate branching, the repeal of the Glass-Steagall Act, unified banking and commerce, as contained in the administration's version of FDICIA, for example, were defeated. The U.S. political system almost requires consensus for legislation to be enacted (Garcia 1993).[4] There was no chance of building consensus on financial modernization when critics characterized these reforms as reckless social experiments at a time when the most important objective was to bring moral hazard in the deposit insurance system under control. Instead of restructuring the financial system, banks' capital requirements were raised, the powers of state-chartered banks and thrifts were limited to those of national banks, early intervention and prompt closure were legislated, supervision increased, and enforcement tightened, in order to protect the deposit insurance funds and the taxpayer from further losses.

In this comment, I will focus on the tightening in enforcement and raise issues associated with congressional supervision of the regulatory agencies' enforcement actions.

Oversight in the Banking and Securities Industries

During the 1980s, Congress became increasingly impatient with the performance of the bank and thrift regulatory agencies. In the United States, direct financing through the securities markets is governed by a caveat emptor philosophy. The role of the Securities and Exchange Commission (SEC) is to make sure that participants in the securities markets have sufficient information to protect their own interests.

The philosophy underlying bank regulation has been different. Most depositors are assumed to be too small, unsophisticated, or busy

[3]In the 1980 and 1982 Acts, to give just three examples: Regulation Q was removed to end cyclical disintermediation, reserve requirements were extended to all depository institutions to help the Federal Reserve control the money supply, and S&Ls were allowed to invest in a wider range of products to reduce their reliance on fixed rate mortgages.

[4]Recognition of a crisis and agreement on a solution were necessary to enact financial legislation under a Republican administration and Democratic Congress (1987–92). President Clinton is currently trying to force legislation through Congress without Republican support, but it is not clear that he can do so.

elsewhere to spend time and money evaluating the soundness of their bank, thrift, and/or credit union. It has been the regulators' job to ensure the safety of funds deposited in these institutions, by examining the safety and soundness of bank operations and guaranteeing domestic deposits up to $100,000.

For many years, the bank and thrift regulators in the United States maintained a high degree of secrecy over the condition and performance of the institutions they oversaw. Regulators argued (and sometimes still argue) that releasing information about a weak institution could lead to a run, while publishing information about a sound bank or thrift would reveal confidential information to its competitors. The regulatory stance to the public was, "We will guarantee the safety of this institution, so you do not need to worry about it." This was particularly true for large institutions, such as Continental Illinois, Bank of America, and Citicorp which were nursed until they recovered rather than being closed (Fromson and Knight 1993).

There was a degree of ambivalence about releasing data, especially data on individual institutions, to congressional members and staff. While acknowledging that Congress might need some data in order to exercise its legitimate oversight responsibilities, regulators feared that the data could be misused and lead to a crisis. When data were supplied in response to a request, a condition was typically imposed that information be kept confidential. The regulators' advice to Congress can be summed up colloquially, "Leave it to us, we will take care of it."

The 1980s can be viewed as a period when Congress accepted this assertion, deferred to the regulators, trusted that they, together with increased market discipline, could resolve the problems that existed (particularly the thrift problem) if given enough time. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 reflect this trust (Cargill and Garcia 1982, 1985). The regulators had advised that giving thrifts (and, to a lesser degree, banks) greater powers and themselves greater authority could resolve the problems that existed.

By the end of the 1980s, however, Congress had decided that its trust had been misplaced. Hearings held by the Senate Banking Committee in the Spring and Summer of 1988 (U.S. Congress 1988a; 1988b), for example, dispelled that confidence and started Congress and the administration on the long road toward resolving the thrift debacle and the deposit insurance crisis in the FIRREA of August 1989, and FDICIA of December 1991. Congress had also come to doubt the energy and enthusiasm of the Justice Department in pursuing litigation against S&L crooks that the regulators referred to it.

Title IX of FIRREA

Title IX of FIRREA, which deals with Regulatory Enforcement Authority and Criminal Enhancements, expressed Congress' dissatisfaction with the regulators' use of their disciplinary powers and with the seriousness of the Justice Department's pursuit of S&L criminals. Title IX extended bank-equivalent enforcement powers to the thrift oversight agencies; clarified powers to issue cease and desist (C&D) orders; increased the grounds for and maximum value of civil money penalties (CMPs) that regulators could impose on wrongdoers in the industry; made supervisory records maintained by other regulators available to the FDIC; broadened the prohibition against the employment of persons convicted of dishonesty or a breach of trust in banks and thrifts; and provided for the publication of formal enforcement actions and more data on agency activities.

Section 918 of FIRREA mandates that the federal banking agencies and the Attorney General report annually to Congress on their enforcement activities. The conference report for the Act requires the agencies to provide data on: "informal and formal supervisory, administrative and civil enforcement action(s) initiated and completed in any year and the number and value of civil money penalties" (CMPs); "break down data on investigations, prosecutions, and convictions"; comment on "any concerns about the Justice Department's handling of these matters, including inadequate responses, unnecessary delays, or other problems"; and recommend additional legislation where needed (U.S. Congress 1989: 323). Unfortunately, neither the legislation or the conference report provide guidance on what the enforcement provisions sought to achieve beyond punishing the crooks in the S&L industry. Consequently, it is unclear how to evaluate the contents of the annual reports that Section 918 mandates.

The agencies' reports record the number of formal and informal actions taken each year; the amount of civil money penalties assessed and still outstanding from individuals and institutions; and other enforcement activity. The content and style of the agencies' annual reports differ somewhat. The FDIC names the individuals and institutions punished or involved in enforcement litigation and summarizes progress on each case; the Office of the Comptroller of the Currency (OCC) and the National Credit Union Association (NCUA) do not. The Federal Reserve (FR) names the individuals and institutions against which it assessed civil money penalties. The Office of Thrift Supervision (OTS) provides a summary of cases settled and outstanding against (named) institutions and individuals.

The resulting Section 918 reports prepared by the agencies ultimately reach the desks of congressional staff responsible for overseeing the regulatory agencies for use in the annual oversight hearings on the banking, thrift, and credit union industries and their regulators. But how should Congress evaluate these reports?

Has FIRREA Increased Enforcement Activity?

Improving enforcement was an important objective in FIRREA; Title IX is devoted to it. It is possible to discern that enforcement activity has increased since the Act.[5] For example, Table 1 shows available data on the number of formal and informal enforcement actions initiated by the OCC, FDIC, FR, OTS, and NCUA in the years before and after FIRREA. It is, however, more difficult to determine whether regulatory supervision has improved. Is more, better?

For the OCC, formal actions increased in 1990, 1991, and 1992 from low levels in 1988 and 1989.[6] Nevertheless, despite these increases, OCC took fewer formal actions in 1992 than in 1985. The number of informal actions rose sharply (eightfold) between 1990 and 1992. At the FDIC, formal actions rose in the two years following FIRREA, but there was no discernable pattern to informal actions, which peaked in 1988, before the Act was passed. The Federal Reserve's formal actions increased in 1990 and 1991. It is not possible to compare OTS's post- and pre-FIRREA behavior, because OTS's records start in 1990 and the agency says it does not have access to its predecessor's (the Federal Home Loan Bank Board's) records. NCUA's data show that the number of its actions increased eightfold between 1989 and 1990 and have continued to rise since then.

Comparing the Agencies' Enforcement Activities

Table 1 shows that OTS took the greatest number of formal and informal actions in 1990 and 1991.[7] (Data for 1992 from the FDIC and OTS are not available when the paper was written.) NCUA took the lowest number of formal enforcement activities in these two years.

The number of institutions supervised and the value of their assets varies considerably among agencies. Table 2, therefore, examines the

[5]In addition to the legislation, increased enforcement activity may have resulted from changed macroeconomic conditions that weakened financial institutions and/or an easing of budget constraints on the supervisory agencies.

[6]Enforcement activity at OCC may have increased in response to the criticism that Robert Clarke received in the Senate Banking Committee's hearings to consider his nomination for a second term as Comptroller of the Currency (U.S. Congress, 1991).

[7]A press release by OTS says that "the agency's enforcement efforts have peaked and will decline now that we have worked through the bulk of cases tied to the thrift crisis."

TABLE 1

ENFORCEMENT ACTIONS INITIATED, 1984–92

Year	OCC[a] Formal	OCC[a] Informal	FDIC[b] Formal	FDIC[b] Informal	FR[c] Formal	FR[c] Informal	OTS[d] Formal	OTS[d] Informal	NCUA[e] Formal	NCUA[e] Informal[f]
1984	457	41	218	n.a.	129[g]	n.a.	n.a.	n.a.	4	n.a.
1985	607	20	353	n.a.	214[g]	n.a.	n.a.	n.a.	1	n.a.
1986	329	62	228[h]	455[i]	339[g]	n.a.	n.a.	n.a.	6	n.a.
1987	296	232	236	413[i]	166[g]	n.a.	n.a.	n.a.	0	n.a.
1988	204	127	223	731	155[g]	n.a.	n.a.	n.a.	2	n.a.
1989	275	140	228	670	150[g]	n.a.	n.a.	n.a.	4	n.a.
1990	412	147	255	579	176	298	536	3,129	33	655
1991	488	1,006	356	655	245	297	1,063	1,561	43	462
1992	563	1,221	n.a.	n.a.	295	365	n.a.	n.a.	52	276

[a]OCC *Quarterly Journal*, Vol. 9, No. 1, and OCC's *Annual Reports on Enforcement* for 1991 and 1992.
[b]FDIC's *Section 918 Report to Congress* for 1991; FDIC *Annual Report* for 1988.
[c]Board of Governors of the Federal Reserve System *Staff Report to Congress* for 1990 and 1991.
[d]OTS Enforcement Actions and Initiatives; *Annual Reports to Congress*. Includes civil money penalties which OTS reports separately.
[e]NCUA's *Annual Reports* for 1984–90, and *Section 918 Reports to Congress* for 1990–92.
[f]Informal actions are actions finalized in 1991 as data on actions initiated are not available.
[g]Federal Reserve data from internal agency *Annual Reports on Formal Enforcement Actions* for each year.
[h]Data courtesy of Mike DeLoose, FDIC Legislative Advisor, Office of Legislative Affairs.
[i]Data for memoranda of understanding only.

TABLE 2

ENFORCEMENT ACTIONS IN 1991 IN RELATION TO THE NUMBER AND ASSETS OF INSTITUTIONS SUPERVISED[a]

	OCC[b]	FDIC[b]	FR[b]	OTS[b]	NCUA
Formal Actions					
per 100 institutions	12.5	4.6	24.9	48.0	0.3[b]
per $100 billion in assets	24.9	33.7	42.8	115.4	23.0[b]
Informal Actions					
per 100 institutions	25.8	8.5	30.2	70.4	3.6[c]
per $100 billion in assets	51.3	61.9	51.8	169.5	247.1[c]
All Actions					
per 100 institutions	38.3	13.1	55.1	118.4	3.9[d]
per $100 billion in assets	76.2	95.6	94.6	284.9	270.1[d]

[a]Number of institutions and their assets are for June 30, 1991.
[b]Actions initiated in 1991.
[c]Actions finalized in 1991, as data on actions initiated are not available.
[d]Formal actions initiated plus informal actions finalized.

SOURCES: Data on enforcement actions came from each agency's annual *918 Reports to Congress* (see Table 1). Data on the number of institutions supervised and their assets were obtained from the Congressional Relations Offices of the OCC, FDIC, FR, and NCUA. Data for OTS came from its *Selected Indicators for all Private Sector Thrifts* 1991.

number of actions taken:, (a) per 100 institutions supervised, and (b) per $100 billion of assets supervised. OTS has relatively the highest number of formal actions. NCUA had the lowest number of formal and informal actions per 100 institutions supervised, but the highest number of informal actions per $100 million of assets supervised.[8]

Table 3 reports the different types of formal and informal actions taken by the different agencies in 1991. There is some overlap; all agencies issue C&D and removal/prohibition orders and assess civil money penalties. Otherwise there is a surprising variability in the types and/or the names of actions taken by the different agencies. NUCA relied almost completely on informal actions while the Federal Reserve split its activities more equally between formal and informal actions.

This variability illustrates just one of the difficulties faced by the Administration and the chairmen of the House and Senate Banking Committees in their current efforts to rationalize and consolidate the bank and thrift regulatory agencies. Someone, for example, will have to decide whether all of these different enforcement actions are necessary and, if not, which should be continued and which curtailed.

Has Enforcement Improved Since FIRREA?

One can conclude that enforcement activity has increased at all of the bank regulatory agencies since FIRREA. But more activity does not necessarily mean more successful enforcement activity. It is not clear from the legislation or its history how to measure success.

Success depends on what Congress intended, beyond punishing the known criminals and deterring others, by tightening enforcement. Although not clear from the legislation, that additional intent could be of two kinds. The first would lead to prompt closure and less costly resolution, an avenue that Todd pursues in his paper, but it might also involve corrective enforcement actions that lead to recovery, rather than demise. It is in assessing recoveries that the measurement difficulties arise.

Section 918 requires agencies to report the number of actions initiated in any year and the number completed. But completing an action does not necessarily mean that it has been successful. The section also requires that agencies report the value of civil money penalties (CMPs) assessed and the amounts that remain uncollected. The value of CMPs collected is one measure of success, but it is not a comprehensive or completely satisfying one.

[8]NCUA, for example supervised the most institutions (12,653) with only the smallest of the agencies value of total assets ($261 billion) at the end of 1992.

TABLE 3

Types of Enforcement Actions Initiated, 1991

	OCC	FDIC	FR	OTS	NCUA
Formal Actions					
Application Conditions	13				
Capital Directives	1	2	2	95	
Cease and Desist Orders[a]	85	158	53	255	12
Civil Money Penalty Orders	190	11	51	199	21
Conservatorships/Receiverships	0			338	0
Formal Agreements	148		76		
Removal/Prohibition Orders	41	74	46	157	10
Suspensions	3		2	3	0
Trust Power Revocation	0				
Termination of Insurance		81			
Injunctive Actions		25		6	
Part 513 Actions				10	
Orders of Investigation	7	5	15		
Total Formal Actions	488	356	245	1,063	43
Formal Actions as a Percentage of all Actions	32.7	35.2	45.2	40.5	8.5

Informal Actions					
Board Resolutions	93	223		28	
Capital Plans				150	
Commitment Letters	205			0	
Consent Merger Agreements				82	
Formal Investigations				93	
Letters of Reprimand	152				
Memoranda of Understanding	37	432		28	
Letters of Understanding					462[b]
Supervisory Agreements				325	
Supervisory Letters	519				
Supervisory Directives		821			
Requests for Voluntary Management Changes				34	
Total Informal Actions	1,006	655	297	1,561	462[b]
Informal Actions as a Percentage of all Actions	67.3	64.8	54.8	59	91.5
Total Actions	1,494	1,011	542	2,624	505

[a]Includes temporary and permanent cease and desist orders.
[b]Data for letters of understanding represent final actions as information on actions initiated are not available.
SOURCES: Data from agency *Section 918 Reports*.

Civil Money Penalties

The Federal Reserve's 918 Report for 1991 states that, between 1975 and 1990, respondents had defaulted on $4.1 million of the civil money penalties it had assessed. Congress perceived the agencies' collection problems as a lack of dedicated follow-through so that Section 918 requires the agencies to report the number and amount of civil money penalties assessed and the amount not collected. It is now possible to evaluate the success of CMP activity according to the ratio of the value of CMPs collected to those assessed.

There has been a marked improvement since 1990 in the ratio of assessments collected at the Federal Reserve. In 1990, less than one percent of the fines levied were paid. In 1991 and 1992, fewer fines were levied, but all were paid in 1991 and virtually all in 1992. OTS appears to have been consistently successful in collecting virtually all of the fines it levied in 1990 and 1991. OCC has collected roughly half of what it assessed in the past three years. FDIC data show a low and variable success rate. These data leave questions. Is it useful to levy CMPs without collecting them? Is it better to levy fewer fines, but collect more of them?

Evaluation Criteria

The questions regarding civil money penalties emphasize that the criteria for evaluating the broader range of supervisory actions are largely undeveloped. The congressional task of assessing whether the regulatory agencies are carrying out their enforcement activities successfully remains an unscientific one. There appears to have been little attention in academic circles to this subject.

A methodological advance is needed. How otherwise will one be able to assess whether, for example, FDICIA's prompt corrective action (PCA) provisions are being faithfully carried out by the different bank and thrift agencies? How will one assess whether PCA is proving successful in achieving Congress's intentions to impede forbearance for troubled institutions and reduce the risk of loss to taxpayers? Some financial regulators, resenting PCA's reduction of their supervisory discretion, could issue regulations in such persnickety abundance as to call the legislation into disrepute.[9]

How then can Congress conduct worthwhile oversight of the regulatory agencies in the post-FIRREA and post-FDICIA environment? A final reality check can be made by examining the numbers of

[9]For example, the American Bankers' Association and others have argued that FDICIA has overregulated the banking industry and contributed to the credit crunch.

institutions that fail and the cost of their resolution. But it would be better to have some measure of success at an earlier stage of the supervisory process. A comparison among the agencies of the percentage of institutions in the different capital bands (ranging from well-capitalized to undercapitalized institutions) would give some indication of relative performance. Some law firms in Washington keep a tally of the regulations which FIRREA and FDICIA require the regulators to promulgate and the progress that the regulators have in complying with its requirements. But such an approach is mechanistic and overlooks the possibility of regulatory overkill.

More sophisticated tools of oversight are needed. For example, supervisors might be required to reveal their objective for taking a particular action, such as, issuing a cease and desist order, making a capital directive or imposing a suspension. After a predetermined interval, they should evaluate whether each action has achieved its objective. This information should be subject to Congressional oversight. But creative readers may be able to construct additional measures of supervisory success.

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International Financial Deregulation, Trade, and Exchange Rates

Mervyn K. Lewis

Free trade has long been accepted amongst economists as the desideratum for global prosperity. But if free trade in goods is to be secured it needs to be accompanied by unhindered cross-border movements of money, finance and capital. Considerable progress in freeing up financial markets was made during the 1980s. National banking and capital markets were opened to foreign competition and international financial markets expanded. As a result, banks and other financial institutions operating in the large industrial countries now compete to a considerable degree free of interest rate controls, product barriers, and territorial restrictions.

However, developments in the 1990s suggest some contrary trends, namely 're-regulation' in the guise of the Basle capital standards and the perception that the world economy may be coalescing into a set of geographic trade blocs. The European Single Market project and the European Economic Area, the Canadian-U.S. Free Trade Agreement (CUSTA), the North American Free Trade Agreement (NAFTA) and the Enterprise for the Americas Initiative, and (to a lesser extent) the Asean Free Trade Agreement (AFTA), are examples of efforts to remove trade barriers between the countries concerned, including moves to facilitate inter-regional movements of capital and finance and create genuinely transnational markets for financial and other services. To the extent that these agreements incorporate features and concessions which go beyond what might be contemplated at a global level (concessions to some are effectively privileges being denied to others), there is a danger that the agreements might weaken commitments to multilateralism.

Cato Journal, Vol. 13, No. 2 (Fall 1993).
The author is the Midland Bank Professor of Money and Banking at the University of Nottingham, United Kingdom.