

Comment on

The Future of Central Bank Cooperation
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Introduction

“Futurology” is a challenging endeavor for both economists and political scientists, and Beth Simmons rises to the challenge for prognosticating on the future of central bank cooperation in a very informative and thought-provoking paper on the future of central bank cooperation. Her bottom line is that central bank cooperation will continue to adapt “shaped by the economic conditions” that central bankers encounter.

In this comment, I will first provide a brief summary of the paper. I will next offer a few general comments. As is my responsibility, I offer some constructive criticisms with respect to emphasis and omissions. Finally, Simmons identifies relations with the central banks of Asia – their reserve holdings and the adjustment process – as the most immediate large challenge for central bankers, and I make a proposal for how G-20 central bankers should help address one aspect of that challenge by establishing an international foreign exchange diversification standard.

Summary

Simmons introduces her informative paper with an examination of trends in central bank players (governors) and their institutions. She concludes that they have become more homogenous both in background and in their institutional structures.

Simmons then proceeds to examine four areas in which one might expect central bank cooperation to evolve in the future. First, with respect to relatively uncontroversial,

but nonetheless challenging, area of developing and sharing information, she predicts and support continued fruitful efforts, which she predicts will increasingly become routinized. She also correctly observes that the demands of today's global economy will require more real time information and information sharing among central banks.

Second, the paper considers the area of global financial stability. Simmons concludes that this is also an area that will require continued cooperative efforts. However, she raises familiar issues with respect to implementation of global standards in addition the adherence to such voluntary standards. She also notes the tension between the efficiency associated with standards drawn up by a small group of countries and their central banks and the legitimacy and authenticity of those standards for other countries..

Third, the paper touches upon the role of central banks as firefighters providing emergency international liquidity. Simmons notes the historical activities of central bank cooperation in this area and suggests that in the future their role might be confined to being "first responders" in the face of financial crises that threaten the stability of the financial system.

Fourth, the paper examines central bank cooperation with respect to issues of macroeconomic management. Simmons looks at exchange market intervention, and appears to conclude that central banks have shrinking role to play. On the other hand, she addresses the challenge of integrating China and a number of other Asian countries into the framework of central bank cooperation. She rightly concludes that the G-7 is not the right forum, and implicitly endorses the G-20 as a better venue. In closing, Simmons points to the collective action problem associated with avoiding a disorderly flight from the dollar by Asian central banks that are now very large holders of dollars.

General Comments

This is a nice paper that covers a lot of ground. It is introduced with a nice framework differentiates different dimensions of central bank cooperation and makes a useful distinction between (1) joint actions by central banks that may be "shallow" and essentially uncontroversial because almost everyone agrees that central banks should

cooperate in certain areas such as the production and sharing of information¹ and (2) joint actions that may be “deep” such as addressing a specific objective that might later prove to be mistaken.

I also like the background material on central bankers and their institutions and the emphasis is not only on trends among G-10 central bank or BIS-member central banks, but also on G-20 central banks as a leadership group. Simmons appears to endorse the G-20 as a reasonable set of countries to consider as the nucleus of the central banking community in the years ahead. I applaud her for this. It coincides with my own bias (Boyer and Truman 2005).

Simmons’ consideration of the four areas of central bank cooperation is reasonable. The reader has to work quite hard, however, to deduce what are the conclusions. Her caution may reflect unease as a futurologist.

Constructive Criticisms

The role of a commentator is not just to praise but also to offer constructive and informative criticism. In that spirit, I offer four observations about a how this paper might have been strengthened.

In considering the role of central bank cooperation in the area of global financial stability and the setting of standards, Simmons acknowledges the varying roles that central banks in different jurisdictions have in supervision and regulation. However, she apparently does not attach a great degree of importance to the fact that the number of central banks with a central role in banking or financial market supervision is diminishing. I view this as a problem for two reasons. First, it increasingly takes central banks out of a direct role in the process of setting global standards, and central banks have a great deal to contribute in this area precisely because they are concerned with broader issues than the safety and soundness of individual financial institutions. Moreover, central banks have long-established global networks of relations – more so

¹ As one who was for many years actively involved in these efforts, I am skeptical about Simmons’ view that they lend themselves to becoming “increasingly routinized.” I can attest that reaching agreement on necessary improvements never was easy or routine. At a minimum, central bankers had to be convinced of the benefits outweighing the costs of the new or improved data; at a deeper level they were concerned about the absolute costs to their institutions and revealing the capabilities of their institutions to generate the data and exposures of their institutions to the risks the data might uncover..

than other regulators. As a result, they are better positioned to nurture the development of global standards in this area as a step toward improved global governance. Second, on the other hand, it is unrealistic to insulate central banks from some involvement in this area because when a problem arises, governments turn to central banks because that is where the money is. It follows that the central banks should be deeply involved at home and abroad from the start.

Implicit in Simmons' discussion of central bank cooperation in the provision of emergency liquidity is the view that the scope for such actions in the future will be more circumscribed than in the past.² The reason, and I suspect she would agree, lies in the fact that central banks have become more independent of their governments and standards of transparency have been upgraded. Thus, it is much more difficult for central banks, acting on their own authority, to provide financial support to central banks in other countries. Moreover, central banks are expected to reveal immediately the existence and details of any such operations. Thus, efforts to window-dress a country's foreign exchange reserves without actually providing useable foreign exchange, which were common for the first forty years after World War II with the BIS playing a central role, are a thing of the past. Moreover, lending another central bank resources that it might actually spend and may not repay is also generally frowned upon.³

In the area of exchange market intervention involving the major currencies, I interpret Simmons as sympathetic to the view that such operations among major currencies are effective, implying this is a central bank tool that has fallen into disuse. My view (Truman 2003b) is that the evidence that sterilized foreign exchange market intervention has any significant effect beyond a few hours or a day or so is decidedly scant. Moreover, most of the intervention we have seen in the past five years by countries' with floating exchange rates, e.g., Japan and Korea, has been either for the account of the finance ministry or directed by the finance ministry. In effect, central banks are out of this business because they understand that sterilized intervention is

² Simmons comments that even those historical activities "plateaued far short of [central banks] acting as [international] lenders of last resort."

³ The Federal Reserve's swap network has been scaled back to include only its NAFTA partners, Canada and Mexico. It is true that under the Chiang Mai Initiative a small swap network has been developed in East Asia, but central banks are primarily involved as agents not principals. In addition, the BIS itself for its own account retains the authority to make small short-term loans to member central banks.

ineffective and they are reluctant to be criticized, e.g., Korea again, for taking on a large amount of exchange risk because such criticism may jeopardize their independence.

If Simmons wanted to expand her exercise in futurology, she might have addressed two related topics. She could have considered the trend over the past 15 years toward the adoption of inflation targeting as a framework for the conduct and evaluation of monetary policy and whether central bank cooperation will evolve in the direction of an even larger number of central banks adopting this framework. I have argued that doing so, starting with the G-3 central banks of the Euro area, Japan and the United States, would enhance central bank cooperation (Truman 2003a) by establish a common framework and facilitating dialogue, analysis, and potentially joint actions.

In addition, the more widespread adoption of inflation targeting might be seen as a step toward the adoption first of a common monetary policy and ultimately one money.⁴ Although the latter step would involve governmental decisions, enhanced central bank cooperation, including through the adoption of inflation targeting could help to pave the way.

A third area that she does not cover is the dramatically diminished involvement of central banks with the activities of the IMF. In part, this trend reflects the fact the central banks in their monetary policies were liberated by the collapse of the Bretton Woods system of exchange rate arrangements. A number of G-10 central banks recently have spearheaded efforts to limit the size of IMF program. In doing so they are offering sacrifices on the alter of the false god of moral hazard. The unintended but serious effects of their campaigns has been to weaken support for the IMF around the world, particularly in Asia.

The Collective Action Problem

Simmons' identifies the challenges associated with the integration of Asian central banks into the framework of central bank cooperation that has evolved over the post-Bretton Woods period. In particular, she argues that central banks face a collective action problem in connection with the potential for a disorderly flight from the dollar via active reserve diversification.

⁴ Simmons does note Cooper (2000) on this prospect but does not take the matter any further.

On the general issue, Simmons under appreciates the degree to which Asian central banks have been “socialized,” to use her term, over the past decade within the BIS community. The People’s Bank of China and the central banks central banks several other Asian economies became members of the BIS beginning in 1996, and some participated in meetings at the BIS before that date. Now there are eight BIS members from Asia, aside from Japan, and my judgment is that those central bankers, governors as well as associates, are fully integrated into the central banking community at the BIS.⁵ Indeed, the BIS should be congratulated for the skillful way it has broadened and deepened its activities over the past decade. Other international organizations have not done nearly as well. G-10 central banks are part of this broader problem. The attacks by certain G-10 central banks on the size of IMF programs has as a by-product alienated Asian governments and central banks from the IMF and on the margin contributed to the build-up of very large reserve holdings.

Turning to the issue of potential reserve diversification, its financial importance is easily exaggerated. The phenomenon focuses on a small number of countries. As of the end of 2004, only 18 countries held more than SDR 25 billion (\$39 billion) in foreign currency reserves.⁶ It is highly unlikely that the authorities in these countries will abruptly embark on a program of substantial, active diversification of the stock of their reserves. Those authorities are acutely aware of the risks involved in terms of disrupting exchange rate relationships as well as precipitating the perceived capital losses that they want to try to avoid.

However, those capital losses are more apparent than real. If the dollar declines substantially further relative to the euro and the Japanese yen, which is highly probable over the next several years, the authorities will suffer a loss only in terms of opportunity cost. If their own currencies appreciate substantially against the dollar, they will suffer an accounting loss, which may be politically awkward but has no economic

⁵ In addition, the central banks of all the countries in the G-20 are members of the BIS.

⁶ Six are industrial countries: Germany, Japan, Norway, Switzerland, the United Kingdom, and the United States. Four of them are members of the G-20. Twelve are emerging market economies: Algeria, Brazil, China, Hong Kong, India, Korea, Malaysia, Mexico, Russia, Singapore, Taiwan, and Thailand. Six are members of the G-20, for an overall total of 10, more than half the 18 large holders. All except Taiwan are members of the BIS, and my impression is that Taiwan informally participates more often with the BIS than with any other international organization aside from APEC.

consequences. Moreover, the purchasing power of their dollar reserves will be essentially unaffected.

Nevertheless, perceptions matter and rumors of large-scale official reserve diversification can be more disruptive to financial markets than the actual diversification. It is for this reason that I have proposed (Truman 2005) an international initiative with respect to reserve diversification. I believe that the G-20 central banks meeting at the BIS should take the lead in this area. My proposal includes the following elements:

First, as a supplement to the “Data Template on International Reserves and Financial Liabilities” (reserve template) of the IMF’s Special Dissemination Standard (SDDS), the major industrial countries should commit to providing regular, for example, at least quarterly with a one month lag, information on the individual currency composition of their foreign exchange reserves (off-balance-sheet as well as on-balance-sheet). At least 21 of the 48 countries that subscribe to the reserve template of the SDDS and have committed to supplying historical data on their reserves also now voluntarily provide periodically (at least annually) specific information on the currency composition of their foreign exchange reserves, including eleven industrial countries (Australia, Canada, Finland, Germany, Iceland, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States) and ten emerging market economies (Bulgaria, Croatia, Colombia, Hong Kong, Latvia, Lithuania, the Philippines, Romania, Slovenia, and the Slovak Republic).⁷ See table 1.⁸ Together their foreign exchange reserves were \$530 billion as of the end of 2004, or 14 percent of the global total of \$3.7 trillion.⁹

⁷ Full compliance with the reserve template requires the periodic disclosure of international reserves broken down by currencies in the SDR basket as a group (the euro, Japanese yen, UK pound, and US dollar) and those not in the SDR basket. Additional disclosure of the currency composition of foreign exchange reserves is optional. The 48 countries comply by providing historical data their reserves including information on the type of investments held, for example, securities, bank deposits (in domestic or foreign banks, onshore and offshore), equities, as well as on-balance-sheet and off-balance-sheet assets and liabilities. An additional 13 countries subscribe to the SDDS and must comply with the reserve template going forward, but do not supply historical data.

⁸ Figure 1 compares data, painstakingly assembled by Anna Wong, on the dollar’s share in foreign exchange in value terms for the countries for which we have a short time series, with IMF data on the dollar’s share in value and quantity terms and with BIS (value) data on cross-border financial instruments. The BIS data combine information on the currency breakdown of (1) BIS reporting banks’ liabilities to non-banks, (2) international money-market instruments (such as commercial paper), and (3) international bonds and notes. They understate the dollar’s share because they include as cross-border bonds and notes in euro instruments issued in the EU area by EU members.

⁹ The 21 countries include 6 of the 18 with significant holdings of foreign exchange reserves (more than SDR 25 billion at the end of 2004): Germany, Hong Kong, Norway, Switzerland, the United Kingdom, and

This is an excellent start on increased transparency in this area. Increased transparency would reduce financial market uncertainty regardless of whether the other elements of my proposal were adopted. What is important to recall is that the development of the original reserve template that was incorporated into the SDDS was a project of the G-10 central banks meeting under BIS auspices. Expanding that template to *mandate* the disclosure of the currency composition of foreign exchange reserves should similarly be an exercise in central bank cooperation under the aegis of the BIS logically involving the G-20 countries, which hold two thirds of global foreign exchange reserves.

As a second step in this area, a standard for reserve diversification should be established. A good starting point would be one-third US dollar, one-third euro, and one-third yen for countries other than the United States, Japan and those in the Euro area. The standard for the Euro area, Japan and the United States might be fifty-fifty. In both cases, countries could be permitted discretion of up to, say, plus or minus 10 percentage points. Alternatively each country could declare a different standard as long as it disclosed the standard and its compliance with the benchmark, and as long as the country committed in advance to a smooth adjustment to any new benchmark. Special provisions could be made for holdings of non-G-3 currencies.

Third, Japan and the Euro area should agree to an off market transaction to swap dollars for euro and yen assets, respectively, to achieve the fifty-fifty standard. The United States is close to fifty-fifty; see table 1.

Fourth, Japan and the Euro area should agree to feed the swapped dollars into the market on daily basis over a period of five years. Assuming that each holds only dollars today, which is an extreme estimate, the total dollar holdings to be disposed of would be \$500 billion, or \$100 billion a year, or about \$400 million a day. The resulting effects on

the United States. The 11 industrial countries hold 24 percent of the total foreign exchange reserves of industrial countries, with Japan with 63 percent of industrial countries' foreign exchange reserves the only major holdout. Five G-10 countries are on the list, accounting for 18 percent of G-10 countries' foreign exchange reserves. Five G-20 countries are on the list, accounting for 7 percent of their combined foreign exchange reserves.

foreign exchange rates of the regular daily sales of \$400 million are likely to be trivial in a market for which daily turnover was \$1.9 trillion per data in April 2004.¹⁰

Fifth, other countries should be encouraged immediately to diversify their current purchases of dollars according to the standard. They also should be encouraged to adjust their existing portfolios smoothly over a five-year period following the example of Japan and the Euro area. If the Japanese and Euro-area authorities wanted to facilitate this process or to stretch it out for more than ten years, they could engage in swaps of their currencies for dollars and, thus, remain in control. They might be motivated to do so out of concern over their respective dollar exchange rates.

The full establishment and implementation of this standard not only would increase transparency but also would remove considerable uncertainty overhanging international financial markets without causing large effects on exchange rates.

Table 1 provides some context on the diversification of foreign exchange reserves over the past four years. At the end of 2004, the US dollar's value share in the reserves of the 21 countries was 50 percent. This is substantially less than the share estimated by the IMF for 2003 (IMF 2004, 103), which was 63.5 percent. The difference reflects the under-representation Asian and Latin American countries in the data in table 1.

Over the past four years, the euro's share in the foreign exchange reserves of the 19 countries for which we have time-series data has risen by 12 percentage points. However, the decline in the U.S. dollar's share accounts for only half of the increase. The yen and other currencies contribute 4 and 2 percentage points respectively.

Four countries have increased the dollar's share in their foreign exchange reserves: Australia, Colombia, New Zealand, and Hong Kong. Meanwhile, Canada, Croatia, Latvia, Lithuania and Romania have substantially reduced the dollar's share. The declines for the other countries principally reflect valuation effects. These data are

¹⁰ Hildebrand (2005) describes a similar transparent program of gold sales by the Swiss National Bank, which appears to have had essentially no market impact. On the other hand, Blanchard et al. (2005) estimate that if China and Japan were unexpectedly to shift half of their foreign exchange reserves, which they also assume are now all in US dollars, into other currencies, the dollar's share in global portfolios would decline from 30 to 28 percent, which is a "substantial shift" within their framework, leading to a decline in the dollar possibly as large as 8.7 percent if the full adjustment was anticipated to occur over a period of one year. Their model is built on the assumption of imperfect asset substitution; the closer the parameterization is to perfect substitutability, the smaller the initial exchange rate adjustment and the more prolonged the adjustment process. In the limit, the model degenerates, and the speed of adjustment goes to zero.

value shares, and the presumption is that most countries mark the value of their foreign exchange holdings to market.

Seven countries have had large increases in the Euro's share: Australia, Canada, New Zealand, the United Kingdom, Latvia, Lithuania, and Romania. The adjustments by the last three countries no doubt are responses to those countries increasingly close ties to the European Union.

Three countries have reduced the yen's share substantially: Australia, New Zealand, and the United Kingdom. Presumably these adjustments were responding, in part, to the low yield on yen-denominated assets. However, they also reflect relative value effects.

In the case of the United States, the euro's share rose by 10 percentage points since 2000 and the yen's share declined by the same amount. Over the period, the United States made no purchases of euro or yen, earned a higher yield on euro-denominated assets than on yen-denominated assets, and the euro appreciated more against the dollar than the yen; this explains the decline in the yen's share in U.S. foreign exchange reserves.

Conclusion

Beth Simmons' paper is interesting and thought-provoking. She sketches out several areas where central bank cooperation can be expected to evolve in the years ahead. She may not have covered every relevant topic, but the paper does a very nice job in covering a broad set of issues. She points to one area of immediate concern, central bank cooperation with Asia and the risk of disruptive adjustments in reserve holdings. I am less concerned than she is about the risks in this area. However, I have provided a sketch of a way forward in dealing with the potential problem of the risks associated with active reserve diversification. Central bankers meeting at the BIS should take the initiative to implement my proposal.

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Table 1: Evidence on Foreign Exchange Reserves Diversification

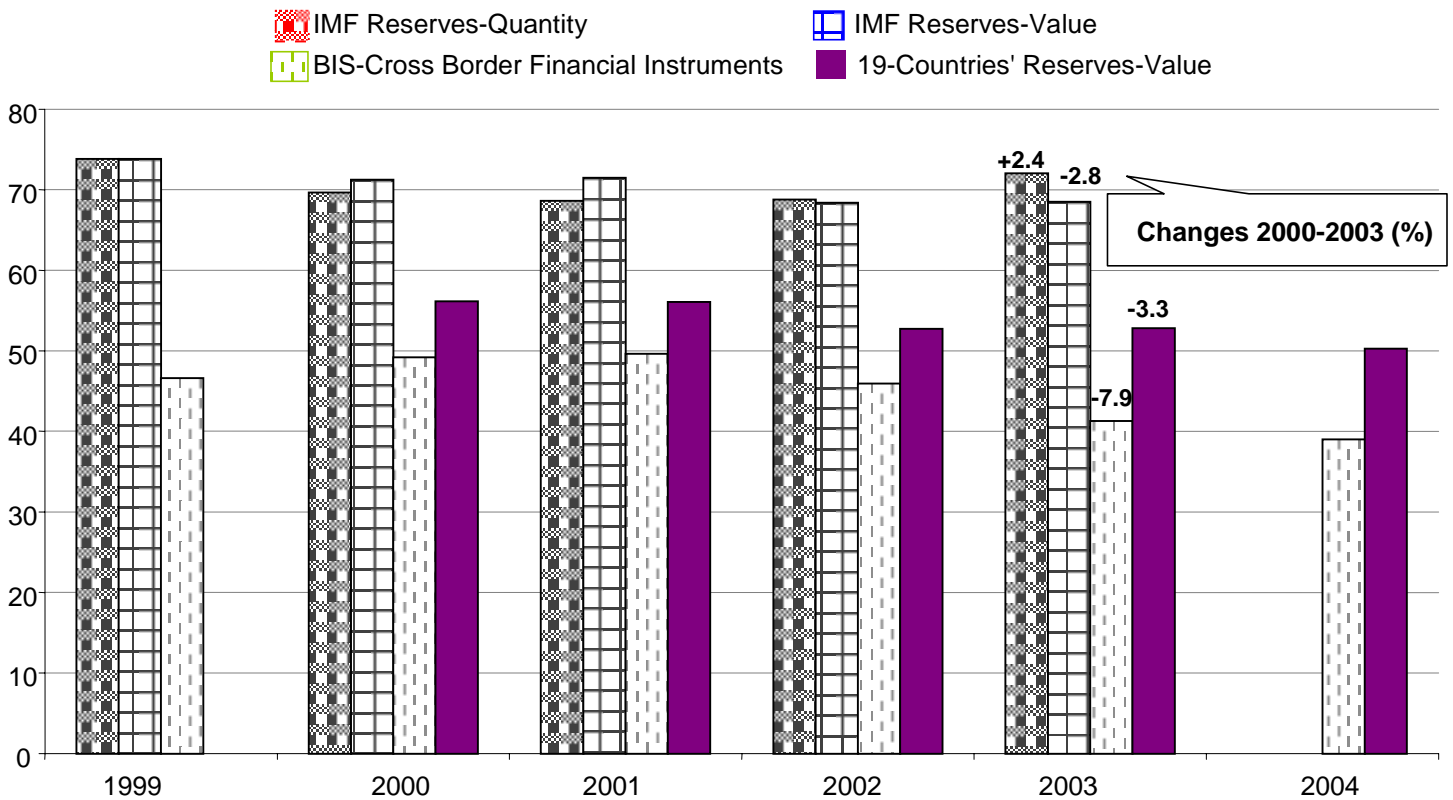
	US Dollar		Euro		Yen		Other Currencies	
	Share 2004	Change 2000-2004	Share 2004	Change 2000-2004	Share 2004	Change 2000-2004	Share 2004	Change 2000-2004
Germany	98	-1	0	0	2	1	0	0
Colombia	85	5	12	-3	3	-1	0	0
Philippines	83	-9	10	9	4	-1	4	2
Hong Kong ^a	79	11	11	-1	2	-3	9	-8
New Zealand	57	4	43	26	0	-31	1	1
Canada ^b	48	-27	49	27	4	0	0	0
Australia	45	5	45	15	10	-20	0	0
Latvia	38	-16	59	27	3	-2	0	-9
Romania ^c	36	-37	59	35	0	0	5	2
Norway	35	14	43	-3	6	-6	16	-4
Switzerland	34	-7	48	3	0	-3	19	7
United Kingdom	30	-6	55	17	15	-12	0	0
Finland	30	0	0	0	5	-10	65	10
Slovak Republic	22	0	78	3	0	-3	0	0
Croatia	16	-12	84	2	0	0	0	11
Slovenia	12	-9	83	11	0	0	4	-2
Bulgaria ^c	7	0	92	-2	0	0	2	1
Lithuania ^c	4	-78	96	80	0	-1	0	-1
United States	0	0	57	10	43	-10	0	0
Subtotal	50	-6	36	12	7	-5	7	-2
Iceland ^d	40	NA	40	NA	5	NA	15	NA
Sweden ^d	37	NA	37	NA	8	NA	18	NA
Grand total	50	NA	36	NA	7	NA	8	NA

Notes:

- Since 2003, the Hong Kong Monetary Authority has grouped yen, euro, and other European currencies altogether into one category as "Non-US dollar bloc". The 2003-2004 yen and euro shares in this table are derived by assuming that they remain the same as in 2002 in the "Non-US dollar bloc", which has decreased as a share of the total since that time.
- Canada holds only three currencies as foreign exchange reserves: US dollar, yen, and euro. Prior to 2003, data published by Canada's ministry of finance only differentiate between US dollar and non-US dollar foreign exchange reserves. Hence, to derive the yen and euro shares for 2000-2002, we assume that the yen share during the period was the same as it was in 2003, and the rising euro share was derived as a residual.
- Assumes 2004 shares are the same as in 2003.
- Data available for only 2004.

Source: Various central banks.

Figure 1: US Dollar's Share



Sources: IMF *Annual Report* (2004) table I.3 and similar tables in earlier *Annual Reports* (IMF Reserves-Quantity and Value), BIS *Quarterly Review* (March 2005) (BIS-Cross Border Financial Instruments), various central banks (19-countries reserves)