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monopoly power in its products. Brown and Stern reduce this bias by dividing the 29 sectors in their CGE model into 24 industries where products are differentiated by firm and five perfectly competitive industries where products are differentiated by national origin. The results appear reasonable, but how are they to be evaluated? The authors suggest by looking at the assumptions' plausibility, but at this aggregation level any behavioural assumptions are simplifications and changing them can lead to huge differences in estimates (compare the oft-cited Cox-Harris CGE estimates of a Canadian gain from North American free trade equal to 9 per cent of GNP with the Brown-Stern estimate of 1 per cent).

Despite the theoretical and empirical difficulties, some positive conclusions do emerge from this work. RTAs do better in a climate of trade liberalization. The EC and EFTA are successes and the auguries for the US-Canada FTA are good. Hyclak believes RTAs generally result in "managed free trade" among the participants, who minimize the political costs of removing trade barriers (p. XIII), but this is belied by the case studies, which show that managed free trade does not work. Where participating countries are determined to defend inefficient industries, RTAs will not get off the ground – even when successful exporters are involved as in ASEAN, let alone in the import-substitution heartland of LAFTA in the 1960s.

The editors and publisher are to be congratulated for the short publication lag. Drabek accountably fails to foresee the events of 1989 in Eastern Europe, but he does a visionary job of emphasizing the high probability of imminent breakdown of the CMEA, only spoilt by his final paragraph's reference to CMEA members' "unwillingness to return to market-based solution of their relations in the foreseeable future" (p. 252). It is dangerous to make predictions in a conference volume paper! The production standards are good, although there are some howlers such as references to the 1980–5 fall of the US dollar (p. 19) and to Iaccoca's 1934 autobiography (p. 124). As an encyclopaedic reference there are gaps in geographic coverage, but the volume does give a good sense of current thinking in this branch of commercial policy.

Richard Pomfret

**Portes, Richard, Alexander K. Swoboda (Eds.),** *Threats to International Financial Stability*. Cambridge, New York, Port Chester, Melbourne, Sydney 1987. Cambridge University Press. XVIII, 307 pp.

Especially in the early phases of the international debt crisis of the 1980s many observers were concerned that the repayment difficulties of Third World borrowers might cause major disruptions in international finance and trade relations. Reschedulings and refinancing packages for overindebted countries provided short-term measures to contain threats to worldwide financial stability. At the same time it was heavily disputed whether the regulatory and institutional framework of international financial markets was capable of preventing contagion effects and major financial crises. The volume edited by Portes and Swoboda deals with the most important issues of this discussion by referring to recent developments in the theory of finance and in economics of uncertainty. It contains the proceedings of a conference on "Risk, International Financial Markets and Public Policy" organized by the International Center for Monetary and Banking Studies in Geneva in September 1986.

The views of about 50 academics, bankers and officials are presented in six papers by academic experts and the comments of private sector economists and officials, a report of the panel discussion, a keynote address by *Markus Lusser*, and an appendix of six country studies. In their introduction, *Portes* and *Swoboda* raise three questions

that they consider crucially important to assess the likelihood of a recurrence of a deep international financial crisis:

- First, what is the extent and nature of shocks that buffet the financial system?
- Second, are international financial markets resilient in the sense that they tend to dampen shocks or, on the contrary, fragile in the sense that they tend to amplify and propagate disturbances?
- Third, what are the appropriate policy responses concerning the design, regulation, and supervision of financial institutions?

In Chapter 1, *Eichengreen* and *Portes* present a general framework for understanding the anatomy of financial crises, their origins and international propagation. This framework is then used to compare the experiences of the 1930s and 1980s. The analysis highlights the importance of two sets of factors in the process of propagation: (i) asset-market linkages running from debt defaults and exchange-rate disturbances to the stability of the banking system, and (ii) the role of economic policy in blocking these linkages. In the 1930s, institutional changes are shown to have generally worked in the direction of heightening the system's vulnerability to shocks. Moreover, the disastrous macroeconomic and trade policies performed in the 1930s contributed to the propagation of shocks. The authors are confident that recent institutional changes have not created further instability and that macroeconomic and regulatory policies have been informed by the lessons of the past. But they stress the need for continued and improved international policy coordination. Policy coordination is evidently required to resist the protectionist tide and to prevent "trade policy conflicts, with the 'inward-looking' consequences of the 1930s" (p. 50). However, it remains highly dubious whether we do need an "international monetary constitution providing rules on exchange-market intervention and choice of reserve asset, constraints on fiscal and monetary policies, or responsibility for the ILLR (international lender of last resort) function" (*ibid.*).

Chapters 2 and 3 deal with the practice and theory of financial regulation and supervision. The focus here is on national policies to ensure financial stability. The comparative perspective is supplemented by the six country studies in the appendix that present the regulatory and supervisory particulars as well as the set-up of institutions in the United States, the United Kingdom, West Germany, Japan, Finland, and Argentina. *Baltensperger* and *Dermine* (Chapter 2) discuss a number of basic questions: What is the economic justification of bank regulation, and why do unregulated financial markets lead to suboptimal results? What forms of regulations are economically efficient, and which ones have negative effects on financial market performance? The authors are well aware of the fact that "even if a regulation is judged to have beneficial effects, it is important also to investigate its costs and weigh them against the associated benefits" (p. 67). Measures aiming at risk reduction frequently affect the allocation of resources negatively. Moreover, protective measures give rise to moral hazard by financial institutions. The authors identify informational asymmetries between banks and their customers as the principal source of market failure. Consequently, stricter and more comprehensive disclosure requirements are asked for. As concerns the pricing of deposit insurance, premiums "should be related to the risks taken by the individual banks in much the same way as capital requirements are related to their asset structure" (p. 88). Though these principles remain fairly general, they provide important guidelines as to how to improve market discipline, and reduce moral hazard incentives and the danger of contagious runs.

*Schaefer* shows how the basic tools of portfolio theory can be used to highlight some shortcomings of the methods of risk assessment currently used in banking supervision and how alternative measures can be formulated (Chapter 3). The discussion mainly refers to the regulation of bank capital in the United Kingdom. It is emphasized that regulators should consider the covariances between asset returns to assess the risk of

bank capital properly. Moreover, regulators should take into account the liability structure as well as the asset structure of financial intermediaries both on and off balance sheets, given the recent proliferation of off-balance-sheet transactions by banks.

The next three chapters focus on major issues that arise in an international context: the dynamic interaction between regulatees and regulators in the cycle of regulation, deregulation, and reregulation; the provision of emergency liquidity assistance in the absence of an international lender of last resort; and the role of the interbank market in the international propagation of financial crises. *Kane* (Chapter 4) applies a contestable-markets view of regulation and portrays reregulation (i.e., adjustments of the inherited system of regulatory instruments) as an economically endogenous process in which politicians and regulators respond self-interestedly to political and economic pressure. Deregulation is viewed as a special case of reregulation. The author attributes recent regulatory relaxations to “heightened competition in what is in fact an international market for financial-services regulation” (p. 112). Competitive reregulation is viewed as potentially beneficial. But the benefits “can be dissipated by explicit and implicit government subsidies to regulatory risk-bearing” (ibid.). The first-best solution to bring such subsidies under control would be to improve the flow of relevant information to taxpayers. However, remaining difficulties in monitoring by taxpayers lead Kane to conclude that greater international regulatory cooperation may be required in an interim period. It remains open to question whether Kane’s conclusion is justified that “the near-term gain in world financial stability promises to offset what should be only a temporary loss in economic efficiency” (p. 143).

*Guttentag* and *Herring* discuss the concept and rationale of an international lender of last resort (Chapter 5). They analyse (i) whether the failure of a bank might have social costs greater than those of providing international lender-of-last-resort facilities, and (ii) which are the appropriate modalities of last-resort lending. The authors make a case for providing emergency liquidity assistance to individual banks even when the general level of liquidity can be sustained by open-market operations. Moreover, they argue that it should be made explicit by the authorities which banks are eligible for lender-of-last-resort facilities, since vagueness may increase rather than reduce moral hazard problems. Two major issues remain controversial, as is evident from the discussion of the paper by Guttentag and Herring. First of all, it remains open to which extent asymmetries of information between the banks on the one hand and the depositors, shareholders, and taxpayers on the other hand may be overcome by improved disclosure of information. Arguably the widely perceived need for last-resort lending is mainly due to information constraints that “are at best artificial and at worst a regulators’ conspiracy” (p. 187). Secondly, even if an international lender of last resort is needed, moral hazard problems might be contained by distinguishing between solvent and insolvent banks. Last-resort lending would then be defined as extraordinary loan advances to banks that are believed to be solvent, but that might fail without emergency liquidity assistance.

In Chapter 6, *Saunders* analyses the potential sources of contagion in the Eurocurrency interbank market and presents empirical evidence on contagion effects. Interestingly enough, “contagion effects measured either through spreads, deposit/loan flows or equity values have been relatively small. Indeed, if anything, the degree of contagion appears to have fallen since the early 1970s” (p. 226). It is hard to decide whether this result is due to unaided resilience of the interbank market or – as Saunders suggests – to “the more interventionist stance taken by bank regulators since 1974” (ibid.). Even if the latter were true, public interventions may have created considerable moral hazard and adverse selection problems. The author’s concern that longer-term instability problems may increase through stabilizing the financial system in the short run appears

justified, even though shareholders and managers are not fully protected from the consequences of a bank failure.

The question of whether short-term crisis management may add to financial fragility and inefficiency in the longer run is also raised in the panel discussion, which is summarized by *Pearce* in Chapter 7. Other questions discussed include: Is the pace of change in international financial markets so rapid that the institutional infrastructure falls behind too much? Do the recent developments in financial markets add to stresses within financial institutions (e.g., with respect to training, communication and systems development)? What are the problems besetting the financial system in Latin American countries? The rapporteur also provides a concise overview on the major issues raised in the previous chapters. Finally, *Lusser* in his keynote address deals briefly with the implications of financial innovations for monetary policy (Chapter 8). The author argues that "after the introduction of such innovations the financial markets are not less stable than before; at times they actually tend to be more stable" (p. 260). Deregulation is considered as the result, rather than the cause, of the recent tide of innovations; it is viewed as a step in the right direction. In *Lusser's* view, new financial instruments do not inhibit the effectiveness of monetary policy significantly.

Taken together, the contributions to this conference volume do provide – as the editors believe – not only a rich survey of the threats to international financial stability, but also important insights into the role of both policy and markets in containing risks. From the discussion it is evident that financial market regulation typically involves a trade-off between the stability of international financial intermediation and its efficiency. The volume thus contributes to a critical reassessment of public bank regulation and stimulates further research on the design of an institutional framework that minimizes efficiency losses.

Peter Nunnenkamp

**Sijben, Jac. J. (Ed.),** *Financing the World Economy in the Nineties.* Dordrecht, Boston, London 1989. Kluwer Academic Publishers. XII, 158 pp.

This book comprises a set of papers and their discussion, presented at a conference held at Tilburg University, March 23, 1988. They aim at discerning some critical economic and financial problems of the world economy and point out possible ways and means toward introducing greater discipline in resource mobilization and policy targets that could help control these problems. In this topical area the central focus of the book lies on integrating the role of the markets with the efforts in macroeconomic policy coordination among nations.

The role of markets is upheld in the papers presented in this book in terms of free trade, competition in the interbank market and the free floating of the U.S. dollar. *Sijben* summarizes this objective (p. 11): "The correction of international imbalances requires that expenditure adjustment be made within the framework of free trade, while averting excessive reliance on exchange rate changes". Furthermore, in chapter 4, *Snijders* points to "the growing need to develop new financial instruments, which can offer protection against the enormous economic uncertainties that have arisen over the last fifteen years" (p. 59). In chapter 5, *Oort* points to the growing importance of risk diversification and risk transfer among banks as a means of bringing about the effectiveness of the interbank market system to deal with debt and uncertainties in the financial world. He concludes by pointing out, that "the buzzwords in banking are, as they have always been, correct risk assessment, prudent risk management, and diversification of risks" (p. 96). In chapter 6, *Roij* points to the interlink that must be devel-