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International Payments and Central Bank Cooperation

1.1 A BIS View of Cooperation

The principal mission of the Bank for International Settlements (BIS), as set down in its Statutes, is to promote the cooperation of central banks.[1] The experts who in 1929 recommended the creation of the "International Bank" wanted it to provide "an increasingly close and valuable link in the cooperation of central banking institutions – a cooperation essential to the continuing stability of the world's credit structure".[2]

Why central bank cooperation? Cooperation on what? With what objectives in view? How? These questions were asked by the BIS itself in 1935,[3] at a time when international economic cooperation lay in tatters, only a few years after the high hopes raised by the Young Plan and the creation of the Bank. The failure of the London Conference of 1933 to revive the international monetary system based on gold had left in its wake acrimony, mistrust, and a myopic pursuit of national interests. Purposeful world economic leadership was not in sight. Dark clouds were gathering on the political and military horizons as Germany unilaterally repudiated the military clauses of the Versailles treaty, Italy perpetuated its aggression on Abyssinia, and Japan prepared to invade China. In this disheartening context, the management of the BIS chose to engage in a definition of central bank cooperation, a concept often mentioned in public discourse but seldom precisely articulated in its details and implications. It was a way for the new international organisation to discharge one of its moral duties. In the 1930s the BIS preached in the desert about the advantages of cooperation, but the intellectual contribution to the definition of the aims, scope, and limits of central bank cooperation outlived the circumstances in which it was made. It provides a useful starting point for the history of central bank cooperation as it unfolded in Basel between 1930 and 1973.

"For many", the BIS wrote, "central bank cooperation means only financial assistance". While mutual "financial aid is a spectacular evidence of central bank inter-relationship, nevertheless these exceptional measures, though useful, do not constitute the real kernel of central bank collaboration, which is or should be evident in continuous and daily practice rather than as an emergency manifestation".[4]

Why, then, central bank cooperation? According to the BIS, each central bank has substantially the same task – namely, "to regulate the volume of credit and currency with a view to lessening pronounced fluctuations in business activity, and to follow a policy designed to maintain fundamental equilibrium in the balance of payments in order to preserve some pre-agreed degree of stability in the international value of its national money, thereby facilitating trade and desirable capital movements from and to the country concerned".[5] But central banks operate in a world larger than their domestic sphere, if for no other reason than that each national currency is internationally traded and domestic policies are subject to influence from abroad. Their viewpoint therefore must necessarily face outwards as well as inwards. The interdependence of financial markets and the international nature and transmission of business fluctuations are such that the domestic policies of a central bank "may be rendered difficult or thwarted by the policy action of a neighbouring central bank". Thus, "far-seeing self-interest demands that banks of issue endeavour to work along parallel lines in the fulfillment of their independent duties, although measures taken to attain the common purpose need not be identical in different markets". According to the consistently held philosophy of the BIS, "long range national advantage and international well-being usually coincide in the desideratum that the credit and currency policy of the world's central banks be, as far as possible, uniform and through cooperation avoid being haphazard or mutually adverse".

The BIS saw a number of relevant matters on which central banks can usefully collaborate.

a. Evolving a common body of monetary doctrine in order to assure "the widest possible measure of common agreement on monetary theory, problems and practice, including agreement upon what the international standard is to be and how to maintain it".[6]
b. Gaining an understanding of the difficulties that confront neighbouring central banks. "The beginning of understanding", the BIS wrote,

"in international affairs, whether in the political arena or in the economic and financial field, is the knowledge based on patient examination and sympathetic consideration of why the other nation adopts the measures which it does. Many of the difficulties which impede international rapprochement have their origin in inadequate acquaintance with all the facts of the situation, and in the lack of objective appreciation of the problems and reasoning of the other side. Even when the differences are irreconcilable, it is at least helpful to have them accurately defined".[7]

c. Learning how to avoid doing harm to one another, especially when one central bank is operating in the market of a neighbour, by the establishment of reciprocal banking, business, and personal relations.
d. Gathering and exchanging monetary and economic data. Such exchange of information is vital, according to the BIS, "with respect to the volume, movement and location of short-term balances and short-term foreign credits in general".
e. Improving inter–central bank practice in a wide range of technical matters.[8]
f. Assisting in the creation of new central banks as well as aiding smaller ones in "their efforts to follow a sound credit and financial policy and to maintain the international value of their local currency".[9]
g. Working out technical improvements to some of the features of the international monetary system.

What were, according to the BIS, the principal objectives of central bank cooperation? The first one was the maintenance of a stable system of international payments. In 1935 this meant "the general restoration of the gold standard and … its successful working in the future". The second object of collaboration was "to attempt, as far as is possible by monetary and credit measures, to smooth out the business cycle, and to contribute toward a greater equilibrium in the general level of economic activity. … It is primarily by wise and prescient contraction or expansion of credit, as sound business conditions demand, that central banks acting in collaboration can do most to avoid undue fluctuations in the purchasing power of gold".[10]

How to cooperate? The BIS's own experience of the previous five years suggested "frequent meetings, visits, incessant exchange of information, common consultation and joint discussion, all to the end that at least mutual understanding may ensue, if not indeed harmonious action. In monetary matters", the BIS explained, "the psychological attitudes prevailing on the various markets are often factors of very great importance; to convey a correct impression of elusive psychological influences is always difficult, but it can certainly be done most easily by word of mouth". With some pride, the BIS added that "it is not generally realised how much progress has already been made to promote greater contact between central banks", particularly since "the members of the BIS meet regularly ten times a year".[11]

After explaining why central banks should cooperate and discussing the areas, objectives, and tools of cooperation, the 1935 Annual Report concluded with a caveat: "Too much should not be expected from the cooperation of the central banks. It is not a panacea for economic ills, although its realization would greatly contribute toward their prevention in some instances, or toward their alleviation in many others".

There are, the BIS noted, many reasons why central bankers find it difficult to cooperate: "the tradition and habit of secrecy", the desire to affirm independence, "questions of prestige", "the spirit of nationalism". The largest stumbling block, however, lies in the fact that "central bank cooperation is but one phase of international collaboration in general, and if that is wholly lacking or if international relations are antagonistic, then central banks, whose tasks are primarily of a technical order, have means inadequate to withstand the contrary tides".[12]

Such were the views on international monetary cooperation officially held in 1935 by the BIS – created in 1930 as the first international financial organisation – whose history from its origin to the end of the Bretton Woods system is the subject of this book. The narrative will cover in some detail the organisation and the operations of this institution. We shall deal with people working at the Basel headquarters of the Bank or regularly gathering there from all over Europe, the United States, and Japan; at times we shall even try to have a glimpse at their daily life. But the focus of the book is on central bank cooperation as it unfolded in Basel over some forty-odd years. Most chapters will open with a section aimed at providing a brief background to the developments in the international monetary scene that required the attention and intervention, successful or otherwise, of central banks and their cooperative institution. Specialists may find these sections redundant, but we trust that many readers, including historians and economists not specialising in international monetary affairs, will appreciate the provision of a framework for specific cooperative (or uncooperative) actions dealt with in subsequent sections of the chapter. Likewise, we felt it to be appropriate, before beginning with the history of central bank cooperation at the BIS, to provide a long-term perspective on monetary systems and cooperation. After outlining the evolution of international monetary systems, we shall briefly spell out the reasons for international monetary cooperation and then discuss how much (and in what form) cooperation existed before the appearance of the BIS on the international scene.

1.2 International Monetary Systems, 1870–1973

One fundamental textbook classification of international monetary systems distinguishes between those supposed to work on the basis of market forces alone and those that require some kind of policy intervention. Systems based either on free-floating exchange rates or on pure (Hume-type) gold-standard–fixed rates belong to the first category. All other systems in between these two extremes are based upon a certain, though variable, degree of management by governments or ad hoc agents such as the central banks.

Such management postulates a certain, though variable, measure of cooperation. The latter can be informal (sometimes also called coordination) or formal. Informal cooperation takes place when each individual player (government or central bank, as the case may be) adheres to given rules of the game that – when autonomously followed by all participants – result in an efficient and stable international monetary system. Formal cooperation takes place when governments or central banks agree on ad hoc actions aimed at upholding or enhancing the efficiency and/or stability of the system. For instance, when every country participating in the gold standard lets changes in money supply reflect the inflow or outflow of gold resulting from balance of payments surpluses or deficits, an informal coordination (or cooperation) is taking place that maintains the viability of the system. When, to take another example, domestic political and social constraints make it difficult for a country to strictly follow the rules of the game (e.g., because the deflation required to maintain a stable exchange rate would create unacceptable levels of unemployment), then the system may be stabilised by formal cooperation in the form of loans (bilateral or multilateral) enabling the deficit country to overcome its temporary difficulties.

In the century that ended with the demise of the so-called Bretton Woods system during 1971–73, the international monetary systems linking the "core" countries of the world economy were based upon four different types of arrangements: (i) the classical gold standard, which ended in 1914; (ii) pegged exchange rates between 1914 and 1925 and again between the mid-1930s and the late 1940s; (iii) the gold exchange standard between 1925 and 1931–36; and (iv) the gold dollar standard of Bretton Woods from the late 1940s to the early 1970s. Each of these systems entailed interventions of some kind by the domestic monetary authorities – particularly those in the major countries – in order to maintain its efficiency and stability and therefore a degree of informal and/or formal cooperation.

In the early nineteenth century, three types of monetary standards[13] existed worldwide. A gold-standard bloc was formed by the United Kingdom (which converted paper money into gold at the price set in 1717 by Sir Isaac Newton), its colonies and dominions, and Portugal. A silver-standard bloc encompassed the Habsburg Empire, most of the German states, the Scandinavian countries, the Netherlands, and, outside Europe, Mexico and most parts of Asia (including China, India, and Japan). A third group of countries – which included France, Belgium, Switzerland, Italy, and the United States – adopted the bimetallic standard (whereby conversion was possible into either gold or silver, at a fixed rate between the two). The overall system proved to be rather stable owing to the free international flow of metal and to the fact that countries from each bloc tended to trade more intensively with each other than with those on different standards, thus also establishing long-lasting links that survived the end of the specific metallic regimes.[14]

By the 1860s, however, a general trend for monetary systems to converge on gold set in, encouraged by the fall in the relative price of silver induced by the operation of new mines in Mexico and Nevada, by the spread of gold coins as a result of rising incomes, by the economies of scale in the use of gold in international transactions, by the political defeat of the silver populist lobby in the United States, and by the new German Reich's adoption of the gold standard.[15] Most of all, the origins of the gold standard are deeply interwoven with the acceleration of international exchanges. Gold was favoured by the very fact that it was the monetary standard of the United Kingdom, the leading commercial and financial power, at a time of rapidly expanding international trade and capital movements due to falling tariff barriers (as sanctioned by the Cobden–Chevalier Treaty) and to rapidly decreasing transport and communication costs resulting from the expansion of the railways, steam navigation, and the telegraph. Whatever the reasons, by the early twentieth century almost the entire world – with the conspicuous exception of China – was on gold, the Russian and Japanese empires having joined in the last decade of the nineteenth century.

The "classical" gold standard, so called in retrospect to recognise its landmark character, was undeniably successful in providing the low-cost international liquidity needed to sustain an extraordinary period of growth of the world economy, now also termed the "first globalisation". Under the classical gold standard but not necessarily because of it, something quite close to price stability prevailed, exchange rates among the "core" currencies remained fixed,[16] and long-term interest rates converged. Scholars continue to disagree on the reasons for this success, which is likely to have depended on a host of favourable conditions both economic and political in nature. Fixed exchange rates remained compatible with medium-term balance of payments equilibrium owing to fairly flexible domestic labour markets and also to fairly free international movement of goods, labour, and capital. At the same time, the social and political conditions prevailing at the time – including low labour unionisation and limited suffrage – allowed monetary policy to target the exchange rate and governments to pursue orthodox fiscal policies without much concern for repercussions on the level of domestic activity and employment and attendant electoral backlashes. A certain amount of luck also helped in offsetting one of the drawbacks of the metallic standard: its dependence upon an exogenous supply of the metal. When, in the 1890s, the existing stock of monetary gold began to be inadequate to supply the desired amount of liquidity at the desired price, new sources of cheap gold came to be exploited in South Africa, defusing the danger of deflation.

For all its long-term success, the classical gold standard was not free from crises threatening the liquidity of the international payments system, foremost among which were those of 1890 and 1907. We shall discuss the role played by cooperation in dealing with these crises and, more generally, in the overall success of the classical gold standard.

During the First World War, gold convertibility was suspended. A floating exchange rate regime ensued, manipulated as far as possible by governments trying to peg their currencies or to let them slide as smoothly as circumstances allowed in the context of considerable financial and monetary cooperation amongst allies, particularly in the Entente camp. As inflation rates differed, however, the pegging was doomed to fail in the medium term, in spite of the hard currency expended in propping up the weakest currencies. Moreover, as soon as hostilities ceased so did inter-Allied financial and monetary solidarity, and each government was left to its own devices for the "defence" of the currency.

In spite of the huge efforts – both economic and political – devoted to orchestrating an orderly "return to gold", the fixed–exchange rate system introduced in the second half of the 1920s did not bear out the high hopes pinned on it. It neither provided a magical cure for most economic ills nor recreated the "belle époque", as some believed it would. In fact, it was short-lived and pretty much part of the problem rather than the solution to the economic troubles of the 1920s and 1930s. It took time for the political and bureaucratic elites, for public opinion, and for most academic economists and practitioners to realise that the First World War had wiped out the conditions associated with the vitality and resilience of the gold standard.

Universal conscription and the mobilisation of millions of people to fight shoulder to shoulder in the trenches for endless periods of time, sharing not only the same bread but the same fate of life or death, resulted in a huge increase in the political awareness of ordinary people. Immediately after the war, the widespread discontent in Europe was channelled into new ways of political mobilisation and action. Even if revolution failed everywhere except in Russia, governments could no longer overlook (as they somehow could in the nineteenth century) the need for mass popular support: universal male suffrage shifted the focus of fiscal and monetary policy towards domestic goals such as reducing unemployment. At the same time, better-organised labour movements and the coming of age of socialist parties increased nominal wage stickiness. Price flexibility was reduced by the globalisation backlash,[17] which had probably started before the war. Tariff barriers were raised everywhere, their effect amplified by the disappearance of large customs unions such as the Habsburg Empire. Cross-border movements of workers were only a fraction of the antebellum total. In short, the conditions that had previously allowed the relatively easy adjustment of the balance of payments and produced price equalisation under fixed exchange rates had all but disappeared by the end of the war.

One of the postwar concerns was the adequacy of supply of monetary gold.[18] It was particularly felt in Great Britain, where the shallow gold reserves cast doubts upon the role of the City as the world's financial centre.[19] Since London was an international repository for foreign exchange reserves, British experts proposed that banks of issue should be allowed to include holdings of key foreign convertible currencies in their official reserves.[20] The gold standard thus became a gold exchange standard. The flaw in the system was that it provided little incentive or constraint for central banks to hold a balanced composition of reserves. International liquidity was, therefore, to some extent at the mercy of central banks (such as those of France and the United States) that showed a high preference for gold rather than foreign convertible currencies. The postwar gold exchange standard, therefore, required a high degree of monetary policy cooperation.[21] In fact, as we shall see, central bank cooperation was indeed more explicit in the 1920s than it had been before the war, but it had to contend with the divisiveness of international politics and focused on the financial conditions for currency stabilisation rather than on overall, day-to-day, policy coordination. Then, in the early 1930s, it failed spectacularly: "unwilling to follow the rules or give up the standard, countries resisted steps to restore equilibrium real exchange rates. In retrospect, the breakdown of the gold standard seems inevitable; at the time, it seemed calamitous".[22]

The Great Depression finally convinced large segments of the elites and of the general public of the deflationary bias of the gold standard. However, the attraction of fixed exchange rates anchored to a solid metallic base was so strong that the gold exchange standard was resurrected by the Bretton Woods Agreements of July 1944, this time cushioned by a higher dose of international cooperation and formalised rules. The final demise of the gold anchor of the international monetary system came only in 1971. The gold exchange standard of the post–World War II period quickly developed into a gold dollar standard. Like its interwar predecessor, it harboured – as Triffin and others feared – a possible deflationary bias, but this did not materialise because of the underlying economic conditions and an unusual amount of international monetary cooperation under U.S. leadership. Social and political conditions as well as international relations again played a crucial role in sustaining the efficiency and stability of the international monetary system. It is commonplace in the literature to stress how the lessons of the interwar period were learned and mistakes avoided after 1945. Europe's "golden age" and the Japanese economic miracle were both the cause and the effect of rapidly increasing international trade in the context of stable exchange rates. The system ended, as we shall see in Chapter 11, when both the United States and Europe were no longer willing (or able) to bear their share of the cost of its continuation.

1.3 Reasons and Conditions for International Monetary Cooperation

Of the various international monetary systems briefly described in the previous section, some lasted longer and delivered more stability than others. The classical gold standard (1870s–1914) seems to have served the needs of international transactions longer and more efficiently than the arrangements that followed it in the first half of the twentieth century. Under the Bretton Woods system, international financial crises were fewer and milder than they were in subsequent decades. Historians and economists disagree on the extent to which these different historical records reflect the intrinsic technical merits of each system rather than the overall economic and political conditions prevailing in each of these epochs. The assessment of the impact of cooperation is part of this debate: was it more useful (or even necessary) in a given exchange rate system than in another? Did it crucially depend on the prevailing climate of international relations? These questions will, more or less implicitly, underlie much of the narrative and analysis contained in this book. Before moving on to that, it may be useful to say a few words about the rationale for international cooperation and, in the next two sections, to review the literature on central bank cooperation before the mid-1920s.

There exists a huge theoretical literature, in both economics and political science, about cooperative behaviour and the conditions for its success. In the ideal economist's world – with atomistic maximising agents, perfect competition both in the product and in the factor markets, and full symmetrical information – coordination is efficiently produced by market forces. In that same world, cooperation, because it entails agreements and commitments, actually stands in the way of competition and is likely to produce suboptimal outcomes. Some economists argue that, even when the real world is far from meeting the standard competitive assumptions, the pursuit of self-interest by individual agents (in our case, governments or central banks) produces a better coordination than cooperative behaviour. Market discipline, even if imperfect, they argue, will in the medium term reward monetary and fiscal virtue and punish vice, naturally creating a "sound" international monetary order. They also point to the inherent instability of cooperation among equal partners – given the high individual rewards to uncooperative behaviour – and to the dangers of rent-seeking inherent in cooperation induced by effective leadership.

Recent technical game theory literature yields mixed results on cooperation, depending on the assumptions made about the structure of the game, the relative dimensions and number of the players, their strategies, the payoff matrix, and other variables.[23] Yet one frequent result is that, in the presence of externalities (such as those deriving from a stable and efficient international monetary system), cooperative behaviour yields higher payoffs to all participants in the game. Another result is that in one-shot games (such as those of the standard Nash type) cooperation is superior to noncooperation, whereas in the case of repeated games reputation and trust may substitute for explicit cooperation. Thus, as far as the international monetary system is concerned, one may argue that formal cooperation is definitely needed in dealing with major single shocks (e.g., financial crises) whereas the long-run sustainability of international monetary arrangements could rest on commitments made credible by reputation (yielding to informal cooperation, as defined in the previous section).

Political scientists, with the exception of extreme realists, tend to concur that international cooperation yields higher (if by no means equally distributed) payoffs to all participants. They therefore focus (and disagree) on how to achieve effective cooperation rather than on its desirability.