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# One hundred and thirty years of central bank cooperation: a BIS perspective

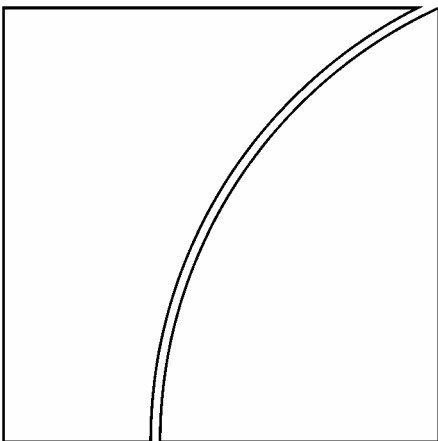
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## Foreword

On 27-29 June 2005, the BIS held its Fourth Annual Research Conference on “Past and Future of Central Bank Cooperation”. This event brought together some 80 senior officials from central banks, academic institutions and the private sector to exchange views on this topic (see the programme attached). This paper was presented at the conference. The conference was part of the BIS 75th Anniversary programme. The views expressed are those of the author(s) and not those of the BIS



## **Abstract**

With the insight of 130 years of history, this paper tries to answer three questions: how did changing international monetary and financial conditions shape the targets and tools of central bank cooperation? What factors influenced its intensity? Did a structured organisation, such as the BIS, make a difference to its effectiveness? We show that while central bank cooperation through history was ultimately directed to ensuring monetary and financial stability, the conception of these objectives, the relationship between the two, the balance in their pursuit, and the strategies followed evolved over time reflecting changes in the monetary and financial environment as well as in the intellectual climate. In turn, the intensity of central bank cooperation was influenced by the state of international relations, the prestige and degree of autonomy of central banks and the technical nature of the issues requiring cooperation. We also argue that the BIS made a material difference, at least when conditions allowed.



**Fourth BIS Annual Conference**  
**Past and Future of Central Bank Cooperation**  
**Basel, Switzerland, 27-29 June 2005**

*celebrating 75 years of the Bank for International Settlements, 1930-2005*

**Monday, 27 June 2005**

**Keynote dinner address**

Tommaso Padoa-Schioppa, former member of the Executive Board, ECB

**Tuesday, 28 June 2005**

**Opening remarks**

William White, BIS

***Chairman: Herman Baron Van Der Wee, Katholieke Universiteit Leuven***

**Session 1**

*One hundred and thirty years of central bank cooperation: a BIS perspective*

Claudio Borio, BIS and Gianni Toniolo, University of Rome Tor Vergata, Duke University & CEPR

Discussants: Marc Flandreau, Institut d'Etudes Politiques, Paris  
Miles Kahler, University of California, San Diego

**Session 2**

*Almost a century of central bank cooperation*

Richard Cooper, Harvard University

Discussants: Barry Eichengreen, University of California, Berkeley  
Albrecht Ritschl, Humboldt-Universität zu Berlin

***Chairman: Harold James, Princeton University***

**Session 3**

*Architects of stability? International cooperation among financial supervisors*

Ethan Kapstein, INSEAD

Discussants: Charles Goodhart, London School of Economics  
Peter Praet, National Bank of Belgium

**Session 4**

*The future of central bank cooperation*

Beth Simmons, Harvard University

Discussants: Michael Bordo, Rutgers University, New Brunswick  
Edwin Truman, Institute for International Economics, Washington DC

**Wednesday, 29 June 2005**

**Chairman: Paul De Grauwe, Katholieke Universiteit Leuven**

**Session 5**

*Central banks, governments and the European monetary unification process*

Alexandre Lamfalussy

Discussants: Peter Kenen, Princeton University  
Yung Chul Park, University of Korea

**Policy panel discussion**

Chairman: Malcolm D Knight, BIS

*Reflections on the future of central bank cooperation*

Participants: Andrew Crockett, J P Morgan Chase  
Jacques de Larosière, Paribas  
Allan Meltzer, Carnegie Mellon University  
Paul Volcker, International Accounting Standards Committee  
Yutaka Yamaguchi, former Deputy Governor, Bank of Japan



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# One hundred and thirty years of central bank cooperation: a BIS perspective<sup>1</sup>

Claudio Borio<sup>2</sup> and Gianni Toniolo<sup>3</sup>

## Introduction<sup>4</sup>

The idea that an “international bank” would facilitate central bank cooperation dates back to the late 19th century. It was officially revived in the immediate postwar period, particularly at the 1922 Genoa Economic Conference. In keeping with the vision of Governor Norman of the Bank of England, the Bank for International Settlements (BIS), established in 1930 to facilitate the transfer of German reparations, was also given the mission of “promoting central bank cooperation”.<sup>5</sup> Since July 1931, when the Hoover moratorium put an end to reparations, central bank cooperation has been the main objective of the BIS.<sup>6</sup>

The 1935 BIS *Annual Report* asked: “Cooperation on what? With what objectives in view? How?”.<sup>7</sup> With the insight of 130 years of history, this paper tries to answer three questions: how did changing international monetary and financial conditions shape the targets and tools of central bank cooperation? Under what conditions could central bank cooperation flourish? Did a structured organisation, such as the BIS, make a difference to its effectiveness?

The paper will not discuss the desirability of cooperation. We assume that (i) central banks are interested in the production of a public good consisting in the stability and efficiency of the international monetary and financial system, at least insofar as it affects their own domestic economy; and (ii) that they believe that a certain (if variable) degree of cooperation enhances the likelihood of maintaining a stable and efficient international financial environment. We take the regular attendance at the monthly BIS meetings by busy central bankers over the past 75 years to indicate that these assumptions are not entirely unfounded. Given these assumptions, we focus primarily on the *process*, rather than the *outcome* of cooperation, and we do so from a *positive* rather than *normative* perspective. In other words, while we recognise that cooperation based on the wrong “model” of how the economy works or on the wrong analysis of current and future conditions can have perverse effects, we are more interested in understanding what factors shape cooperation than in the extent to which it achieves its ultimate objectives. We define cooperation broadly, to include both purposeful exchanges of information (“low-key” cooperation) and joint decisions and implementation (“high-profile” cooperation).<sup>8</sup>

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<sup>1</sup> This is a revised version of the paper originally prepared for the BIS 75th Anniversary Conference on “Past and Future of Central Bank Cooperation” that took place on 27-29 June 2005.

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<sup>4</sup> We would like to thank Gunter Baer, Piet Clement, Andrew Crockett, Charles Freeland, Ryozi Himino, Alexandre Lamfalussy, John Lowen, Robert McCauley and Paul Van den Bergh for their helpful comments. The views expressed by Claudio Borio are his own and not necessarily those of the BIS.

<sup>5</sup> Article 3 of the BIS Statutes.

<sup>6</sup> Article 3 of the current BIS Statutes, including also the ancillary missions of providing additional facilities for international financial operations and [acting] as trustee or agent in regard to international financial settlements.

<sup>7</sup> BIS, *5th Annual Report*, Basel, 13 May 1935, pp 41-44.

<sup>8</sup> In practice, exchange of information is critical and accounts for the lion's share of international cooperative efforts. The exchange is aimed at (a) developing a better understanding of different points of view (eg concerning the “model” of the economy, other constraints on decisions, preferences, intentions, etc) and/or (b) developing a convergence of viewpoints on the link between policy actions and outcomes (eg about the model of the economy, prevailing and prospective economic conditions, etc). This definition is broader than the one typically used in the international relations literature, where what is envisaged is some form of coordination of actions in a game theoretic context (see, for instance, Keohane's (1984) notion of

The paper is divided into several sections. Section I outlines the main goals and determinants of central bank cooperation. Each of the following sections broadly reflects a given set of conditions in the international monetary and financial arena: Section II deals with cooperation in the context of the pre-1914 gold standard; Section III traces developments from the wartime regime to the creation of the BIS; Section IV covers the most uncooperative period in the history of the 20th century (1931-45), marked by autarky, beggar-thy-neighbour policies and open conflict; Section V is devoted to cooperation under the Bretton Woods system; Section VI considers the years from about 1973 to the present, when the balance of cooperation shifted from monetary to financial stability. A final section summarises the paper's main findings and draws some general conclusions.

## **I. Central bank cooperation over time: changing targets, tools and intensity**

Central bank cooperation through history has ultimately been directed to ensuring monetary and financial stability. However, the conception of these objectives, the relationship between the two, the balance in their pursuit, and the strategies followed have evolved over time, reflecting changes in the monetary and financial environment as well as in the political and intellectual climate. Accordingly, depending on the circumstances and the intellectual perspective of the time, we think of monetary stability as covering either stability in an aggregate price level (index) or in the relative price of two units of account, ie the exchange rate between national currencies or between a given currency and gold. We think of financial stability, narrowly defined, as being impaired whenever widespread defaults threaten to take place, due to either a banking or a sovereign debt crisis.

We shall see that changes in the operational conception of monetary and financial stability against the background of an evolving monetary and financial environment have deeply affected the targets and instruments of central bank cooperation (Table 1). Broadly speaking, the first 100-odd years covered in the paper were characterised by the belief that a fixed exchange rate system was a desirable goal that underpinned the pursuit of domestic objectives, notably price stability. Cooperation therefore focused either on supporting or, when it broke down, on restoring the fixed exchange rate system. International liquidity packages were a prominent instrument in this context. International cooperation aimed at financial stability was high on the policy agenda during the gold standard period, but not always easy to disentangle from that in pursuit of monetary stability as conceived at the time. Banking or external debt crises could threaten the convertibility constraint and against the backdrop of liberalised financial markets, without a prudential apparatus in place, international cooperation primarily took the form of liquidity assistance to support convertibility. By contrast, in the Bretton Woods period, financial repression tended to keep overt financial instability in check, obviating the need for international cooperation in this area. After 1973, with floating exchange rates and fully fiat money regimes, the pursuit of domestic price stability came to be increasingly regarded as a task that individual central banks could and should perform outside of international cooperation (except as far as the exchange of information was concerned). By contrast, as financial liberalisation gathered momentum, cooperation was seen as crucial in creating a stable financial environment. In addition to international emergency liquidity packages aimed at emerging market countries in distress, the major innovation was the joint development and acceptance of codes and standards aimed at strengthening the global financial infrastructure through so-called "soft laws", especially in the prudential regulatory field.

Throughout the past 130-odd years international financial cooperation was in the first place a government business. Central banks played a larger or smaller role according to the latitude of their room for manoeuvre in the international arena. As the paper focuses on cooperation among central banks rather than overall financial diplomacy, it is useful to try to pin down what factors influenced the degree of involvement of central banks in the overall game of financial cooperation (or lack thereof).

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"mutual adjustment", which is more akin to the concept of policy coordination in the economic literature (eg Bryant (1987)). Our definition is closer to Truman's (2003) and Cooper's (2005).

One can think of the intensity and depth of central bank cooperation as varying over time according to three main factors: (i) the overall conditions in international relations; (ii) the prestige enjoyed by central banks with the public at large, which also affects their institutional relationship with the political authorities (ie the allocation of tasks in monetary policymaking, including provisions for central bank independence); and (iii) the technical nature of the problems requiring cooperation. Table 1 provides our subjective assessment of the varying intensity of each of these three factors, resulting in an overall ranking by sub-periods of the intensity of central bank cooperation, as described in the following sections of the paper.

Table 1

**Regimes, targets and tools of cooperation**

	<b>Gold standard</b>	<b>Bretton Woods</b>	<b>Post-Bretton Woods</b>
<b>Regime characteristics</b>			
Monetary regime	– gold convertibility as ultimate constraint (on countries and overall system)	– fixed but adjustable exchange rates – gold as (soft) constraint on overall system	– unrestricted fiat money
Financial regime	– liberalised financial markets – no (limited) prudential regulatory apparatus in place	– financial repression (administrative controls)	– progressive liberalisation – prudential regulation in place
<b>Conceptions and experience</b>			
Monetary stability	– identified with gold convertibility – approximate price stability (until Great Depression)	– increasingly identified with price stability – seen as consistent with fixed exchange rates until late 1960s	– identified with price stability – after the Great Inflation, global disinflation
Financial stability	– financial instability can threaten convertibility – financial instability not uncommon (especially at the periphery)	– financial repression keeps overt financial instability in check	– re-emergence of financial instability
Targets of cooperation	– maintaining gold convertibility	– re-establishing conditions for current account convertibility – sustaining fixed exchange rates	– price stability seen as a domestic affair (except in Europe) – financial stability gains ground
Tools of cooperation <sup>1</sup>	– emergency liquidity lending	– emergency liquidity lending – Gold Pool	– (sporadic) FX intervention – emergency liquidity lending (to EMEs) – developing codes and standards (banking, payment and settlement systems) – strengthening market information

<sup>1</sup> Other than exchanges of information (“low-key” cooperation).

*International relations.* Needless to say, international financial diplomacy was always dictated and largely run by governments as part of their foreign policy. Over the period covered in this paper, the state of international relations varied enormously from war (1914-18 and 1939-45), to competitive nationalism (1873-1913), to confrontational unilateralism (1918-39), to various degrees of cooperative multilateralism within the so-called Western world (1945-2000). In most cases, central bank diplomacy closely mirrored governments' foreign policy, governors being, after all, high-ranking civil servants. In the few instances when central bankers exercised a degree of autonomy in the international arena - as in the case of the EEC governors in the 1960s - they were still strongly conditioned by the overall state of international relations. The notion, sometimes expressed at the BIS meetings, that the governors in Basel could be free from political "interference" was to a large extent an illusion.

*Prestige and independence of central banks.* Central banks were never terribly popular with the public at large. Knowledge of their arcane tasks was limited even among the most educated members of the public. Similarly, "banks" have always been quite unpopular with ordinary citizens ever since the Middle Ages. In this context, however, the prestige of central bankers varied considerably over time, depending on how well they seemed to deliver monetary and financial stability. The overall standing of central banks with public opinion affected their relationship with governments and therefore the latter's willingness to allow central bankers discretionary powers in financial diplomacy.

*Technicalities involved in cooperation.* Naturally, the more technical the issue calling for cooperation (and the more unique the central bank expertise), the greater is the scope for cooperation. Other things equal, these conditions tend to channel international cooperation through central banks, by leveraging another source of expertise. They can also provide central banks with a greater degree of discretion in pursuit of that cooperation. Accordingly, central banks played a larger role when cooperation required keeping the exchange rate within the gold points, engineering complex currency swaps, and agreeing on supervisory standards.

Table 2 contains our own subjective appreciation (on a 0-4 scale) of the weight of the three above-mentioned factors in explaining the overall intensity of central bank cooperation over seven relevant sub-periods into which the time span covered in the paper can be conveniently divided.

Table 2  
Intensity of central bank cooperation

Period	International relations (1)	Prestige and independence of central banks (2)	Technicality of issues requiring cooperation (3)	Overall intensity of cooperation (Total score/3) (4)
1870s-1913	2	2	3	2.33
1920s	1	3	4	2.67
1930s	0	1	1	0.67
1950s	4*	2	2	2.67
1959-73	3*	3	4	3.33
1973-mid-1980s	3*	2	4	3.00
Mid-1980s-2005	3	4	4	3.67

Note: All rankings on a scale of 0-4.

\* "Western world" only.

Nationalism strongly affected international relations before 1914; the scars of the war and of the peace treaty strained them further in the 1920s. Tension was increased by the depression, making the 1930s the most confrontational peacetime decade. By contrast, "consensual American hegemony" made the 1950s probably the best decade for international relations within the Western world. As American leadership lost ground from the 1960s onward international relations became less harmonious; nevertheless cooperation remained at a much more intense level than at any time before 1939. The paper also deals with the peculiar type of international cooperation that existed among the allied

powers during World War I and, in an implicit way, even among enemy central banks during the Second World War.

Before 1914, central banks were relatively little known to the public and quite strongly dependent on governments as far as their international operations were concerned (eg emergency lending to a foreign central bank was a highly sensitive political matter). In the 1920s, central banks gained power and prestige, as well as a higher degree of independence, owing to their role in the restoration of gold convertibility. With the Great Depression central banks everywhere lost prestige, as public opinion associated “bankers and financiers” at large with the debacle and governments were only too glad to divert as much blame as possible to central banks. At the same time, the responsibility for monetary policy was shifted to the treasuries; in some cases, central banks became little more than dignified government departments (the German Reichsbank representing an extreme case in point). To be sure, in the 1930s central banks were given new regulatory and supervisory responsibilities. But these did not have a significant impact on international cooperation until half a century later. With their contribution to postwar reconstruction, in the 1950s European central banks slowly began to refurbish their public image. By the 1960s they had regained prestige and, in several cases, a degree of de facto autonomy from their respective governments. While key decisions in support of Bretton Woods required government direction and approval, commonality of purpose - maintaining the system afloat - made the degree of independence less relevant. After the loss of prestige associated with the Great Inflation phase, starting in the mid-1980s central banks slowly regained a high standing, as their efforts to bring inflation under control bore fruit. From the 1990s, this was progressively enshrined in greater and more formal central bank independence. If, paradoxically, this autonomy and focus on domestic price stability at times proved inconsistent with efforts to implement international cooperation on exchange rates, it was valuable in the international cooperative efforts undertaken in the field of prudential regulation.

As for the degree of technicality involved in the matters requiring cooperation, Lord Norman believed that central banks were the sole repository of the sophisticated techniques required to manage the international gold standard. Thus, contrary to textbook assumptions, the actual running of the pre-1914 system did not rest on adherence to simple mechanical rules. The arcane subtleties of managing exchange rates within the gold points, of nurturing market expectations, of maintaining a high level of reserves as required by politicians and public opinion alike, of sterilising gold inflows, were all the exclusive domain of central bankers. International cooperation to keep the system viable could only rest on their technical expertise. An even higher degree of technical sophistication was probably required in the 1920s, when the reinstatement of the gold standard was the main task of cooperation. In the 1950s, cooperation for multilateral settlements called for a payments network and a clearinghouse technology developed at the BIS, but required little of the typical financial and monetary expertise of central banks. After 1958, with current account convertibility and the demand for financial engineering to prop up the dollar and the pound, the technical expertise of central banks again proved invaluable, for instance in coordinating currency swaps and in the management of two separate gold markets. International cooperation in prudential regulation and the development of “soft laws” that marked the period from the mid-1970s onward was also characterised by a high degree of technical content, which central banks derived from their intimate knowledge of national banking systems, on which international convergence of prudential standards and rules could be based.

An un-weighted average of the scores given to the three factors affecting central bank cooperation yields an overall ranking of the seven sub-periods according to the intensity of cooperation, which reaches its highest points in the years from 1958 onward and its lowest in the 1930s.

We next describe in some detail central bank cooperation from the mid-1870s to the present.

## **II. Cooperation under the classical gold standard**

With the Reichsbank’s commitment to convert its notes into gold in 1876, the yellow metal became the unchallenged monetary standard of the developed “core” of the world economy. For the following 40-odd years, until the outbreak of World War I in 1914, the “classical gold standard” provided the background for a relatively efficient and stable system of international payments, in an epoch of rapidly expanding commodity trade, record-high labour migration, and free and growing capital mobility, often called the “first globalisation”.

Under the classical gold standard, convertibility was the single anchor that underpinned both monetary and financial stability. On the one hand, gold convertibility was assumed to deliver stable prices and was therefore identified with monetary stability. On the other hand, convertibility was supposed to guarantee financial stability: as long as bank deposits could be converted into gold at sight and sovereign external commitments were met in gold there would be, by definition, no fear of financial instability. Thus, in the context of liberalised financial markets with few or no prudential regulatory constraints, a single tool, the regulation of the supply of liquidity and of its price by central banks, was seen as underpinning the pursuit of both objectives. Under these conditions and assumptions, central banks would uphold the gold standard as an international public good by cooperating in two ways: (i) by keeping their own house in order to enhance the credibility of their country's commitment to gold, a form of tacit cooperation, and (ii) by extending emergency lending to central banks whose low level of gold reserves threatened to jeopardise convertibility. Routine cooperation on a continuous basis was not deemed useful.

Economic historians disagree on the extent of central bank emergency cooperation during the classical gold standard and on its usefulness for the viability of the system (eg Flandreau (1997), Eichengreen (1992 and 1995) and Gallarotti (1995)). They do agree, however, that whatever cooperation did occur was carried out on a strict bilateral basis and was undoubtedly less intense than in the years following 1914.

The fact that central bank cooperation was limited and mostly tacit is partly explained by the strongly nationalist character of international relations (which, for instance, made governments reluctant to lose gold reserves in favour of would-be enemy countries) and by the fact that international financial relations were more the domain of governments than of central banks, which were privately owned, if tightly supervised, institutions.

Managing the gold standard was a fairly complex technical matter but international cooperation was not considered of paramount importance for the stability of the system. On the one hand, believing in automatic market adjustment, the policy recommendation of mainstream economics was that each player adhere to the rules of the game.<sup>9</sup> If there was an understanding of the gold standard as an international public good, it underpinned emergency cooperation only: there was little grasp, except by some practitioners and non-mainstream economists, of the usefulness of day-to-day cooperation in technical matters such as payments technology. On the other hand, the economic environment made maintaining convertibility easier before 1914 than at later times. The balance of payments adjusted smoothly to domestic monetary policy thanks to labour and product market flexibility. Unrestricted international capital mobility produced the expected stabilising flows, London's financial hegemony gave it de facto coordinating powers, as capital flows responded rapidly to small changes in the London rates. More important still, the perceived political costs of maintaining gold convertibility were relatively small for three main reasons. First, the system delivered (or was believed to deliver) price stability and growth. Second, given flexible markets, the output and employment trade offs entailed by the commitment to the gold standard were relatively contained and therefore socially acceptable. Finally, suffrage limitations and the weakness of workers' organisations made it politically affordable for governments to guarantee gold convertibility, a priority for the upper and middle classes, even at the cost of some unemployment.

Even among core countries, however, the classical gold standard did not assure continuous domestic financial stability and this in turn led to some instances in which cooperation did take place. Occasionally, contagious banking crises did occur (eg Kindleberger (1996)). In the most severe instances - eg in 1890 and 1907 - they were dealt with by emergency lending among banks of issue. In 1890, the drain on the reserves of the Bank of England seemed to be putting the gold standard at risk. At the last minute the central banks of France and Russia stepped in by offering London a gold swap sufficiently large to reverse market expectations about the adequacy of the Bank's gold reserves (Clapham (1944) and De Cecco (1974)). In 1906 the Bank of France purchased an extremely large amount of sterling-denominated bills to avoid a sharp increase in the London bank rate in response to a gold outflow from England to the United States. Again, in 1907, both the Bank of France and the Reichsbank allowed their reserves to decline, moving gold to London to finance England's transfer of

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<sup>9</sup> There is, of course, considerable debate about what exactly those rules were and how closely they were followed. See, in particular, Bloomfield (1959) and, for a broader discussion, the articles in Eichengreen (1985).



gold to the United States (Eichengreen (1992)). Even though their relevance is played down by some scholars (Flandreau (1997)), these episodes indicate that some central bank cooperation took place when the survival of the fixed-rate system was at stake.

This reluctance to cooperate except in circumstances when the gold standard was threatened also explains why cooperation to address instability at the periphery was even rarer. In contrast to the experience of core countries, at the periphery the gold standard did not deliver stability (Bordo and Flandreau (2001)), and banking and exchange rate crises were not that infrequent (Bordo et al (2001)).

To sum up: the political and intellectual legitimacy of the gold standard, the relatively minor adjustment costs, and the character of the 19th century democracy all provided incentives for pursuing exchange rate stability by simple domestic adherence to the “rules of the game”. Given the popularity of the gold standard and its technical complexities, the main banks of issue played the high-profile role of guarantors of convertibility; they had no incentive to exploit whatever room for manoeuvre their governments allowed them in international monetary relations.

It must be added that international relations based on power-politics stressed the need for a high level of metal reserves (except in London), inducing central banks of surplus countries to sterilise gold inflows, thus increasing the adjustment cost of those in deficit. Those who championed systematic multilateral cooperation among central banks were driven by the observation that asymmetric adjustment was unnecessarily costly and a threat to international monetary stability.

In 1892 Julius Wolff, a professor at the University of Breslau, submitted a project at the Brussels International Monetary Conference for the creation of an international currency, to be used for emergency lending to central banks, backed by gold reserves contributed by the central banks themselves, and issued by a joint institution based in a neutral country. Similar suggestions, including the creation of an international central bank located in Berne, were made by several others. But it was Luigi Luzzatti who gave these ideas more precise shape and wider publicity. He observed that the US financial problems of 1907 had created an international liquidity crisis (a “monetary famine” as he called it) from which the main central banks had tried to protect their respective markets, scrambling for gold through competitive interest rate increases and other means. A “monetary war” of this kind was - according to Luzzatti - both detrimental and unnecessary: “peace” could be achieved through “cordial cooperation” in supplying gold to illiquid central banks. He argued that lending amongst monetary authorities should become the norm, rather than being occasional and emergency-driven. Central banks - Luzzatti said - lent to each other out of their long-term self-interest, but politics could get in the way of a clear vision of economic self-interest. Hence the need for an international body, to be set up in normal circumstances, in order to provide for emergencies in a technical, apolitical way.<sup>10</sup> Amongst the several favourable reactions to Luzzatti’s ideas was that of Cortelyou, the US Treasury Secretary, who announced his intention of convening a European conference of central banks to better specify and implement Luzzatti’s proposals (Toniolo (2005: 20-22)).

### **III. Cooperation in war, monetary stabilisations and the creation of the BIS**

The First World War led to the abandonment of the gold standard and the imposition of exchange controls. Once the war was over, countries sought at varying paces to re-establish the previous order, sometimes after having experienced traumatic bouts of inflation.

From the perspective of the broad objectives and instruments of cooperation, the period did not represent a major break with the past. True, the experience with high inflation in some countries and with large excess gold reserves in the United States helped to develop notions of monetary stability

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<sup>10</sup> “There is no absolute remedy for financial crises - Luzzatti wrote - that are the consequence of human weakness, greed and imperfect forecasting. (...) What I simply ask for are agreements among experts capable of eliminating from inevitable crises those elements that are due to poor organisation of the banks of issue and treasuries or to the lack of agreements for mutual self-interested gold lending.”

more closely identified with domestic price stability than with convertibility.<sup>11</sup> But the objective of convertibility remained paramount. And in the absence of a well established regulatory framework, both monetary and financial stability were primarily pursued through a similar set of instruments, namely the provision of liquidity, domestically and internationally.

What did change, and markedly, was the global constellation of economic and political constraints. In particular, the German reparation problem loomed large throughout the period. In contrast to the classical gold standard phase, the prospect of a potential default in a core country profoundly shaped the evolution of events, the forms of cooperation, and their success or failure. It was also the factor which, surprisingly perhaps, would be at the root of the creation of an institutionalised vehicle of cooperation for central banks, the BIS.

In what follows, we consider sequentially the forms of central bank cooperation during the wartime period, those during the subsequent years, and the specific factors leading to the establishment of the BIS.

## **Wartime**

One might think that World War I made central bank cooperation both unnecessary and infeasible. After all, in the summer of 1914 central banks all over Europe suspended gold payments, putting an end to the classical gold standard. A fiat money monetary regime was adopted by all belligerent countries and most neutrals. In financing military expenditure, each country found its own mix of tax, debt and printing press. The more or less extensive use of the printing press depended on social and economic conditions specific to each country. Against this backdrop, one would think that no cooperation among central banks was necessary and that no incentive existed for it.

In fact, the opposite is true: total war made financial cooperation unavoidable. Cooperation largely took the form of inter-allied lending, but did not stop there. As public opinion - friendly, enemy and neutral - took the rate of exchange as a good predictor of military success and failure, exchange rate pegging policies became part of the military effort. Thus, a strong incentive existed for inter-allied cooperation in the foreign exchange markets. It was during the war that central banks established standing bilateral agreements for the first time. The governors of the central banks of England and France even set up a direct telegraph line between their respective offices to provide swift, regular communication. President Strong of the New York Fed spent a long time in Europe in order to promote formal links between his bank, London and Paris, while the Bank of Italy sent a permanent representative to New York (Toniolo (2005: 16-17)).

As soon as the wartime conditions ceased, however, so did the incentives to maintain allied financial solidarity and the cooperation that had gone with it.

## **Towards the new gold standard**

There was a broad consensus after the war on the desirability of a return to gold convertibility. But its practical implementation was difficult. A return to the prewar gold parity would have spelled macroeconomic disaster for any continental European country, given the intervening inflation. At the same time, the distributional implications involved in choosing a new parity were politically explosive. The transition from a war- to a peacetime economy required a large amount of government assistance, hardly consistent with the fiscal and monetary policies needed to convince the markets of a credible gold standard commitment. Internationally, the problems of debts and reparations had to be solved in order to recreate a stable system of international payments.

In principle, therefore, cooperation looked attractive in the postwar conditions; indeed, more lip service was paid to central bank cooperation than had been the case before 1914. In 1921, Norman issued a "manifesto" outlining four principles of central banking: independence from national governments; separation from commercial banks; banking supervision; and cooperation. He saw the latter as "confidential interchange of information and opinion", the conduct of foreign banking operations

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<sup>11</sup> See, for instance, Laidler (1999) for an interesting discussion of the monetary policy debates in the United States at the time. See also De Kock (1974) for a discussion of the evolving notion of monetary stability.

through the central bank of the country concerned, and the mutual extension of such facilities as “the custody of gold, monies and securities and the discount of approved bills of exchange” (Sayers (1976)). At the 1922 Genoa Conference central banking was the subject of profound debates by economic experts, academics, and central and private bankers. A resolution was passed containing the first official international recognition of the desirability of formal cooperation among central banks.

In spite of the obvious incentives to cooperate, strained international relations stood in the way. The war and its settlement had left in their wake a long list of unresolved issues, old and new conflicts of interest - not least amongst allies - incomprehension, new nationalisms and old ethnic rivalries, and deeply rooted desires for revenge. As observed by Eichengreen (1992), “so long as governments were at loggerheads, it was unlikely that national central banks could successfully collaborate”.

Nevertheless, in the 1920s cooperation among central banks was more explicit than it had been before 1914 for three main reasons. First, in many countries, the central bank’s prestige had been enhanced by the contribution made to the war effort, while at the same time the prospect of a return to gold convertibility gave back to central banks the aura of technical wizardry they had enjoyed before 1914. Second, the backing of the community of central banks, in the form of syndicated hard-currency loans, was the seal of approval, awaited by the markets, of the sustainability of a country’s pledge to convertibility. Finally, contrary to pre-1914, cooperation was tirelessly preached and promoted (understandably primarily *pro domo sua*) by the heads of the two leading central banks: Montagu Norman of the Bank of England and Benjamin Strong of the Federal Reserve Bank of New York.

### **The creation of the BIS**

The BIS, as the organisation for central bank cooperation, owes its existence to German reparations. In the late 1920s a short window of opportunity existed to try to provide a stable solution to a problem that had poisoned international relations since 1919. The conferences of Paris, The Hague and Baden Baden, which gave birth to the BIS, are a good example of how economic cooperation may develop out of partly converging interests when the international political environment is not poisoned by unbridgeable divisions.

The main driving force behind the creation of an “international bank”, as part of a treaty on reparations, was the so-called “commercialisation” of the reparation payments, whereby part of the German debt would be issued in the form of long-term bonds to be subscribed by international private banks and financial houses. Governments were keen on receiving lump sums up-front rather than payments over a very long period of time, while private bankers saw a major business opportunity in underwriting and managing the operation. The German Government, for its part, considered it essential that a mechanism be found for a good portion of the reparation payments to be reinvested in Germany.<sup>12</sup>

Given that obligations of sovereign states are notoriously difficult to enforce, the creation of an international organisation such as the BIS was seen as potentially useful in improving the chances of future payments enforcement (Simmons (1993)). It could do so, for instance, by overcoming information asymmetries about economic and policy conditions that might affect the regular flow of payments and by linking the fulfilment of the debtor’s obligations to various incentives, such as the reinvestment in Germany of part of the proceeds from payments of interest and principal. At the same time, such an international institution, as the bondholder’s Trustee, could facilitate collective creditors’ actions in case of default. More generally, central bank cooperation was also seen as conducive to a more stable international monetary environment, which would facilitate the fulfilment of both lenders’ and borrowers’ contractual obligations.

It is against this background of converging interests that central bankers, led by Lord Norman, also made the BIS an instrument of their technical cooperation and independence.

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<sup>12</sup> A large literature exists on the origins of the BIS; for recent contributions, see Simmons (1993), Baffi (2002) and Toniolo (2005: 33-60).

#### **IV. The failure of cooperation (1931-45)**

The Great Depression was already looming at the time of the creation of the BIS. Soon afterwards, a severe contraction in output and prices came to be intertwined with a succession of major banking crises, of which the failure of Creditanstalt in Austria was just the first, as well as sovereign defaults. The gold standard progressively disintegrated and countries retreated into autarky. In the meantime, international relations suffered continuous blows and became increasingly strained until the time when they would be consigned only to the language of arms, during World War II.

Before central bank cooperation was to progressively atrophy, although never quite disappear, in the early 1930s its main objectives and tools remained those developed during the gold standard era, viz the provision of liquidity, domestically or internationally, in the attempt to prop up the system. Admittedly, the widespread banking crises led to the establishment of elaborate domestic regulatory and supervisory frameworks, with central banks often in charge (Allen (1938)). But in contrast to what would occur later in the century, they did not give rise to international cooperative efforts, given the inimical conditions of the time. And with the final abandonment of the gold standard, monetary stability became more firmly identified with price stability. This meant that, for the first time, monetary and financial stability became clearly distinct goals, both conceptually and operationally.

For our purposes, when considering central bank cooperation in the new context of the BIS, the period can best be divided into three parts: the Great Depression, autarky and war.

##### **The Great Depression, 1931-33**

If “to understand the Great Depression is the Holy Grail of macroeconomics” (Bernanke (2000: 6)), this paper is certainly not about participating in the search. It is enough to recall that most explanations of the length and depth of the 1929-33 slump focus on the structure of the international gold standard and on policymaking. There is broad agreement that policy coordination would have made at least some difference.

The international lending to Austria, Germany and Hungary in 1931 was the first multilateral international action undertaken in response to a financial crisis. Fear of contagion and of a German default on public and private debt provided the rationale for the scheme, which, however, failed. Among the reasons for the failure, scholars include poor understanding of the situation and political conditionality as well as the inadequate timing and size of the loans. Central banks acted both individually and through the BIS, their recently created cooperative agent.

Even though the operation failed to produce the hoped-for results, did the BIS make any difference? Its creation had somehow produced new expectations about collective action by central banks: when Spain contemplated the convertibility of the peseta, it approached Basel, rather than London and Paris individually, for advice and a possible loan. Likewise, as soon as Creditanstalt's predicaments became known, the BIS was involved in studying the Austrian situation and played a role of its own in the syndicated central bank loan that followed. It also advised on and participated in lending to Germany. Thus, the new multilateral player was drawn into the game in its own right. It is likely that it made some difference in advising, providing information to lenders and coordinating loans. In the exasperated nationalistic environment of the time, experts from an international organisation were better received than government emissaries. The BIS managed to have a loan to Austria from the major European central banks approved and broadly organised within a week of the outbreak of the crisis. In financing and advising Hungary, it was even speedier. Subsequent delays were of a political nature.

For the rest, in a context of overall failure, it is difficult to keep the assessment of the BIS action within the narrow limits of the technical options open to it. The BIS was too small to make a quantitative difference in international lending (Baffi (2002)). Politics stood in the way of the effectiveness of its coordinating activities. Arguably, adherence to the mainstream economics of the time made the BIS a poor policy advisor, even though some of its people on the ground understood the banking structure of Central Europe better than bankers in London and New York.

##### **Autarky, 1933-39**

There are four main reasons why, in the 1930s, central bank cooperation at the BIS was reduced to research and exchange of information: strained political and economic international relations; a

destructured international monetary system; diminished central bank power and prestige; and political (and intellectual) disagreement on how to reform the system of international payments.

In spite of their division among gold standard and non-gold standard countries and of the fact that what little cooperation existed took place on a strictly bilateral basis, central bankers continued to appreciate the services provided by the BIS. They kept meeting regularly in Basel, and taking advantage of the Bank for settling payments and making gold transfers. Besides providing those services, the BIS stepped up the collection of statistics, its monetary research, and the training of central bank staff. Moreover, it elaborated and disseminated its own ideas about reforming the gold standard (it would not consider floating rates as a permanent option).

Can regular personal intercourse and day-to-day technical cooperation be dismissed as irrelevant in the autarkic context of the 1930s? The answer depends on expectations. If one believes that international multilateral cooperation was hardly natural in the first part of the 20th century, then even the minor exception to the rule provided by the BIS might be seen as a positive development. This is particularly true if one takes a longer-term perspective. Effective institutions take time to develop. Had the BIS suffered the fate of other interwar international organisations, it would not have been available for central bankers after the war, when more favourable conditions for multilateral cooperation finally prevailed.

### **War, 1939-45**

Oddly enough, one can plausibly speak of wartime low-key cooperation among BIS central banks of enemy countries. As they shared an interest in keeping the BIS alive, central banks cooperated, even against the wishes of their own governments, to create the conditions for the BIS to survive the war. Central banks believed that the expertise, networking and assets of the BIS would turn out to be useful in the eventual reconstruction of the international monetary system, in which they hoped to play a substantial role. They all also tacitly agreed on the desirability, even in wartime, of an observation post on international monetary conditions, accessible to all, and of a place where informal, tenuous links might be maintained even amongst belligerents. This was, after all, the reason why both sides accepted the existence of neutral countries even in a context of total, unrestrained conflict.

In order to keep the BIS alive during the war, central banks maintained communication lines open amongst themselves, through neutral emissaries - a form of central bank diplomacy often frowned upon by their respective governments. As a result, the BIS was the only international organisation to stay active during the war, trying as best as it could to adhere to a self-imposed neutrality code. This, however, did not prevent it from making blunders, reproached and used against it at the end of the war (Toniolo (2005)).

## **V. Enhanced central bank cooperation (1950-73)**

The BIS emerged from the war a small institution with apparently no or only a meagre future ahead. Owing to a mix of misinformation and truly objectionable aspects of its wartime conduct, the Basel institution was strongly opposed by the American Treasury and frowned upon in influential British circles. The United States fought hard at Bretton Woods for the liquidation of the old "International Bank", which they saw as compromised with the past, too European in outlook and, in any event, made irrelevant by the creation of the new twin institutions (the IMF and the World Bank). Central banks - with the support of Lord Keynes and thanks to the complex legal setting put in place in 1929-30 - succeeded in fending off the assault on the BIS but were themselves too busy with reconstruction to make much use of their cooperative tool in the immediate postwar years. Moreover, economic (including monetary) policy was by then in the hands of governments, with central banks in many countries confined to the role of high-profile departments of the Treasury. In these circumstances, little central bank cooperation took place in the second half of the 1940s. Nevertheless, the competent body of international civil servants based in Basel took care of settling the problems inherited from the war (of paramount importance was the restitution of looted gold), reviving the BIS's banking activities and strengthening its balance sheet, thus preparing for future central bank cooperation.

The monetary and financial environment in which the BIS would thereafter support central bank cooperation was profoundly different from anything seen since its inception. On the monetary side, Bretton Woods saw the establishment of a fixed but adjustable global exchange rate regime, with gold convertibility a tenuous constraint for a system that de facto evolved into a dollar standard. On the financial side, the system allowed for controls on foreign exchange transactions and on capital flows, so as to retain autonomy for domestic macroeconomic policies. Domestically, these controls were generally complemented by a complex web of regulations/constraints designed to reduce cost of funding for governments, to allocate credit and to operate monetary policy. The overall objective was to combine progressive trade liberalisation with stable exchange rates, so as to avoid the perceived “chaotic experience” of the interwar years, while at the same time allowing autonomous national policies to try to achieve full employment. Exchange rate parities were to be adjusted only in cases of fundamental disequilibrium.

In this environment, central bank cooperation largely focused, initially, on re-establishing the conditions for international convertibility of currencies and, subsequently, on supporting the system once it came under strain. Despite their loss of formal independence, thanks to their technical expertise and operational capabilities over time central banks regained a significant degree of influence, even though the ultimate policy decisions rested with treasuries. For the rest, in a context of domestic financial repression and constraints on external capital flows, financial stability concerns did not figure prominently on the policy agenda. The prudential framework put in place in the 1930s would continue to remain largely dormant for a while longer.

The discussion of the role of the BIS during this period is best conducted under three headings: its support for intra-European payments on the road to currency convertibility; the efforts to keep Bretton Woods afloat through coordinated international lending and the creation of a gold pool; and the initial steps taken to address emerging concerns about the rapid growth of the Eurocurrency markets. We leave for the next section a description of the work done at the BIS in support of closer monetary cooperation in Europe. While this work started with the setting up of the Committee of EEC Governors in 1964 in Basel, the efforts gathered momentum in the 1980s.

### **Technical skills at the service of cooperation**

It was to a large extent American aid, particularly the Marshall Plan, which created the incentives for postwar European cooperation. The OEEC was set up in Paris as a forum for discussion and coordination of the use of American grants and loans. Soon, however, its scope was broadened, as it became clear that one of the main postwar economic problems concerned the revival of Europe’s international trade. Given the low level of European gold and dollar reserves, Europe’s trade deficits with the US could be financed only with American credit. This was the main economic purpose of the Marshall Plan. But intra-European trade also needed reviving. This meant the gradual dismantling of the myriad of barriers to trade erected from the early 1930s onward. As a precondition for freer trade, the intricate system of bilateral (basically barter) payment agreements had to be relaxed. Free convertibility of European currencies into each other and the dollar, while explicitly set as a policy target, was deemed to be premature.<sup>13</sup> A viable alternative seemed to be the creation of a managed system of intra-European settlements (basically an international clearinghouse).

The September 1949 devaluation of the pound and the re-alignment of the other main currencies were conducted in a coordinated fashion, reflecting the new postwar cooperative mood, and moved exchange rates closer to the purchasing power parity of European currencies. The stage was thus set for trade liberalisation and a form of multilateral settlement. These were bold political moves for European governments to make, as long years of tight bureaucratic controls on trade and foreign exchange had created well entrenched vested interests. The matter, therefore, stood firmly in the hands of governments, whose representatives met at the OEEC. Central banks were required to provide the technical backing.

The European Payments Union (EPU), created in September 1950 by 18 countries, was the cooperative tool for introducing intra-European multilateral settlements. Within the EPU, bilateral

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<sup>13</sup> Eichengreen (1993) believes that conditions for convertibility existed in the early 1950s - an opinion that was quietly shared in Basel at the time.

balances were automatically offset, so that each country had one single balance, debtor or creditor, towards the EPU rather than towards its individual trading partners. At the same time, the Union extended credits to debtor countries, drawing from a fund created by surplus balances and by an initial allocation of dollars from the US Treasury.

The BIS was appointed Agent for the Union, in charge of managing multilateral settlements. The Bank had by then accumulated unrivalled experience in performing trustee and agent functions, a non-negligible part of its original mission. It had also established a system for cross-reporting by central banks of their own payments balances, which provided the technical basis for the EPU network. Thus, besides again acting as a well established forum for confidential exchanges among central bankers from the EPU countries, the BIS made a significant technical contribution to the success of the scheme.

The EPU was one of the great success stories in international monetary cooperation. Its aim was fully realised with the introduction of current account convertibility for European currencies, at fixed dollar-gold parities, at the end of 1958. The reasons for this success reside mostly in the political climate of the decade, underpinned by the strong American stance in favour of multilateral Atlantic and European cooperation.

It is in this climate that, for the first time since 1930, the United States took a very positive view of the BIS. M S Szymczak, a Federal Reserve Board governor, argued that the BIS was “likely to provide the most practicable way in which central bankers of the ‘Atlantic community’ could find regular occasions for informal discussions on matters that concern them as members of the community” (Toniolo (2005)). The return of the Americans to Basel considerably enhanced the prospects for cooperation at the institution.

### **Keeping Bretton Woods afloat**

With the introduction of current account currency convertibility at the beginning of 1959, the postwar international monetary system appeared to be set on a steady state based on fixed dollar exchange rates, a gold dollar anchor, multilateral organisations intended both to regulate and to facilitate the operation of the system, and rules for parity adjustment.

Even before convertibility was formally introduced, experts believed that international monetary cooperation should be stepped up after its introduction. A report by the Federal Reserve Bank of New York argued that the “Paris set-up (ie the OEEC)” was created to deal with “an inconvertible world whereas Basel was an ideal set-up for a convertible world”. “From the point of view of finance - the Report went on to say - the arguments for its existence are not so cogent, but as a vehicle for providing monthly gatherings of central bank governors, and others, the arguments for it are overwhelming. The BIS is perhaps the most effective vehicle of cooperation amongst central banks in the world today.”<sup>14</sup>

In the 1960s a large number of international monetary decisions originated at the “Basel club”. At the informal Governors’ meetings matters were discussed and often decisions made (to be subsequently formalised at official meetings). The Gold Pool, The Sterling Group arrangements, the IMF General Arrangements to Borrow (GAB) and the G10 multilateral surveillance exercise all originated at the Basel club, which also played a role in helping to shape the reform of the international monetary system. The BIS supported an increasing number of official and semi-official “groups”, sometimes made up of both government and central bank officials, through secretariat services and analytical background work. Since the matters addressed by these groups often overlapped, as did participation, Basel also provided informal coordination among them. Thus, the Basel club came to be an effective locus of financial diplomacy.

According to Bank of Italy Governor Guido Carli, in the 1960s the BIS played the dual role of decision-maker and executive organ. Decisions were made “by the group who met on the afternoon and evening of the day before the Board official meeting”. The operative side consisted in executing those

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<sup>14</sup> Letter from Szymczak to Allan Sproul, 11 September 1950, quoted in Toniolo (2005: 320).

decisions, subject to government approval, for instance in the case of the support to the pound and the Gold Pool (BIS (1980)).

There are many reasons why the 1960s turned out to be among the heydays of central bank cooperation at the BIS. First, the very nature of the international monetary setup (including the implicit political pact upon which it was based) required constant, almost day-by-day coordinated intervention on the currency and gold markets. Second, with the resumption of convertibility, the role and prestige of central banks was enhanced, not least because of the high skill content of monetary policymaking required by the new environment. Third, the decision-making processes at the larger multilateral institutions (the IMF and World Bank) were often more complex. Finally, the BIS was host to the representatives of the countries that then mattered for international policymaking (soon nicknamed the G10), within a setting that provided confidentiality, technical support and, when needed, the backing of independent financial weaponry.

We now turn to a brief description of the main central bank cooperative efforts undertaken in the 1960s.

### *Support for the dollar*

Soon after the introduction of current account convertibility, the US Government stepped up bilateral economic diplomacy aimed at persuading the governments of the European surplus countries to fulfil their responsibilities in the adjustment process. In particular, the Europeans were urged to avoid sterilisation of dollar inflows, to liberalise imports and, most of all, to show their confidence in the system by steering clear of gold conversion. It soon appeared, however, that there was a limit to what bilateral diplomacy could achieve. The September 1960 annual meeting of the IMF registered concern about the dollar's exchange rate. Kennedy's election, two months later, did little to reassure markets. It is in this context that the United States "re-discovered" the BIS, 30 years after its short-lived enthusiasm about the "International Bank".

In January 1961, Alfred Hayes - President of the Federal Reserve Bank of New York - attended the Governors' meeting in Basel for the first time. His presence alone produced a more relaxed climate of opinion among European central bankers.

In the following months (and years) both sides of the Atlantic came to terms with the notion that no drastic measures for a structural adjustment of the US balance of payments would be politically acceptable. Ruling out a "permanent solution" to the dollar-gold convertibility problem, all parties concerned felt it imperative to gain time and allow the system to remain viable for as long as possible. Gaining time basically meant exercising imagination on how best to "recycle" European surpluses by various forms of lending to the United States. To this end, Basel became the focal point for operational international coordinated action in support of the stability of exchange rates. The FRBNY participated regularly in the BIS monthly meetings, highlighting, as Coombs put it, "a shift to a low-key, cooperative search for the right answers" that shaped "the course of international financial cooperation for the [following] decade" (Coombs (1976)). From the BIS perspective, Gilbert saw a "spirit of trust and cooperation" being established through the "expertise, frankness and concern for the problems and opinions of other countries" of people like Roosa and Coombs (Gilbert (1980)).

### *The Gold Pool*

For dollar-gold convertibility to be credible, it was essential that gold traded at the London free market close to the official price at which the United States was committed to convert dollars into gold on demand from central banks. When in late 1960 the free market price of gold shot up by over 15% above the official price, it was first suggested at the BIS Governors' meetings that a scheme should be created by central banks to buy and sell gold in the market in order to keep the free and official prices close to each other. The suggestion was at first dismissed, but the BIS began to monitor the London gold market closely.

In the autumn of 1961, as concerns about the free market gold price increased, the US Secretary of the Treasury revived with the UK Chancellor the idea of joint central bank operations on the London gold market. Discussions on the Gold Pool scheme were first conducted between the two governments but when the continental Europeans had to be brought on board, the Americans were easily convinced by the British to turn to Basel's multilateral venue. The BIS governors agreed to give the Gold Pool a try. Europe's central banks together matched a US contribution to a pool of gold made available for sales on the London gold market. The Bank of England acted as the Pool's operative branch, with its operations being reviewed on the occasion of the BIS Board meetings. It is perhaps



noteworthy that the BIS commanded sufficient communality of purpose and mutual trust for the scheme to be agreed there and then, without a formal written agreement.

The creation of the Gold Pool was sufficient to calm the market, so that interventions were soon discontinued. At the same time, central banks agreed to continue to abstain from buying gold in the free market on an individual basis; the task was left to the Pool itself, which would thus act also as a purchasing syndicate. The running of the Gold Pool settled into a routine pattern. The Bank of England reported on a monthly basis to a group of experts from the participating central banks, who met at the BIS at regular intervals. The BIS also provided secretariat services to the Gold Pool, feeding the group of experts with more complete and reliable statistical data on world gold production and consumption than had been previously available.

The Gold Pool is a perfect example of multilateral cooperation facilitated by the existence of the BIS, which played a crucial role in both creating and supervising it. The Pool performed well in smoothing price gaps as long as the underlying fundamentals did not undermine its credibility as a price setter. Until about 1965 the very existence of the Pool contributed to keeping the free price of gold close to the official one. In fact, the Pool bought considerable amounts of gold, which was allocated pro quota to participating central banks. After 1965, however, the Pool navigated in increasingly stormy waters. With sales far outweighing purchases, participating central banks accumulated losses on their joint gold operations; eventually, they felt unwilling to sustain them. In 1967 France withdrew from the Pool. In March 1968 the Gold Pool central banks announced that they would no longer supply gold to the free market but only buy and sell the metal at the official price among themselves (Toniolo (2005: 421)).

#### *The Sterling Group arrangements*

Throughout the 1960s, the weakness of the pound sterling, the junior reserve currency in the system, remained an almost constant threat to exchange rate stability. As Gilbert put it: “whenever sterling might be devalued, confidence in the dollar price of gold could be expected to evaporate and a large rise in the market demand for gold, as well as in central-bank conversions of dollars for gold at the US treasury, could be anticipated” (Gilbert (1980: 135)).

In 1961, following the DM revaluation, and again in 1963, the pound was hit by heavy sales. On both occasions it was supported by international lending arranged on a bilateral basis. When the pound again came under fire in 1964, the Bank of England collectively sounded out the BIS governors at a Basel meeting about a joint support package; speed and absence of conditionality suggested looking to Basel for assistance rather than going to the IMF (Toniolo (2005: 390)). A \$3 billion facility was granted by eight central banks, under the auspices of the BIS.<sup>15</sup>

In 1966, a first Sterling Group Arrangement was finalised. It consisted of a line of credit opened to London by nine central banks and the BIS. The latter acted as principal for the group. The novelty of the Arrangement was that it was not made in response to an emergency but rather created a permanent stabilising buffer for sterling, justified by its role as reserve currency. On this occasion, the coordinating role of the BIS was again particularly in evidence.

After the 1967 devaluation of the pound, the Bank of England worked directly with the BIS to prepare the blueprint for a second Sterling Group Arrangement aimed at keeping the pound at the new fixed parity. In June 1968, a \$2 billion “safety net facility” was finalised between the Bank of England and the BIS acting on behalf of 12 central banks. The facility consisted of foreign-currency swaps made available by the BIS to the Bank of England for a three-year period.

These are just the most relevant cases of multilateral central bank cooperation arranged at or through the BIS in the 1960s and aimed at maintaining the system of fixed exchange rates envisaged at Bretton Woods for as long as possible. After 1968, however, these efforts looked increasingly doomed to failure, the US began a policy of “benign neglect” of the dollar and multilateral cooperation to prop up the system lost momentum.

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<sup>15</sup> As noted by Hirsch (1965: 103), quoted in James (1996), “In twenty-four hours the central banks created more international liquidity with fewer questions asked than the most expansionist Triffinite would ever suggest for the IMF”. The episode is described in detail in Coombs (1976).

## **The emergence of the Eurocurrency market**

During the 1960s, European central bankers began to be concerned about the rapid growth of the so-called Eurocurrency markets - largely dollar-denominated deposits held by banks outside of the United States, not least in London. At this time, the concerns focused primarily on the monetary policy implications of these markets, including the possible loss of monetary control and the fuelling of speculative pressures on exchange rates. The market was the clearest sign of how increased mobility of capital flows could potentially add to strains on the Bretton Woods system. There were, however, also budding questions about its impact on banking stability, given its largely unregulated nature - an interest that would become much more important after the end of the Bretton Woods era.

Central banks thus began to improve the statistical information about this hitherto largely unknown phenomenon by pooling at the BIS the information available to individual countries. In 1964, central banks presented to the G10 deputies a first report on "The eurocurrency market and the international monetary system". At the time, central banks felt satisfied that the eurodollar threatened neither macro nor banking stability and only required closer monitoring, as "anything that grows by 25-40 per cent per annum" would call for (Toniolo (2005: 459)). In the following years, they quietly also intervened in the market to try to keep interest rates paid on eurodollar and domestic-currency deposits within a desirable interval. From the early 1970s, however, concerns about the Eurocurrency market were frequently voiced in the press. Central banks refocused their interest on the issue and in April 1971 established the Standing Committee on the Euro-Currency Market. At the time, they also announced an agreement not to deposit their reserves in the market (McCauley (2005)).

## **VI. Post-Bretton Woods (1973-2005): from monetary to financial stability**

The collapse of Bretton Woods deeply affected central bank cooperation and, therefore, the life of the BIS. Floating rates and rapidly increasing international capital mobility influenced the objectives of cooperation, its forms and instruments as well as its functional and geographical scope.

The objectives of cooperation shifted away from monetary stability towards financial stability. To be sure, neither central banks nor the BIS abandoned their involvement in foreign exchange matters. In particular, they played a significant role in the journey towards a single currency in Europe and a more peripheral one in the few instances of high-profile coordinated foreign exchange intervention. Exchanges of information on international and domestic monetary issues continued to take place and even intensified at the Governors' meetings and other gatherings of experts in Basel. But the balance of BIS activities shifted towards safeguards against financial instability. This evolution gathered momentum with the passing of time, both reflecting and entailing a significant shift in the forms and instruments of cooperation. By the end of the century, the BIS had become one of the main players shaping the so-called new "international financial architecture" (White (2000) and Crockett (2002)).

The BIS continued to perform its core function of facilitator of low-key exchanges of information and views among central banks. But its decision-oriented activities shifted away from operational or "practical fire-fighting" (Baer (1999)) to the design and implementation of policies. In this area, new high-level committees, notably the Basel Committee on Banking Supervision (BCBS) and the Committee on Payment and Settlement Systems (CPSS), played a major role. The process through which these codes and standards were developed and implemented represented an innovation on the previous instruments of international cooperation in the financial field. This is because these codes and standards were not the outcome of internationally legally binding agreements ("hard law") but were voluntarily implemented in national law and regulation, through a mixture of peer pressure and market forces, following informal international agreements among participants ("soft law")<sup>16</sup> (Giovanolì (2000), Crockett (2002) and Giannini (2002)).

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<sup>16</sup> The definition of "soft law" used here is close to, but somewhat more specific than, the one sometimes used in international law. There, "soft law" sometimes has the general connotation of recommendations, guidelines or principles that are not sufficiently specific to have legally binding force. Those recommendations, however, can be and often are issued as part of legally binding international agreements, such as treaties. The term here highlights the fact that the international agreement itself is not legally binding on the parties reaching it. On this, see, in particular, Hillgenberg (1999). An example of a "hard

These developments also inevitably led the BIS to broaden its functional and geographical scope. Functionally, while owned by and working for central banks, the BIS gradually began to provide services for supervisory and regulatory authorities more generally. Geographically, the codes and standards elaborated by the Committees were adopted well beyond their member countries. And beginning in the early 1990s, the institution embarked on a major “outreach” effort designed to involve in its activities an increasing number of countries, and implying significant changes in its governance structure. This marked the transformation of the BIS from what had generally been regarded as a European institution into a global one.

### **Why the shift? The evolving backdrop to cooperation**

As in previous periods, the origins of the evolution in central bank cooperation can be traced back to the changes that took place in the international monetary and financial environment.

Bretton Woods had been a system designed from first principles by governments and largely run by governments. It was governments that ultimately sanctioned exchange rate parities and decided on the broad contours of adjustment processes. For their part, central banks were entrusted with the day-by-day management of international liquidity and acted as the main government consultants on international monetary issues.

The new “system” that emerged in the 1970s was one in which exchange rates, liquidity and adjustment became largely determined by decentralised financial markets, with governments playing a more indirect role. Exchange rates among the main currency areas were left to float; the financing of external positions was predominantly driven by private capital flows; and adjustments were induced by either the threat or the reality of a market reaction. Needless to say, this evolution from a government-led to a market-led system (Padoa-Schioppa and Saccomanni (1994)) did not take place overnight. In fact, it had started well before the breakdown of Bretton Woods, in part contributing to its demise. But by the mid- to late 1990s it was largely complete. The underlying force driving the change was financial liberalisation, both within and across national borders, together with the quickening pace of financial innovation, supported by technological advances in the elaboration and transmission of information. The end result was the “second globalisation” wave of the century.<sup>17</sup>

The new global system, while unique, shared a number of characteristics with its predecessors. With the gold standard it had in common the freedom for financial capital to move unimpeded within and across national jurisdictions. From Bretton Woods it had inherited the governments’ ambition to pursue autonomous macroeconomic objectives based on the management of national currencies. Unlike Bretton Woods, though, it had dropped even the pretence of an external anchor in the form of gold. The floating of exchange rates among the main currency areas was the most tangible sign of the system’s mixed antecedents. It reflected the wish to regain autonomy in the management of the domestic economy, and the growing difficulties in maintaining fixed rates in a world of increasing capital mobility. Efforts to fix rates were limited to regions, notably Europe, or left to countries’ unilateral decisions, notably in the developing world.

The forms of cooperation that developed were the offspring of the new challenges that policymakers faced in this unfamiliar environment and of the mindsets with which they approached them. Cooperation in macroeconomic, and hence monetary, issues followed divergent paths at the global and regional levels. By contrast, financial cooperation inexorably gained ground, evolving from the purely technical to the political and from the core of industrialised countries to the global economy.

#### *Monetary cooperation*

Domestically, the emergence of stagflation in the early 1970s shook policymakers’ long-held beliefs about the workings of the economy and cast doubt on their ability to reconcile full employment with price stability. It also resurfaced long-standing differences of perspective between key countries -

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law” approach would, for instance, be the creation of a World Financial Authority, as advocated by Eatwell and Taylor (2000).

<sup>17</sup> For comparisons between the two globalisation waves, see, for instance, Bordo et al (1999), James (2001) and, especially for the real side of the economy, Feenstra (1998) and O’Rourke and Williamson (1999).

notably the United States, on the one hand, and Germany, on the other - whose historical memories had been deeply scarred by two contrasting defining moments in the interwar period, namely the Great Depression and hyperinflation, respectively. Internationally, a central question for much of the period remained how to address US balance of payments deficits while maintaining world non-inflationary growth: the United States would typically seek to foist expansion on reluctant partners abroad and other countries would expect an equally reluctant United States to retrench, notably by cutting its budget deficits in the 1980s.

Macroeconomic cooperation efforts, for which the informal grouping of the G5/G7 took increasing responsibility, waxed and waned in the light of the evolving political, economic and intellectual backdrop (Volcker and Gyohten (1992), James (1996) and Truman (2003)). A high point was reached at the Bonn Summit of 1978, when the locomotive theory prevailed. But this was soon followed by disillusionment with the real growth results and the subsequent flare-up of inflation. After a lull, by the mid-1980s high-profile multilateral cooperation efforts had largely become limited to coordinated intervention to address perceived large-scale misalignments in the dollar, as exemplified by the Plaza (1985) and Louvre (1987) Accords: macroeconomic policy coordination took a back seat as central banks became increasingly reluctant to sacrifice monetary orthodoxy on the altar of global cooperation. As under the classical gold standard, policymakers became increasingly convinced that the best way of maintaining economic stability was to keep "one's own house in order". Faith in the ability to influence exchange rates through intervention failed to elicit a consensus sufficient to underpin anything other than sporadic actions (eg Galati and Melick (2002), Saccomanni (2002) and Cooper (2005)). The long battle against the Great Inflation, finally won in the 1990s, remained essentially a domestic affair, if in various ways shaped by global conditions,

By contrast, macroeconomic cooperation was intensified at the regional level, notably in the case of the European Monetary System. The establishment of economic and monetary union in 1999 crowned a long period of closer monetary and exchange rate cooperation in the area. The project yielded undoubted economic benefits, not least shielding the area from the episodic financial turbulences in global markets. But its success was above all testimony to the importance of a strong political consensus in this field: from its inception, the project had been first of all political, and only secondarily economic. Moreover, it was underpinned by the willingness to accept German leadership in the fight against inflation (eg Giovannini (1988)). By the end of the period, embryonic signs of closer regional monetary cooperation could be seen elsewhere, including in the Gulf countries and Asia and, in perspective, Latin America.

### *Financial cooperation*

Cooperation in the financial sphere, by contrast, had a more linear evolution. The trigger was the increasing frequency and severity of episodes of financial instability. These emerged particularly in the wake of the liberalisation of financial systems and capital flows, echoing developments that had already been seen under the gold standard and during the interwar period (Goodhart and Delargy (1998), Bordo et al (2001) and Bordo and Flandreau (2001)). These episodes varied in breadth and intensity, variously affecting individual institutions, whole banking systems and countries' external debt.

Learning how to operate in a liberalised and more competitive environment, how to price and manage risks after so many years of financial repression, would inevitably be a long process, for the authorities and market participants alike. Initially, it was the unexpected rapid rise in inflation and efforts to bring it down that caused the major problems. Subsequently, it was booms and busts in credit and asset prices even in the context of low inflation (BIS (1997), Borio and Lowe (2002) and Borio and White (2003)). Especially in emerging market countries, problems were exacerbated by the interaction between volatile global capital flows and macroeconomic or structural deficiencies (eg G10 (1997) and Goldstein and Turner (1996)).

Obviously, not all episodes of financial instability could act as a trigger for cooperation. As long as such instability remained a domestic affair, there was no need. Purely domestic instability played a role only insofar as it raised the authorities' awareness that the challenge was a shared one. But in an increasingly globalised economy, in which financial markets knew no borders, instability could not entirely be contained within national boundaries. If the Eurodollar markets had epitomised this internationalisation as far back as in the 1960s, their subsequent rapid growth during the period in the wake of the recycling of oil surpluses now took centre stage. Even the failure of a single, rather small institution, heavily involved in foreign exchange transactions, could easily spread instability abroad, as shown by the collapse of Bankhaus Herstatt in 1974. The financial difficulties of a sovereign or a

banking system could cause major losses to foreign lenders and investors. And, arguably more than before, problems at the periphery could easily be transmitted to the core, owing to the greater economic weight of the countries involved. The major banking crisis threatened by the sovereign debt crisis of Mexico in 1982 represented a watershed in this domain. Moreover, in a highly competitive international environment, unilateral action by regulators in one country risked putting their firms at a competitive disadvantage. This was all the more so now that other restrictions on financial activity were being, or had been, dismantled; hence the pressure from the regulated firms to ensure a “level playing field”.

Against this background, cooperation followed two trajectories that by the end of the 1990s had fully converged. On the one hand, following the failure of individual financial institutions in the mid-1970s, supervisory authorities and central banks began the long journey to strengthen prudential regulation and the payment and settlement system infrastructure. On the other hand, starting with Mexico’s default in 1982, policymakers also made strenuous, if not very successful, efforts to address emerging market countries’ debt crises. Here, while the central banks played an important technical supporting role, the main decisions were made by national treasuries and coordinated by the IMF. Following the Asian crisis of 1997, these two strands met in the stepped-up concerted attempt to strengthen the “international financial architecture” (Camdessus (1998)). The root cause was the recognition that deficiencies in the financial infrastructure of individual countries could have a first order effect on financial instability, both domestically and internationally (eg G10 (1997)). This heralded a paradigm shift in policymakers’ and academic thinking - one which, paradoxically, was rediscovering lessons already learnt at the time of the gold standard: the macroeconomy and the financial sector were inextricably intertwined.<sup>18</sup>

### **Cooperation at the BIS**

The BIS adapted to this new environment, which implied a shift in the forms of cooperation. The room for global macroeconomic cooperation was somewhat reduced by the central banks’ focus on domestic price stability and by the concern of some of them that cooperation might undermine this stability when it called for expansionary policies at home to correct global imbalances. Moves to strengthen central bank independence to increase their credibility in pursuing price stability limited this room further (eg Simmons (1996)). At the same time, negotiations on tough policy questions took place elsewhere or on a bilateral basis, with the involvement of governments. Even so, the BIS did function as a place where central banks exchanged views, improved mutual understanding of issues of common interest, and influenced the solutions reached. At a regional level, the Bank built on its tradition in support of European integration. Above all, a world of increasingly seamless capital markets, in which international banking and finance played such a pivotal role, was also one which naturally placed central banks, and the BIS, in a prominent position (see also Kahler (2000)). This was so by virtue of their knowledge of payment systems and market functioning, their closeness to the banking sector and their long-standing responsibilities for financial stability, often complemented by banking supervisory functions. In this area, their independence actually facilitated joint initiatives; arguably, it provided a degree of insulation from the political process that helped to keep decisions at a more technical level. Let us consider each area in turn.

#### *Monetary cooperation*

In relation to global exchange rate cooperation, the role of the BIS was one of indirect support. Exchange rates were discussed in the regular meetings, especially by the Gold and Foreign Exchange Committee, at the technical level. And the BIS provided secretariat support for the G7 working group on foreign exchange intervention that produced the Jurgensen Report (1983), which defined the policy consensus of the time on the issue. While concluding that intervention could be useful under certain circumstances in the short run, the report stressed the importance of complementary macroeconomic policies for longer-lasting effects (Truman (2003) and Volcker and Gyohten (1992)). This conclusion

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<sup>18</sup> Contrary to the prevailing macroeconomic approach, it would no longer be possible to evaluate the soundness of macroeconomic policies or the sustainability of external positions without making a thorough assessment of the strength of the financial sector and of global financial market conditions.

was confirmed in a subsequent G7 statement and set the basis for further coordinated policy actions in this area, up to the present day.

The BIS maintained its support for closer monetary cooperation in Europe, resuming a thread that had started with the EPU and had already seen some significant further developments beginning in the 1960s. For it was in 1964 that the Committee of Governors of the Central Banks of the Member States of the European Community had been established. Importantly, contrary to a proposal by the European Commission, the Committee would regularly meet in Basel and not in Brussels, and would not operate under the Commission's leadership - a way for the Governors to underline their wish to retain independent room for manoeuvre. Likewise, the mandate of the Committee, watered down relative to the initial proposals, was "to hold consultations concerning the general principles and broad lines of policies of the central banks" and to "exchange information at regular intervals about the most important measures that fall within the competence of the central banks". Over time, however, the Committee also took over more operational tasks, starting in 1970 with the setting-up of a system to provide short-term financing to address temporary balance of payments deficits and continuing with the operation of the "snake" one year later (Baer (1994)).

In the period following the breakdown of Bretton Woods, the BIS's support for the journey towards closer monetary arrangements in Europe took various forms. The Bank continued to provide secretariat services to the Committee of Governors of the EEC central banks (Baer (1994)), and to host regular meetings of officials that discussed regional and global monetary issues. Notably, the Bank acted as a facilitator for the work of the Delors Committee, whose 1989 Report set the roadmap for EMU, laying out concrete stages to achieve the objective and the general contours of the final goal, taking into account the lessons from the far less successful Werner Report from 1970 (Baer (1994) and Lamfalussy (2005)).<sup>19</sup> The new Report also set the basis for the Statute of the European System of Central Banks, subsequently approved almost without change. Operationally, the BIS provided the technical infrastructure for the European exchange rate arrangements, starting in 1973 with the agency function for the European Monetary Cooperation Fund. And it also acted as clearing agent for the "private ecu", a claim issued by banks mimicking the composition of the official ecu basket, the fulcrum of the exchange rate mechanism adopted in 1979.

Did the BIS also make a material contribution to the global fight against inflation? Here, the assessment is necessarily more speculative. True, operationally, the fight against inflation was not founded on policy coordination. Even so, the regular and frank discussions among governors and senior officials that took place in Basel arguably helped to develop a common understanding of the problem, to consolidate the determination to address it in difficult conditions, and to elaborate adequate solutions.

### *Financial cooperation*

The BIS's role in cooperation in the financial sphere involved both crisis management and crisis prevention. The crisis management role echoed its activities during 1931. Crisis prevention aimed at strengthening three core elements of the financial system, namely institutions, payment and settlement systems, and market functioning. These two strands evolved in complex ways, sometimes quite independently, at other times crossing each other's path as a result of common catalytic events, normally in response to crises. For these reasons, in what follows, rather than proceeding strictly chronologically, we discuss each aspect in turn.

The operational aspects of crisis management largely took the form of bridge financing to countries experiencing financial difficulties, generally intended to prefinance disbursements by the IMF. The financing was granted with the backing and guarantee of a range of central banks, often comprising the G10. In contrast to its lending in the 1930s, the BIS rarely took on credit risk. The catalyst for this type of operation was the Mexican crisis of 1982. The crisis had largely caught policymakers by surprise (but see below). The BIS could thus exploit its comparative advantage in speedy execution, based on the mutual trust among governors honed by the regular meetings, and its fully functional operating infrastructure (Volcker and Gyohten (1992)), not least as the conditions for an IMF

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<sup>19</sup> Governors served on the Committee in a personal capacity alongside three external experts, including Alexandre Lamfalussy, then BIS General Manager. The two independent rapporteurs were Tommaso Padoa-Schioppa and Gunter Baer, the latter from the BIS.

stabilisation loan were not yet in place (Cooper (2005)). The Mexican bridging loan was just the first of a long list of similar operations, several to help contain the shockwaves from the Mexican crisis,<sup>20</sup> and others in subsequent episodes, including Mexico and Argentina in 1995, at the time of the Tequila crisis, and Thailand in 1997, during the Asian crisis. Special disbursement procedures introduced by the IMF in the late 1990s seemed to remove the need for BIS prefinancing. Nevertheless, it was felt that multilateral support packages of this kind could on occasion reduce the risk of a financial crisis in one country spreading elsewhere. This was the case with the last (and largest) BIS-coordinated package, granted to Brazil in 1998 to supplement, rather than prefinance, IMF lending, with the intention of boosting market confidence. The BIS applied no policy conditionality to this type of lending and remained reluctant to tie up its resources for long (eg BIS (1984)).

Following the failure of Bankhaus Herstatt and Franklin National Bank of New York in rapid succession in June and October 1974, in December that year the G10 governors established the BCBS, at the time known as the Committee on Banking Regulations and Supervisory Practices. The Committee brought together for the first time central banks and banking supervisory authorities (in those cases where supervision was not performed by central banks). The initial motivation for establishing it was to exchange information on the condition of internationally active banks, since at the time these were not providing consolidated statements of their activities (Kapstein (1996)).<sup>21</sup> Naturally, the proposal came from the Bank of England, with London playing host to hundreds of foreign banks operating in the most active segment of the euromarket. No-one could have imagined at the time, though, that the Committee would, over the years, become the core body influencing banking supervisory standards worldwide.

The Committee's evolution was marked by several milestones. Reflecting its original purpose, it started with a low-key agreement allocating cross-border supervisory responsibilities among member authorities ("the Concordat") in 1975, closely followed by the principle of home country consolidated supervision.<sup>22</sup> But it rapidly extended its activity to developing good practice guidelines and then standards in all areas of banking regulation and supervision. The first landmark agreement was the development of minimum capital standards in 1988 (Basel I), designed to raise banks' cushions against failure and to adapt them to the growing off-balance sheet exposures. In some respects, the agreement was a distant child of the Mexican debt crisis, since US Congress's insistence on tighter capital standards for US banks as a quid pro quo for granting higher resources to the IMF and its concern with avoiding a loss in US banks' international competitiveness played a catalytic role (Kapstein (1991)). A second landmark agreement was the Core Principles for Effective Banking Supervision in 1997. In this case, the catalyst was the Mexican crisis of 1995 and the contagion it caused, which highlighted the need to strengthen banking systems in emerging market countries. The Core Principles were designed as a model for banking supervision regardless of the specifics of individual banking systems. In subsequent years, they were adopted by supervisors across the world. A third landmark was the revision of minimum capital standards in 2004, known as Basel II. This was in part motivated by the need to adapt the previous, admittedly coarse, standard to advances in risk management techniques, which had encouraged regulatory arbitrage. Beyond individual measures, though, what makes the Basel Committee important is that its processes set an example for international cooperation efforts of other regulatory authorities in the financial field (Zaring (1998); and see below).

The intellectual if distant origins of the CPSS, too, go back to the disruptions caused to foreign exchange settlements by the failure of Bankhaus Herstatt. The episode raised awareness of the critical, if underestimated, role of wholesale payment and settlement systems in securing financial stability. In contrast to the gold standard period, when concerns with payment systems had largely pertained to disruptive shifts between bank deposits and cash, now they focused entirely on the credit and liquidity risks incurred in the process of executing transactions (Borio and Van den Bergh (1993)).

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<sup>20</sup> The Mexican debt crisis led to the rescheduling of two-thirds of the outstanding debt of 25 developing countries (Lamfalussy (2000)).

<sup>21</sup> In fact, the press communiqué announcing the establishment of the Committee in February 1975, at the time of its first meeting, simply stated that its objective was "to assist the Governors in their continuing work of surveillance and exchange of information".

<sup>22</sup> The Concordat was subsequently revised and tightened twice, in 1983 and 1991, following the failures of Banco Ambrosiano and BCCI, respectively.

The reason was the literal explosion of gross payment and settlement flows associated with the quantum leap in financial activity, a distinguishing feature of the second globalisation wave of finance compared with the first. As guardians of domestic payment systems, as active participants and as suppliers of a risk-free settlement medium, central banks were in an ideal position to take the lead in joint action.

The forerunner of the Committee was the Group of Experts on Payment Systems, established in 1980. But it was not until 1990 that standard setting work started in earnest, as the CPSS was established following a report setting principles for wholesale net settlement systems (the “Lamfalussy Report”). Thereafter, the Committee continued its activities, analysing issues of common concern, setting standards and encouraging the adoption of risk mitigation techniques by the private sector (BIS (1994) and Borio (1995)). The latest such example was the establishment of CLS in 2003, a private sector scheme aimed at reducing the settlement risk in foreign exchange transactions - the risk originally highlighted by Herstatt’s failure some 30 years previously (Galati (2002)).

Following the end of Bretton Woods, the concerns of the Euro-Currency Standing Committee gradually shifted from monetary issues towards financial instability and its focus shifted from the euromarkets per se to market functioning more generally. In the mid-1970s the Committee improved the coverage of its international banking statistics to cast light on the rising exposure of banks to the developing world. The statistics started being published in 1974, and in 1978 were complemented by information on the exposures’ maturity structure. These figures revealed the extent of the massive growth in countries’ indebtedness and its increasingly short-term character, which was sowing the seeds of the subsequent crisis. By 1978, the *BIS Annual Report* was drawing attention to the risks involved. In the meantime, behind-the-scenes efforts were being made by the BIS General Manager of the time, Alexandre Lamfalussy, with the agreement of the G10 governors, to encourage banks to exercise greater prudence in their lending, but to little effect.<sup>23</sup> Once the Mexican crisis did erupt, the Committee further upgraded the coverage of the statistics. Improvements were again made in the wake of the Asian crisis of 1997 (Wooldridge (2002)) and have continued to the present day.

In addition, the Committee took the lead in the study of market functioning generally, with specific attention to the implications of financial innovations. The first study in this domain was the “Cross Report” in 1982, a key reference at the time for the understanding of derivatives markets. Several subsequent studies laid the basis for the development of statistics for OTC derivatives as well as the FX markets. Improving the flow of information to the markets so as to contribute to their smooth functioning has been a leitmotiv of the Committee since its inception. This has included, inter alia, key work aimed at improving the disclosure of official foreign exchange reserves in 1999, conducted jointly with the IMF and subsequently incorporated into the SDDS (Special Data Dissemination Standard). Over time, the Committee systematised its monitoring of global markets with a view to identifying potential vulnerabilities. Partly to reflect this shift, in 2000 it was renamed the Committee on the Global Financial System (CGFS).

With the Committees active across a range of areas relevant to the strengthening of financial systems, it was not surprising that, following the 1997 Asian crisis, they became more closely drawn into efforts to shape the new international financial architecture. Two developments epitomise this change. First, when in 1999 the G7 established the Financial Stability Forum (FSF), to help coordinate and catalyse initiatives, the BIS was represented on it in various forms. The FSF brought together senior representatives of central banks, supervisory authorities and finance ministries alongside international regulatory bodies and international financial institutions. All three Committees as well as the BIS had separate seats at the table; in addition, the BIS hosted the FSF’s secretariat and gave the body its first chairman, Andrew Crockett, at the time BIS General Manager (albeit serving on the FSF in a personal capacity). Second, the core principles issued by the BCBS and the CPSS became part of the set of 12 codes and standards seen as critical for the new architecture.

From the viewpoint of the instruments of cooperation, probably the most interesting aspect of the workings of the BIS-based Committees, pioneered in the financial regulatory field by the Basel Committee, has been the reliance on “soft law”. Setting standards through non-binding agreements reached by national authorities, implemented largely through peer-group pressure within national

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<sup>23</sup> These efforts, based on a checklist of questions drawn up by Arthur Burns, Chairman of the Fed at the time, are discussed in detail in Lamfalussy (2000).



jurisdictions, possibly after adjustments to the local law, and with the support of market forces, has become the norm for most of the standards underpinning the new architecture. Arguably, soft law is particularly well suited to financial matters, where it can provide a balance between quality, speed, flexibility and efficiency, on the one hand, and ownership and accountability, on the other. This balance is necessary for the subsequent acceptance and implementation of the standards. Financial arrangements are highly technical, evolve quickly and differ considerably across countries, reflecting different historical experiences, cultures and legal traditions. Working together, national experts are in a good position to ensure the quality of the regulatory framework. Moreover, accountability of the experts to the national political institutions and implementation through peer-group pressure can foster close ownership.

While soft law has allowed a solid body of codes and standards to be put in place, as the importance and geographical reach of the task have grown, some questions have begun to emerge. There have been calls for greater inclusiveness. Notably, the Basel Committee process was initially designed for internationally active banks, not necessarily for setting standards with a global reach. In addition, the process has become more politicised, as national legislatures have taken a keener interest in its outcomes, and sometimes even raised issues about the degree of accountability.<sup>24</sup> The Basel Committee has been adjusting to the new environment, especially by intensifying and broadening its dialogue with regulatory authorities beyond member countries as well as with the industry and by greatly increasing the transparency of the process. The merits of the “soft law” approach in the financial area have been highlighted by the recent move within the European Union to adopt a framework for regulatory standard setting that in some respects resembles the one used by the Basel Committee (the so-called “Lamfalussy approach”), with a clearer distinction between primary and secondary legislation and a more intense and broader consultative process than in the past (Lamfalussy (2001)).

#### *A broadening geographical and institutional reach*

The increasing breadth of the activities performed by the BIS during this historical phase naturally went hand in hand with a functional and geographical widening of its client base.

Functionally, the shift in focus towards financial stability meant that the BIS provided an increasing range of services to non-central bank supervisory authorities. The Basel Committee was just the first case in point. Accordingly, partly in order better to reflect the shift of supervisory responsibilities away from central banks in some key jurisdictions, in 2004 the Committee began to report directly to a body bringing together the governors and heads of banking supervision of member countries. In addition, in 1999 the BIS set up the Financial Stability Institute, which has largely concentrated on disseminating best practice and providing training services to supervisory authorities. And in 1998 and 2002, respectively, the BIS began to host, although without providing secretariat services, the International Association of Insurance Supervisors and the International Association of Deposit Insurers.<sup>25</sup>

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<sup>24</sup> The issue of the “accountability” and “democratic deficit” of international financial institutions has risen to prominence in the wake of the second globalisation wave; given space limitations, it is not possible to do justice to it in this short essay. For a detailed discussion of these issues see, in particular, Keohane and Nye (2001) and Kahler (2004). Within this broader debate, a specific question has been whether “soft law” processes such as those typified by the Basel Committee, based on networks of sub-government agencies, are more or less accountable than those enshrined in “hard law” processes such as those that underlie the operation of the WTO or IMF. Those who see legitimacy arising from the operation of governments, as the supreme representatives of sovereign nation-states in the international arena, tend to argue that hard law processes are more accountable, and regard with some suspicion the room for manoeuvre afforded to the agencies (eg Keohane and Nye (2001) and, in particular, Alston (1997) and Picciotto (1997)). By contrast, those who favour a more “disaggregated” notion of the state and sovereignty and allow for the legitimate direct operation of transnational networks at sub-government level in the international arena argue that the latter can afford some advantages also from the perspective of accountability (Slaughter (1997) and (2004)). In the specific case of central banks, their delegated “independence” in the domestic context naturally extends to their international operations. While this independence is largely intended to insulate their monetary policy functions (eg Cukierman (1992) and Berger et al (2001)), similar arguments have been put forward also for financial supervisory functions and hence supervisory authorities more generally (eg Quintyn and Taylor (2003)). This raises interesting questions about the meaning and substance of accountability in these situations, about the balance between autonomy and accountability, and about the trade offs that might arise between “effectiveness” and “politicisation” (see, for instance, De Gregorio et al (1999), who argue for reduced oversight of the IMF by national governments, by analogy with national central banks).

<sup>25</sup> The cooperative efforts aimed at preventing systemic strains associated with computer failures at the turn of the century are another example of the broadening range of BIS services. In 1998, the Basel Committee, the CPSS, IOSCO (International

Geographically, the changes were even more extensive, as the Bank came under growing pressure to become more global. On the “push” side, the establishment of the ECB meant that part of the activities, including purely banking ones, previously centred in Basel moved to Frankfurt. On the “pull” side, the growing weight of emerging market countries in the world economy acted as a powerful magnet for an institution whose policy setting functions were already extending their geographical reach. The challenge the institution faced was how to become more global while at the same time retaining that “club-like” atmosphere so much treasured by its founders. The strategy followed included changes in the composition of the Board,<sup>26</sup> extension of membership, broader participation in its various activities, a rebalancing of the analytical work towards the emerging regions of the world, and greater physical proximity through the opening of representative offices. By the end of the period, the range of central banks participating in BIS meetings had been greatly expanded, the number of shareholding central banks had risen from 32 in the early 1990s to 55, and the Bank had opened representative offices for Asia and the Pacific in Hong Kong SAR (1998) and for the Americas in Mexico City (2002). Partly echoing its technical services in support of European monetary integration, in 2003 the BIS started to provide assistance to joint financial efforts by central banks in Asia. This took the form of managing ABF1 (Asian Bond Fund, 2003) and acting as administrator for ABF2 (2005), a dollar and a local-currency bond fund, respectively, set up by EMEAP central banks to encourage the development of bond markets in the region (Ma and Remolona (2005)).

## Conclusions

This paper has investigated three main issues: how have changes in the international monetary and financial system shaped the objectives and tools of central bank cooperation? Under what conditions could central bank cooperation flourish and be effective? Did the existence of the BIS make any difference in its effectiveness? It is now possible to pull together and summarise the partial answers hinted at in the various parts of the paper.

### Targets, tools and intensity of central bank cooperation

While the tasks of cooperation have consistently been the pursuit of international monetary and financial stability, the definition of these tasks, their relative importance and mutual interaction have evolved alongside the global monetary and financial regimes, international relations and developments in economic thinking.

Under the gold standard, monetary and financial stability were perceived as largely coincident for practical purposes. Monetary stability was broadly identified with gold convertibility. And financial instability could and did threaten gold convertibility. In a financial environment characterised by open financial markets and the absence of a framework for prudential regulation, authorities responded to monetary and financial instability by bilateral emergency liquidity assistance. The pursuit of a generalised reintroduction of the gold standard in the 1920s induced the first attempts at multilateral central bank cooperation. The creation of the BIS also responded to the need for an institutional and permanent approach to central bank cooperation. The BIS received its baptism of fire during the international financial crisis of 1931, when the battle was fought, and lost, with the old weapons of international emergency lending. It was then, however, that experts at the BIS realised the limitations of the instrument, given the complex links between Central Europe’s underlying banking problems, liquidity crises and exchange rate stability.

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Organization of Securities Commissions) and the IAIS (International Association of Insurance Supervisors) set up the Joint Year 2000 Council in order to ensure high-level attention to the Year 2000 challenge and promote a coordinated, consistent approach across the financial sector regulatory community. The secretariat of the Council was provided by the BIS. While its activities were principally directed to financial market authorities, the Council also worked closely with other groups, such as the G7 finance ministers, the United Nations, the World Bank, the IMF, the European Commission, the OECD, the FSF, the G10 governors, and the Global 2000 Coordination Group (the latter representing globally active financial firms that undertook to stimulate the Year 2000 readiness of market participants around the world).

<sup>26</sup> The US Federal Reserve, the Bank of Japan and the Bank of Canada joined the Board of Directors in 1994.

In the following years of uncertainty about the international monetary system and generalised administrative controls on capital movements, the monetary and financial stability objectives of cooperation ceased to have any practical meaning of immediate relevance. Central bank cooperation at the BIS continued only in the form of low-key exchanges of information and the provision of mutual technical services.

Under Bretton Woods, cooperation was also focused on convertibility of domestic currencies at fixed exchange rates, as under the gold standard. But its relationship to monetary and financial stability objectives markedly changed. On the one hand, monetary stability was more firmly identified with domestic price stability. This would be easily achieved, it was believed, as long as domestic demand was not pushed too hard beyond full employment. Fixed exchange rates were seen as a means of avoiding the chaotic beggar-thy-neighbour policies of the 1930s and of supporting the orderly reduction of trade barriers and global trade expansion. Financial repression, both domestic and international, provided a check on overt financial instability, so that securing financial stability was not a major policy objective. Towards the end of the period, though, the rapid growth of the Eurocurrency market - both a reaction to financial repression and the herald of the arrival of a new era of international capital mobility - began to raise financial stability issues separate from those of monetary stability.

In the post-Bretton Woods years, the aims of central bank cooperation progressively shifted from monetary to financial stability, and new tools were introduced. The experience of the Great Inflation of the 1970s convinced central banks that domestic monetary stability, their overriding responsibility, could be pursued primarily by domestic policy. After some disappointing attempts in the 1970s, cooperation on exchange rates became largely subordinated to the pursuit of that objective. At the European level, cooperation in pursuit of the stability of the European Monetary System, created in 1978, rested on accepting the leadership of Germany in bringing inflation down. At the global level, cooperation on monetary issues became less feasible once the more inflation-conscious countries or currency areas saw it as not entirely consistent with domestic price stability.

At the same time, financial liberalisation allowed the re-emergence of overt financial instability. It became increasingly clear that such instability could no longer be fought with ex post emergency lending only. To be sure, emergency liquidity lending to countries in financial distress was stepped up, echoing similar actions during the gold standard period. But now an elaborate prudential regulatory apparatus was in place, set up following the widespread banking crises of the Great Depression, and central banks in most countries enjoyed supervisory powers over the banking system. Between the 1930s and the 1960s, regulatory powers had largely been used as a complement to financial repression policies. In the new context of international capital mobility, prudential regulation became a crucial element in the pursuit of financial stability, within the ambitious aim of creating a new international financial architecture. Central banks led international cooperative efforts to strengthen prudential frameworks, helping to prevent an international race to the bottom in deregulation.

In the evolving framework of international monetary and financial regimes, economic conditions and consensus on priorities and policy tools, the effectiveness of central banks' specific contribution to multilateral cooperation also depended on a broader set of conditions, some of which were directly related to central banks themselves. In particular, we have seen how 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.

### **Did the “International Bank” make a difference?**

The paper has discussed neither the need for nor the effectiveness of central bank cooperation in creating and/or upholding monetary and financial stability as international public goods. At least from the 1920s onward, however, central bankers did believe that cooperation would enhance international monetary and financial stability. They took advantage of the creation of the BIS, originally primarily a “reparations bank”, to institutionalise their cooperative efforts.

Did the BIS make a difference? Or would an equally effective cooperation have taken place in its absence?

There is no obvious way of proving a case one way or the other. Economists, divided on the pros and cons of cooperation itself, are rather mute on the merits of its institutionalisation. By contrast, those

political scientists in the institutionalist tradition are naturally predisposed to assigning a positive role to international institutions (eg Keohane (1984)).

We believe the case for the BIS to be fairly well grounded: the institution appears to have made a material difference, at least when conditions allowed.

There are good a priori reasons to believe that an institutionalised and permanent mechanism for cooperation enjoys a number of advantages over ad hoc cooperative tools. First, it provides a kind of “neutral territory” for cooperation to take place, largely thanks to an independent secretariat, which can allay concerns about national biases. Second, it guarantees a continuity and depth that would be harder to achieve through looser, ad hoc arrangements. Third, through regular meetings at all levels in a familiar setting, it creates an environment particularly well suited to the development of a mutual understanding, to learning from each other’s experience, to building consensus and to breeding close and long-lasting personal relationships. Finally, through these channels and the presence of a functioning infrastructure, it can make it easier to take speedy decisions at times of need. It is the sometimes uneventful series of meetings in more tranquil times that lays the basis for more effective action-oriented cooperation when such is required.

From a more empirical perspective, one can point to the governors’ revealed preferences. For 75 years they made time in their busy schedules for regular and frequent visits to Basel; they also placed their senior staff in the various committees based at the BIS and insisted on assiduous participation. So convinced were the central bankers of the usefulness of their international institution that they went a long way towards preserving its viability and very existence, at times against the indifference or even the opposition of their own governments. The extreme case took place during World War II, when central banks from opposite belligerent countries joined efforts to keep the BIS alive.

Beyond a priori reasoning and the governors’ revealed preference, in the absence of a clear counterfactual, it is hard to find uncontroversial evidence for the usefulness of the BIS. It is, however, possible to point to a number of instances consistent with the notion that it did make a difference. Here are just a few of them. As soon as it was established, the BIS received a request for support in a stabilisation scheme for the peseta, breaking with the previous practice of organising such support packages on a bilateral basis. As soon as the EPU was created, the BIS was ideally placed to provide the needed international clearinghouse services. It is also telling that the secretariat of the EC governors was not located in Brussels but in Basel, despite political pressures to the contrary. It was certainly not by chance that cooperation among prudential supervisors started in Basel, acting as a model for regulatory authorities in the securities and insurance industries. Likewise, the ease with which emergency liquidity assistance was put together at the time of the Mexican crisis would be difficult to imagine in the absence of an institutionalised cooperative mechanism (Volcker and Gyohten (1992)).

The Mexican crisis also highlights one of the idiosyncratic advantages of the BIS: that of being set up as a bank. As such, it was able to provide a number of services to member central banks (gold swaps, shipments and custody, deposits and short-term loans in various currencies, reciprocal settlements, etc) and to pay for the meetings, statistics, reports, support staff, and secretariat without requiring appropriation from its members, a feature that contributed to the independence of the institution. Moreover, the availability of financial resources on a swift commercial basis allowed the BIS to provide international lending either alone or, more frequently, as a member or leader of a consortium of central banks. If the Bank’s resources were never of a magnitude that could make a major quantitative difference to international lending, its participation was seen as the seal of approval by a reputable financial institution appreciated by markets and private lenders.

One should perhaps also point to the resilience of the BIS, its ability not only to survive but to reinvent itself at various junctures. Created to facilitate the transfer of German reparations, when these ended in 1931 the BIS found a natural role as the locus for central bank cooperation for the stability of the gold standard. When gold lost its glitter after 1936, the BIS refined a system of international settlements to adjust it to the increasing regulations restricting currency convertibility. This showed its worth again in the 1950s, when the EPU was established. As an institution designed for a fixed exchange rate environment, the BIS seemed to be destined to policy irrelevance after the end of Bretton Woods only to prove its usefulness in support for the European journey towards monetary union and, above all, in a new role centred on financial stability and prudential regulation. In the process, the Bank extended its provision of cooperative services beyond the central banking community to include non-central bank supervisory authorities - a step that should stand it in good

stead in future, given the incipient trend in shifting supervisory responsibilities away from central banks.<sup>27</sup> And when the establishment of EMU and broader geopolitical shifts risked limiting the global relevance of its activities, the BIS responded by expanding its membership, by involving a much broader set of central banks in its activities and by establishing in loco offices in Asia and the Americas. This capacity to respond to unexpected events has been the key to the institution's continued relevance.

We are obviously not arguing that cooperation among central banks would not have taken place without the BIS. Central bank cooperation predates the birth of the institution. However, while scholars disagree about the extent of such cooperation before 1930, they do agree that it was mostly ad hoc and always bilateral. This is why personalities like Lord Norman, and others before him, had long advocated the creation of an "international bank". Our conclusion from looking back at 75 years of history is simply that the presence of the BIS has facilitated and deepened cooperation, ensuring a degree of continuity and effectiveness that would otherwise have been hard to attain.

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<sup>27</sup> Consistent with this shift, in its own analytical work the BIS has been highlighting the tight nexus between monetary and financial stability as well as the importance of paying due attention to the systemic (macroprudential) orientation of prudential frameworks, thereby highlighting the complementary role that monetary and prudential authorities can play and the need for cooperation between the two (eg Crockett (2001), Borio and White (2003) and BIS (2005)).

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## **Comments on Borio and Toniolo's paper, "One hundred and thirty years of central bank cooperation: a BIS perspective"**

Marc Flandreau<sup>1</sup>

The article "One hundred and thirty years of central bank cooperation: a BIS perspective" by Claudio Borio and Gianni Toniolo provides a broad perspective on the evolution of central bank cooperation before and since the creation of the BIS in the early 1930s. Rather than adopting an analytical perspective on the forms and patterns of central bank cooperation in the past 130 years, the paper provides a guided tour of famous episodes of international monetary history featuring the BIS in prominent - if varied - roles. What I find particularly interesting in this approach is that it encourages us to revisit seemingly familiar episodes from the point of view of the BIS, with a constant focus on the record of international cooperation. "Classic" episodes appear less familiar as a result.

Thanks to Borio and Toniolo, we discover the BIS involved in what can be aptly called a proto (if failed) IMF support scheme, improvised in the currency crisis of the early 1930s. We see it reborn after WWII as an agent for the governments participating in the European Payments Union with the mandate to manage bilateral European balances in a context of "dollar scarcity" (a somewhat ironic endeavour when one recalls that one of the goals of the creation of the BIS was to "depoliticize" the payment of reparations). We learn about the BIS effort to counteract a scramble for gold, as governments in the 1960s began to cash their dollar balances. We observe its gradual emergence as an agency for monitoring the development of new markets - from the rise of the Eurodollar markets to more recent developments in global financial markets. Finally, we learn about its successful transformation from a mostly European institution to a truly international agency, first in the early 1960s, when the US administration reversed its former policy of neglect, and then when it successfully attracted new members and developed foreign facilities in Asia and Latin America.

At the same time, I have reservations regarding Borio and Toniolo's generally enthusiastic and positive conclusions regarding the experience of central bank cooperation. I am a long time sceptic of the argument that in practice, central bank cooperation plays a key role in supporting stable exchange rate regimes. Such cooperation appears to me to have played the same role in history as the Holy Grail in the medieval tale. People look for it, talk about it, travel far to secure it, but rarely, if ever at all, succeed in getting within reach. This is true for the 19th century experience, when central bank cooperation occurred occasionally, when special circumstances made it every country's obvious best policy, and soon retreated when circumstances changed (Flandreau (1997)). I find nothing in Borio and Toniolo's account to suggest that the 20th century was fundamentally different in this perspective, perhaps not surprisingly, given that century's poor record in terms of peace and stability of international relations.

Consider two characteristic examples: the very creation of the BIS was the product of European governments' inability to agree on virtually anything, including things monetary. It was set up in order to maintain minimal communication lines in a period when international financial integration had reached an absolute low. In effect I have shown that 1930-31 was the year when measures of international financial disintegration reached record highs (Flandreau and Rivière (1998)). And indeed, the BIS began operations with attempts to arrange international rescue packages to prevent the fall of the pound sterling, following the guidelines of the occasional 19th century operations, but failed abjectly, most probably because global cooperation was just not there.

Another example is the Gold Pool. As the implications of the well-known Triffin dilemma began to unfold in the 1960s, it became increasingly clear that US gold reserves were becoming more and more

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<sup>1</sup> Sciences Po and CEPR.

vulnerable to foreign withdrawals, both public and private. The villain of the piece, it will be recalled, was de Gaulle and his almost Thatcherite concern for getting his money back. De Gaulle's moves may have been politically driven. They may also have been inspired by lessons of history: the collapse of the pound sterling in 1931 had left the Bank of France technically bankrupt, given the large sterling reserves it held at the time. Seen from this perspective, the problems of the 1960s appear less driven by the French, and more structural: defending the adjustable parities of the Bretton Woods system and the link between dollars and gold required finding ways to contain free-riding, or equivalently, to enforce cooperation. The Gold Pool attempted just that. It induced central banks to participate in what amounted to a dollar support scheme. The scheme collapsed, however, when the pool began accumulating losses, thus proving unable to prevent defection (of course, France led the way). This is hardly evidence of successful cooperation.

These two episodes cast some doubts on the record of the BIS as a vehicle for international monetary cooperation. That the BIS was created to enforce cooperation, that its Annual Reports have consistently emphasized the importance of cooperation, that its modern leaders are keen on cooperation, and certainly rightly so, should not prevent us from being able to assess its actual achievements. Historians know well that, for instance, repeated government decrees to prevent people from drinking are no evidence that people are actually drinking less. If anything, they suggest that people are drinking more.

This is not to say that the record of the BIS in implementing international agendas, or in contributing to the provision of global public goods, has been one of failure. However, to find substantial success, we must leave aside monetary cooperation and focus on financial cooperation. What I have in mind is the success of the Basel Committee in contributing to the design and implementation of the Basel I and more recently the Basel II banking supervision rules. In my view, Borio and Toniolo do not underline strongly enough the stark contrast between the fate of cooperative attempts in the monetary and the financial fields. I find the growing popularity of Basel I and Basel II truly remarkable. Even more so, since setting financial standards is just as vulnerable to free-rider problems as setting an exchange rate. One goal of Basel I was to raise capitalization ratios across the world in order to improve the resiliency of the banking system. But of course, with the rest of the world improving standards, individual nations have an incentive to lower their own capitalization in order to improve the competitive position of their banking system. This challenge was fully understood when the Basel I initiative was launched by the US Congress (see Kapstein (1991)). Of course, it could be that, very much as happened in the occasional instances of monetary cooperation in the 19th century, special circumstances played a role. One could invoke, for instance, US hegemonic power, the trauma that the Latin American debt crisis of early 1982 had caused to policy makers, etc. If that is so, then financial cooperation of the Basel I and II types may not be here to stay, and we should expect to see their achievements unravel in the future. However, I think that this is not the case and that financial cooperation is here to stay, at least for a while, for one reason I would now like to spell out.

In the article by Borio and Toniolo, and even more prominently in Toniolo's remarkable book on the BIS (Toniolo (2005)), the intellectual origins of the BIS are traced to Luzzatti's suggestion to establish an international bank to facilitate emergency lending in crises. Luzzatti was essentially theorizing on the basis of the 1907 international financial crisis. His starting point was that financial crises created dilemmas for central banks: support to the ailing financial system meant injecting extra liquidity, but this conflicted with the maintenance of fixed parities (gold convertibility). To attenuate the conflict, Luzzatti suggested formalizing a system of emergency reserves lending among central banks. The central bank facing a domestic financial crisis would be entitled to draw on foreign exchange at the same time as supporting the domestic financial sector, thus containing the crisis within national boundaries. Borio and Toniolo show that this role has never entirely disappeared as a BIS activity. But it is obvious that, to a large extent, it is the IMF, not the BIS, which has become the chief instrument of such policies.

Yet another intellectual origin of the BIS, which Toniolo (2005) mentions in passing, was due to Lévy (1911). Lévy theorized the strategic relations between governments and central banks. Providing a pioneering account of the now conventional time consistency problem, Lévy concluded that the trend he observed across the world towards a greater insulation of central banks from government interference was a welcome one, and suggested that an even better arrangement would be to create a

central bank of central banks, located in a neutral nation (he suggested Switzerland), and entrusted with the role of custodian of global settlements.<sup>2</sup>

This perspective on the origins of the BIS may give us a clue to understanding the contrasting record between monetary and financial cooperation. The trend that has accompanied the expansion of the Basel I and Basel II packages, it should be noted, has been the considerable progress, witnessed in the past 25 years, of central bank independence. Not that governments have entirely abandoned their privileges. For one thing, they are still responsible for the selection of the exchange rate regime. Central banks, however, have gained considerable powers regarding the implementation of monetary policy targets. As a result, they have transformed themselves into powerful information agencies with very detailed knowledge of the situation in their respective financial systems. Moreover, in their attempt to gain further influence by achieving their goals of financial and monetary stability, they have realized the benefits of cooperation with one another under the auspices of the Basel setup. The interpretation I suggest, therefore, for the success of international financial cooperation, has much to do with the progress of central bank independence worldwide. This may explain how the free-riding problem, which is inherent in financial cooperation just as in monetary cooperation, has been solved. Unlike governments, independent central banks are probably less sensitive to lobbying by representatives of the domestic banking system on the need to loosen prudential standards, given that prudential supervision of the banking system is a permanent concern for them. In effect, central bankers are paid to remain deaf to such calls. To the extent that they provide markets with a level playing field, as they do by setting global standards, central banks are free to agree among themselves on how this playing field should be designed. The conclusion, therefore, is that the progress of central bank cooperation in financial matters is very much a by-product of the global push towards central bank independence. As Lévy had anticipated, a global agency located in Switzerland is a natural extension of a global regime where the management of money and finance, if not of the exchange rate, has been gradually depoliticized.

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<sup>2</sup> On the trend towards greater insulation of central banks from government interference, see Flandreau et al (1998).

## **Comments on Claudio Borio and Gianni Toniolo's paper, "One hundred and thirty years of central bank cooperation: a BIS perspective"**

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Claudio Borio and Gianni Toniolo provide an ideal starting point for the conference with their critical review of central bank cooperation over the past century, a narrative that is both detailed and comprehensive.

Of the three questions that they pose, I will emphasize the second and third, which examine the conditions under which central bank cooperation has succeeded and the independent contribution of the Bank for International Settlements (BIS) to its effectiveness. I will reframe these questions and suggest answers that complement those proposed by Borio and Toniolo. At the same time, I wish to underline the applicability of this history of central bank cooperation to international economic governance and to our understanding of international institutions.

Despite its persistence over the past century, Borio and Toniolo observe that central bank cooperation has varied according to its depth or "tools" (whether it advances beyond information exchange to mutual adjustment of national policies) and its scope or "targets" (monetary and financial stability). Why has central bank cooperation been deeper and wider in some eras - the 1920s, the 1960s, and the past twenty-five years - than others (particularly the period from 1930 until 1960)? Variation in cooperation may come from changes in either the demand for cooperation or its supply. As Borio and Toniolo suggest, the international environment has heavily influenced the pattern of central bank cooperation. I would emphasize in particular the role of international capital mobility. Central banks (and their governments and publics) will demand more cooperation during periods of capital mobility for two reasons. The risks to international financial stability increase because of cross-border spillovers from previously domestic financial crises. Open capital markets also produce policy and political choices through the trilemma. In a context of democratic government (with pressures for an autonomous monetary policy), capital mobility will place considerable strain on a system of fixed exchange rates. Managing those strains may also increase demand for central bank cooperation (as it did in the 1920s and the 1960s).

As Borio and Toniolo make clear, the attitude of national governments toward international economic cooperation is a second environmental variable, treated as exogenous, that has influenced the demand for central bank cooperation. Economic closure after 1930 set sharp limits on central bank behavior, reinforced by nationalization of most central banks and their legal subordination to national governments. Even during the 1960s, a high point in cooperation, deep involvement by central banks in shoring up the Bretton Woods regime could not exceed the wishes of their governments. (The withdrawal of France from the gold pool is a key example of this deference.) If nationalistic governments set boundaries to central bank cooperation, does central bank independence then serve to liberate central banks for international cooperation? Growing capital mobility, if it undermines fixed exchange rates, may also promote central bank independence as an instrument for re-establishing the credibility of national monetary policies. Governments and electorates, however, tend to delegate authority to central banks for a particular purpose - maintaining price stability.

Central bank independence under such conditions may therefore create tension between the national role of central banks in insuring price stability and their international role in maintaining the exchange rate regime, a dilemma within the trilemma, one that may undermine the supply of central bank cooperation. In contrast to the interwar era, however, central banks in the major industrialized economies have been largely spared this dilemma over the past three decades. As a consensus on floating exchange rates and monetary policy autonomy (or monetary union within Europe) has taken hold, the role of central banks in managing the exchange rate regime has been largely relinquished.

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By giving up their role in the international monetary regime, central banks have been freed to cooperate more deeply in maintaining the stability of the financial system. Demand-side changes - international capital mobility and economic cooperation among the major national governments - have reinforced a supply-side change - increasingly independent central banks largely free of conflict between domestic mandates and a deeper but narrower international cooperation - to produce the latest era of successful central bank cooperation.

Borio and Toniolo emphasize the mutability of the “targets and tools” of central bank cooperation over time. I have stressed mutability in policy targets and a narrowing in the scope of cooperation as a key determinant of deeper collaboration in recent decades. What role did the BIS play in promoting or reinforcing this pattern of persistence and change? Borio and Toniolo ask, in effect, whether a replay of history in which the BIS had not been created (or had disappeared in the wake of World War II - as it nearly did) would have changed the course of central bank cooperation. This counterfactual question may not be the most useful one, however, since the BIS in most respects mirrors central bank cooperation rather than presiding over it or directing it. Its institutional features of informality, an ability to reach self-enforcing bargains efficiently, an absence of bureaucratic inertia, confidentiality, and reliance on soft law have characterized central bank cooperation from the start.

The BIS can plausibly claim to have reinforced central bank cooperation in three ways. Borio and Toniolo, in describing a low point early in its history, note that central banks nevertheless believed “the expertise, networking and assets of the BIS” would prove useful eventually (p. 11). The first two of these - expertise and networking - have been key BIS contributions to the supply of both central bank cooperation and international financial cooperation. The BIS is notable for its resilience. The International Labour Organization (ILO), for example, is older, but its role in the world economy and the value placed on its expertise by member governments have diminished over time. The BIS has continued to provide expertise that remains valuable to its shareholders and other clients in rapidly changing circumstances. This ability to maintain its “R&D” edge over time rather than peddling obsolete technologies, is striking. BIS success in this regard is owed in part to retention throughout its history of one group of core clients - the central banks of the major industrialized economies. Consider by way of contrast the Organisation for Economic Co-operation and Development (OECD), also an institution dedicated to research and information sharing, but one rendered less effective because of its diverse and numerous clients within national governments.

The BIS has been able to expand its influence and effectiveness beyond its core clientele through its networked form of organization. The BIS may be a club, but it is a club embedded in a much wider network attracted by its service provision (including service as secretariat and research unit) for other agencies. Its networked form has permitted the BIS to incorporate new participants outside its central bank clientele without endangering its decision-making core or raising issues of institutional membership.

These supply-side organizational contributions by the BIS to central bank cooperation are complemented by a striking demand-side characteristic - its relative immunity to the controversies that swirl around globalization and its consequences. Compared to the other global economic multilaterals - the IMF, the World Bank, or the World Trade Organization (WTO) - the technical identity of the BIS has shielded it from intensive political scrutiny. The BIS may owe its low political profile to the prestige that central bankers currently enjoy in the industrialized economies. Another reason may be its mode of operation - through national authorities, avoiding many of the controversies surrounding conditionality and perceived threats to national sovereignty. Whatever the cause and however temporary its immunity may be, turning to the BIS has little domestic political stigma attached, a perception that increases demand for its services.

Claudio Borio and Gianni Toniolo have provided an excellent analytic overview of both central bank cooperation and the BIS. They do not venture to speculate about the current challenges to this broadly successful history. If the major national economies are not convulsed by economic nationalism, can this model of central bank cooperation continue to succeed through its unique combination of institutional persistence and adaptation? Innovation in the financial markets will set a tough benchmark for replenishing its store of expertise; the rise of the Asian economies may call into question the European and Atlantic bias at the core of its network; and calls for accountability by democratic publics may tax its decision-making efficiency. So long as the second era of globalization continues, however, demand for its unique contributions to international economic cooperation is likely to grow.