Comments by Robert O. Keohane on Barry Eichengreen and Marc Flandreau, "Central Banks as Architects," BIS meeting, June 25, 2010.

Unfortunately, family health issues prevent me from attending this meeting and presenting this commentary in person. But my task is also complicated by a lack of fit between my areas of expertise and the topic of the paper. I am a student of contemporary world politics, with interests in large political-economic issues, such as those raised by the 2008-10 financial crisis, and in the political processes that generate economic policy.

Of the papers for this conference, Charles Goodhart's tackles these issues most directly. He discusses the "procyclicality" of Basel II and says that as late as the summer of 2007, "neither bankers, nor regulators, nor virtually all commentators had any appreciation of the (systemic) risks that were being run" (p. 17). Indeed, regulation led to a "poor outcome, in that the banks held a stock of required capital that could not be trenched upon without signaling a crisis occasion, while the usable buffer was too small" (p. 25). Clearly, regulation by central banks failed.

Perceived failure by central banks invites politicians to take charge. In his paper for this conference, Harold James states that "the increasing politicization of central banks" (at the present time) "looks like a dramatic repeat of the interwar story." Indeed, Professor James detects signs of increased financial nationalism in attacks on the US Fed interventions for helping foreign interests. When the clear rule followed by central banks becomes muddied, central bank discretion seems more problematical, and politicians deploy financial nationalism to take over. So in Professor James's view, "the pendulum is swinging back, toward a nationalized Bank of England, a more accountable Federal Reserve, and an ECB that answers to the people of Europe" (p. 25).

I wish that at least one of the papers at this conference would have explored, in depth, the political reasons for the policies and policy changes discussed by Professors Goodhart and James: the policies actually adopted in Basel II, other central bank policies prior to the 2008 financial crisis, and the shifts toward politicization of central banks. Such a discussion should also have examined the still-formidable abilities of central banks to resist such politicization and to maintain, or even expand, the domain of their activities. Perhaps the previous two sessions have explored these questions and if so, I very much regret not being able to be here for this discussion.

The Eichengreen-Flandreau paper does not take up these issues of how politics generates a failure to regulate systemic risk, or how it shapes reactions to such failure. Instead, it is about banking in the interwar period, and politics does not play a significant role in the authors' argument. The focus is instead on the importance of network effects and increasing returns on international currency issues. The authors are eminent economic historians and their argument is interesting; but it does not connect closely with the previous two sessions or with international politics, which is my own area of expertise. I am therefore not an ideal discussant for this paper, and arguably not an appropriate one. My comments will therefore range a little more broadly than the focus of this paper, referring to broader issues raised in the first two sessions.

There are some references to politics in the paper. For instance, war plays a role: Britain took advantage of World War I to expand its banking position in Latin America at the expense of Germany. It is well-known that World War I facilitated the rise of the United States to a strong international economic position, and it is not surprising, given British control of the seas, that the war strengthened Britain's economic position relative to Germany in Latin America, while weakening it relative to the United States. The effects of war in advantaging states – especially maritime powers – that can maintain access to neutral areas for trade and investment, are well-known. However, we can hope that the contemporary relevance of this insight is limited: that understanding future patterns of global finance will not turn on understanding the effects of war.

The paper indirectly raises another set of political issues when it tells us that the Federal Reserve was the "architect" of a policy that promoted the international role of the dollar. The Fed did so, the authors argue, by becoming a "secondary-market-maker of last resort" in an effort to help to build a liquid secondary market for bankers' acceptances in New York. The authors say (p. 18) there is a message here for China, and elsewhere in the paper refers to the international role of China's currency. But these issues are only referred to obliquely.

From a political scientist's perspective, some of the most interesting political issues raised by this paper's narrative are *not discussed.* As in the valuable papers by professors Goodhart and James, the effects of political activity are more evident than its causes. In the Eichengreen-Flandreau paper the Fed is a shadowy institution: we see the effects of its actions but not their real source. That is, the reasons for Fed actions, and the interests behind them, are never analyzed. In particular, the whole narrative depends on a provision of the Federal Reserve Act of 1913, which "removed the prohibition on foreign branching and authorized banks to deal in trade acceptances" (p. 5). The only explanation for this crucial action is in a footnote, which states that one motive for the act was to create a market in trade acceptances in New York, in the belief that this would be a stabilizing move.

For a political scientist this account is unsatisfying. Other questions come to mind. What *interests* were behind this change in the law? Was the justification that a market in trade acceptances would enhance financial stability a genuine reason for its enactment, or only a public spirited justification for an action that had more parochial motives? Did major New York banks lobby for the change in the law? Were the non-New York banks supportive – which might support the stabilization argument – or opposed to the change – which might suggest more self-interested motives on the part of its sponsors? Did the President take a position, focused on US economic or strategic interests? In other words, the sources of the key *political* move that created the process discussed by Eichengreen and Flandreau remain obscure.

We are now either still in the largest financial crisis of the last 70 years or just emerging from it. In this context many scholars and commentators, from different disciplinary and doctrinal perspectives, have been engaging in soul-searching about how international economic institutions, and more deeply the economic theory on which their practices are based, failed. We find such reflection in the recent book by Carmen Reinhart and Kenneth Rogoff, *This Time is Different.* So in the interest of helping to focus a discussion on these larger issues, I now use the Reinhart-Rogoff analysis to ask pose some broad questions, from the standpoint of a political scientist.

Reinhart and Rogoff (p. 170) document an increase of 86 percent, on average, in public debt during the three years after major postwar banking crises. They sketch out a prototype for the "sequencing of crises" in which default on external and/or domestic debt follows banking crises (p. 271). They declare that "capital flow and default crises have been around since at least 1800…Why they would end anytime soon is not obvious." (p. 291) And in the last paragraph of their book (p. 292) they state that "highly leveraged economies, particularly those in which continual rollover of short-term debt is sustained only by confidence in relatively illiquid underlying assets, seldom survive forever." I would like to know whether, in view of their deep knowledge of economic history, professors Eichengreen and Flandreau agree with the implication: that sovereign debt crises are likely to follow the banking crisis of 2008 and the subsequent explosion of public debt in rich democracies. *Should we now expect a wave of sovereign defaults?*

In response one might point to the fact that the major democracies are on friendly terms with one another and that institutions such as BIS and IMF exist. Indeed, Reinhart and Rogoff document that financial crises were much less frequent, and less intense, during the second half of the 20th century than in the preceding 50 years (Figure 16.3, p. 254). Until the crisis of 2008, it would have been easy to argue that the combination of American hegemony and institutionalization was benign. But the 2008 crisis originated in the US subprime mortgage market, emanating from a classic bubble aggravated rather than controlled, by Fed policy. As Professor Goodhart's paper recognizes, international efforts under the Basle I and Basle II processes were ineffective.

In this context, we need to ask some difficult political questions about institutions such as the BIS and IMF. Has control – or at least influence -- over these public institutions perhaps passed largely to private actors, as a result of pluralist political processes with which political scientists are all too familiar? In pluralist democracies, those who pay attention have the most influence, even if there is no corruption of any kind. Almost everyone else ignores almost every policy issue almost all of the time. If only bankers pay attention to banking issues, it should not surprise us that policy favors bankers and that self-serving banking practices that generate systemic risk will not be well-controlled.

In domestic politics, there is at least some recourse: Congress or Parliament can hold hearings and pass legislation, and voters can "throw the rascals out." No such clear recourse is possible for international institutions such as the BIS or IMF. We need to think more deeply about the accountability and legitimacy of international financial institutions. I was pleased to see the discussions in Ross Levine's paper about transparency and in Peter Stella's about the tradeoff between central bank independence and political legitimacy. Accountability, which is a fundamental principle of democratic governance, has three key components: that some actors have the right to hold other actors to a set of standards, to judge whether they have fulfilled their responsibilities in light of these standards, and to impose sanctions if they determine that these responsibilities have not been met. One result of the financial crisis of 2008 is a new debate about what the proper standards of accountability for central banks are. How can central banks be held accountable for their actions without generating dangerous and dysfunctional political interference?

I return at the end to the question, raised a minute ago, about whether American hegemony has been benign. Despite the crisis of 2008, a good case can be made that it was benign over the first 60 years since World War II. But we are now quite clearly in the twilight of that hegemony. As the developing countries outpace the rich countries in rates of economic growth, American dominance will fall. China will become increasingly important and assertive. But China and the United States are emphatically not strategic partners: they are rivals, which at best display wary and limited cooperation. So historical analogies from the period before 1914, when Great Britain, France and Germany were strategic rivals, may become more relevant.

To summarize, let me indicate seven questions to which I would like to have answers. [3 slides here]

1) Is the banking crisis of 2008-09 likely to lead to a series of sovereign default crises?
2) Could any concerted cooperation among governments or central banks prevent such crises?
3) What is the political likelihood of such cooperation?

4) Should we understand contemporary international financial institutions such as the IMF and BIS primarily as providing real public goods, or as acting at the behest of, and in the interests of, organized private actors?
5) Are there feasible ways of enhancing the political accountability, and therefore legitimacy, of these institutions?
6) As American hegemony declines, will destabilizing pressures increase in the area of global finance?
7) If so, are there institutional reforms that could mitigate these pressures and help to maintain financial stability?

These are questions that I hope this conference has either addressed in earlier sessions, or that it will confront at this or another session before it adjourns.