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Edited by Claudio Borio, Gianni Toniolo and Piet Clement
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Introduction

Past and Future of Central Bank Cooperation

PIET CLEMENT[1]

While the oldest central banks in the world claim a lineage stretching back to the late 1600s, central banking in the modern sense is a relatively recent phenomenon, making its first appearance in the second half of the nineteenth century. Even then, not that many central banks were around. In 1900, there were no more than eighteen (Capie 2003: 373). By that time, what constituted a central bank had come to be defined by a common set of core functions. These included a responsibility for monetary (i.e., price and exchange rate) stability, support for financial stability (if necessary, by acting as lender of last resort), and, in some cases, the domestic note-issuing monopoly. The rise and spread of modern central banking was closely intertwined with the process of nation building and political emancipation throughout the nineteenth and twentieth centuries. As new nation-states were created, setting up a central bank was often part of defining their identity. By the beginning of the twenty-first century, the number of central banks had reached almost 180, nearly as many as there were independent states, and ten times as many as 100 years earlier.

[1] Historian, Bank for International Settlements. The views expressed in this chapter are those of the author and do not necessarily reflect those of the BIS.

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Central bank cooperation is as old as modern central banking itself. To be sure, the mandate of each central bank – to preserve monetary and financial stability – is by definition a domestic one. But in an increasingly interdependent world economy, the international dimension plays a key role, particularly for the smaller economies. For the past 130 years or so, central banks have cooperated with one another, bilaterally or multilaterally, *ad hoc*, sporadically, or within a more or less regular and formalized framework.

This cooperation is the subject of the current volume. Rather than discussing the desirability of international central bank cooperation as such – and whether a positive or normative case can be made for it – the volume deals primarily with the history and future of central bank cooperation in action: How did/does it operate? What has it achieved? Under what circumstances has it been successful or not? What are the main factors fostering or hampering cooperation? As central bank cooperation is only part of the wider area of international financial cooperation, which includes intergovernmental cooperation – for instance, through the International Monetary Fund, the World Bank, or the G8 – and private sector cooperation, this broader context features prominently in the following pages. The main focus, however, remains on central bank cooperation.

The contributions contained in this volume were originally prepared for a conference held in Basel, Switzerland, to mark the seventy-fifth anniversary of the Bank for International Settlements (BIS), the "central banks' bank." The book provides a comprehensive overview of the history of central bank cooperation through the BIS and otherwise (chapters 1 and 2); offers an in-depth analysis of two major episodes in the recent history of monetary and financial cooperation, namely the agreements on international capital standards reached between financial supervisors (chapter 3), and the European monetary unification process as it has unfolded after Maastricht (chapter 4); and looks at some of the key issues that are likely to shape central bank cooperation in the future (chapters 5 and 6).

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A specific characteristic of this book is that it considers central bank cooperation from a multidisciplinary angle. In bringing together economists, historians, and political scientists, a conscious attempt has been made to break away from a purely economic analysis of central bank cooperation and place more emphasis on other determinants such as history, culture, institutional developments, and political processes. It is hoped that this approach not only enriches the analysis of and debate on central bank cooperation as such, but also provides some significant pointers to its potential future development.

Chapters 1 and 2 look at the history of central bank cooperation over the past 130 years, partly from a BIS perspective. Both Claudio Borio and Gianni Toniolo (in chapter 1), and Richard Cooper (in chapter 2) provide a chronology in which central bank cooperation can be seen to have waxed and waned. During the first globalization era (1870–1914), the international monetary system based on the gold standard performed remarkably well. Central bank cooperation was limited. As Borio and Toniolo point out, the main banks of issue were able to focus on their high-profile domestic role as "guarantors of convertibility," while problems relating to international imbalances were largely left to sort themselves out through automatic adjustment, facilitated by high levels of capital mobility and by the relatively low political costs of deflation and unemployment (given the limited representative character of nineteenth-century democracy). Even so, the classical gold standard could not guarantee continuous domestic financial stability, and in a handful of severe banking crises, central banks cooperated by extending emergency credits to one another in order to prevent risks of contagion. This cooperation, however, was essentially of a bilateral and *ad hoc* nature. The abandonment of the gold standard at the outbreak of World War I and the difficult process of returning to gold convertibility in the 1920s markedly increased the scope and demand for central bank cooperation. It was "tirelessly preached" (Borio and Toniolo) by leading central bankers such as Bank of England Governor Montagu Norman. A culminating point was reached in 1930 with the foundation

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of the BIS, intended to settle Germany's World War I reparations. The main central banks involved in the reparations issue took the opportunity of this institutional innovation to turn the BIS into an instrument of their cooperation and an expression of their independence (as they effectively owned and ran the institution). However, the creation of the BIS could not prevent the breakdown of the international monetary and financial system during the Great Depression as "events overwhelmed the limited capacity of central banks to cooperate" (Cooper). The unsuccessful attempt to counter the 1931 financial crisis through multilateral action and international lending was followed by a rapid descent into protectionism, currency manipulation, and isolationism (Eichengreen 1992).

The post-World War II period, in contrast, saw enhanced central bank cooperation, but in a profoundly different monetary and financial environment (Borio and Toniolo). The Bretton Woods system was designed to avoid the "mistakes" of the interwar period. It provided for fixed but adjustable exchange rates pegged to gold (or to the gold-backed dollar) and allowed foreign exchange and capital controls to safeguard the greatest possible autonomy for domestic macroeconomic policymaking. By and large, governments were in charge of the Bretton Woods system, with central banks acting *de facto* as agents of government. Nevertheless, there was scope for intensive central bank cooperation, which manifested itself first and foremost through the European Payments Union (EPU, 1950–58) – an elaborate scheme designed to help war-ravaged European countries restore current account convertibility and "one of the great success stories in international monetary cooperation" (Borio and Toniolo). Intensive cooperation continued after the end of the EPU, as it quickly became clear that the Bretton Woods system, now fully operational, required a good deal of international coordination and even intervention. The key was the protection of the gold-dollar convertibility that formed the basis of the system, and a number of joint central bank initiatives were developed to this end, including the Gold Pool, central

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bank swap arrangements, and sterling support. Thus, "the 1960s saw the real birth of multilateral central bank cooperation envisioned but stillborn in 1930" (Cooper). After 1968, however, with the demise of the Gold Pool and the return of the United States to a policy of "benign neglect" of the dollar, multilateral cooperation to shore up the Bretton Woods system lost momentum. The fixed exchange rate regime collapsed in 1971–73, making way for the era of floating.

The end of Bretton Woods had a profound impact on central bank cooperation. In a context of floating rates, economic stagnation, and rising inflation, "macroeconomic policy coordination took a back seat as central banks became increasingly reluctant to sacrifice monetary orthodoxy on the altar of global cooperation" (Borio and Toniolo). However, at a regional level, macroeconomic and thus monetary policy coordination remained attractive as a way to better insulate a group of already well integrated economies from external or global shocks. This was the path taken by the countries of the European Community, leading, in the 1990s, to "the ultimate form of central bank cooperation" (Cooper) among them, namely that of monetary union. At the same time, the gradual liberalization and deregulation of financial markets from the 1970s sealed the shift in the objectives of central bank cooperation away from monetary stability toward financial stability issues. The strong growth of global financial markets, spurred on by rapid advances in information and communications technologies, and epitomized by the surge of the eurocurrency market from the 1960s, created a high degree of financial interdependence between countries. Financial innovations, such as derivatives and securitization, contributed to a better distribution of risks and improved market efficiency, but also added sources of potential instability to the system. These developments highlighted the importance of sound and efficient payment and settlement systems. They also gave rise to concerns that if a financial crisis were to occur, it might more easily take on a global dimension as a result of contagion effects. Such considerations supported the view that active cooperation between central banks was required in

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order to develop and promote the adoption of minimum standards in the fields of banking supervision and of clearing and settlement systems (thereby contributing to a level global playing field), and, more generally, in order to preserve systemic stability (Lamfalussy 1994). The case for cooperation was further reinforced by the need to integrate the fast-growing emerging markets into the international financial system. As far as central bank cooperation through the BIS is concerned, these developments led to a broadening of its geographical and institutional reach that is still ongoing (Borio and Toniolo).

In assessing the historical experience of central bank cooperation, Borio and Toniolo and Cooper agree that it has grown extensively, if fitfully, over the past century. Both chapters provide important insights into why this should have been the case. First, of course, the nature of the international financial and monetary system itself has strongly influenced the scope and pattern of central bank cooperation. This refers in particular to the shifting balance between fixed and floating exchange rate regimes, and to the extent of international capital mobility. Thus, under Bretton Woods, "in a context of domestic financial repression and constraints on external capital flows, financial stability concerns did not figure prominently on the policy agenda" (Borio and Toniolo). By contrast – and as noted above – after Bretton Woods, the transition from a government-led to a market-led financial system with rapidly increasing capital mobility raised financial stability concerns, prompting central banks to intensify cooperation in this field. As a result, after 1973 financial cooperation basically followed two paths: on the one hand, the strengthening of international prudential regulation and of payment and settlement systems following the high-profile collapse of a number of individual financial institutions; and, on the other, the strenuous efforts to address emerging market countries' debt crises, notably after the 1982 Mexico default. By the end of the 1990s, Borio and Toniolo argue, these two trajectories had fully converged in the concerted attempt to strengthen the international financial architecture, following the 1997 Asian crisis.

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It is clear that the scope and intensity of central bank cooperation are not only determined by prevailing financial and monetary conditions, but also, to a considerable extent, by the broader political and institutional environments. Borio and Toniolo conclude that "central bank cooperation was more intense in periods when international relations were friendlier and oriented to multilateral rather than bilateral cooperation, when the reputation and independence of central banks was high, and when the issues requiring a cooperative approach were such that the technical expertise of central banks would make a difference." At first sight, it may appear that the increased independence most central banks enjoyed from the 1980s, together with their strong focus on domestic price stability, would have acted as something of a brake on international cooperation. It may have done so as far as cooperation on exchange rates was concerned, but in the cooperative efforts in the field of prudential regulation, Borio and Toniolo underline, this newly found central bank autonomy has proven a valuable asset.

To better understand the evolution of central bank cooperation, it is not enough to analyze its context and its shifting targets. Also, the different tools that have been and are being employed to achieve these targets have to be looked at in a systematic manner. Richard Cooper provides a useful distinction between the different possible ways in which central banks may cooperate. These range from simple information exchange (what Beth Simmons calls "shallow cooperation" in chapter 5) to the "most demanding form" (Cooper) of commonly agreed actions. While information exchange and standardization of concepts and even of regulations (Basel Capital Accord) are widely held to be beneficial, joint monetary policy actions – including joint market interventions – are much more controversial (Bordo and Schwartz 2000).

In terms of the instruments of cooperation, it is useful to single out two significant developments over the period considered in this volume. The first one refers to the role of the BIS. The institutionalization of central bank cooperation through this organization has certainly helped, the

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authors of this volume agree, to foster useful information exchange and the building of a conceptual consensus among central banks. Second, within the framework of the BIS, a particular form of cooperation has sprung up from the 1970s onward that has since proven its merits. The more or less informal committees first set up among the G10 central banks to discuss and monitor the eurocurrency markets (1971) and to exchange information on domestic banking regulations and supervisory practices after the Herstatt episode (1974) have provided an interesting model for effective cooperation in the financial field (Borio and Toniolo). Information exchange was usually followed by discussions on the commonality in the different national approaches and eventually by the development of common codes and standards – for cross-border banking supervision or for the sound functioning of payment and settlement systems. However, the codes and standards developed through this process were implemented not as the outcome of legally binding agreements ("hard law"), but rather through voluntary adoption in national law and regulations as the result of a mixture of peer pressure and market forces ("soft law"). This successful approach has been copied many times since.

In all of this, of course, the authors do not intend to suggest that central bank cooperation has always been successful or has gone unchallenged. In recent decades, monetary cooperation – if defined as the international coordination of monetary policy action, for example, through agreed interest rate adjustments or foreign exchange market interventions – has not been an unqualified success and its usefulness has been repeatedly called into doubt. However, Cooper reminds us that during the past half-century there has in fact been "little cooperation in framing monetary policy *per se*" and that, at least where the Federal Reserve is concerned, "international factors were rarely decisive in determining policy." In other words, the evidence points to the fact that, even at the height of international cooperation, central banks have always safeguarded their ability and freedom to act independently. Thus, according to Cooper, international monetary cooperation has not been quite as "dangerous" as its

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detractors have sometimes depicted it. Criticism has also been leveled at the role of central bank cooperation in times of financial crisis, as emergency credits and lender of last resort-type actions have raised alleged moral hazard issues (as the likelihood of a public bailout may not be the best incentive for prudent market behavior). Cooper argues, though, that the concerns voiced with regard to central bank cooperation have generally been overstated and that, at least in theory, "cooperative solutions to policy choices in interdependent systems can lead to superior outcomes to non-cooperative choices in the same environment."

In chapters 3 and 4, Ethan Kapstein and Alexandre Lamfalussy, respectively, illustrate and discuss two major examples of central bank cooperation "at work." Kapstein retraces in more depth the recent history of international cooperation among financial regulators, with specific reference to banking supervision and the so-called Basel process. The first steps toward global standards in banking supervision were taken by the G10 Basel Committee on Banking Supervision from the mid-1970s onward in the wake of highly publicized bank collapses (Herstatt, Franklin National). The cooperation among central banks and financial regulators in this field eventually yielded the 1988 Basel Capital Accord, a set of minimum capital standards for internationally active banks that became globally accepted. Its successor, known as Basel II, was formally endorsed by the G10 central bank Governors and heads of supervision in June 2004. In Kapstein's words, cooperation in this field over the past thirty years has been rewarded with the "undeniable – and even unexpected – achievement of these regulators in crafting a more robust financial system," even though much remains to be done. He credits this success partly to the ability of financial supervisors to "depoliticize the systemic risk environment and to transform crisis management into a technocratic exercise," thereby simplifying the decision-making process.

To Kapstein it is clear that it will not be possible to simply recreate this successful model going forward. For one thing, the "Basel process" has outgrown its original G10 framework and – particularly in the wake

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of the 1997 Asian crisis – has had to become more generally inclusive of systemically important constituencies worldwide. Second, as Kapstein argues, the central banks' and supervisors' concern with financial stability has not been the only driving force behind the Basel Capital Accord and Basel II. Competitive concerns to "level the playing field" have also played a decisive role. Naturally, with private sector interests at stake, and voiced ever more strongly, national and political interests too (re-)enter the field. The challenges posed by the rapidly evolving risk environment itself point in the same direction. Kapstein draws attention to the apparent paradox that in today's financial system risk seems to have become at the same time more consolidated and more atomized: more consolidated through the emergence of large, complex financial institutions, which operate on a global scale and may have become "too big to fail"; and more atomized because these same institutions have passed on at least part of their risk exposure to other players, including firms and households, for instance, through securitization and credit derivatives. These developments, Kapstein believes, raise the stakes and will further strengthen the linkage between regulators and legislators, already apparent in the Basel II process. Finally, while it is true that the Basel process has helped to improve the resilience of the financial system, this cannot be considered shockproof. The high public cost of recent financial crises, in terms of bailouts financed with taxpayers' money, has again highlighted the issue of the democratic legitimacy of a process that is essentially driven by independent, technocratic institutions and unelected officials. It thus remains to be seen whether the framework engendered by the Basel process will be sufficiently robust to cope with the challenges posed by a widespread politicization of banking regulation. Kapstein thinks it inevitable that central bankers and financial regulators will have to work more closely with elected officials on these issues.

As a former General Manager of the BIS and former President of the European Monetary Institute, Lamfalussy is particularly well placed

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