Central bank cooperation: reflections on the experience of the last eight decades

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It is a great honour and gives me great pleasure to speak here at this conference commemorating CEMLA's 60th anniversary. The track record of CEMLA since its foundation in 1952 – in promoting monetary studies and technical cooperation among central banks and contributing to the professional formation of central bank staff – bears witness not only to the desirability of international central bank cooperation, but also to its reality. Central banks undoubtedly have a certain propensity for looking across national borders. After all, each central bank is a unique institution within its own country, with its own national mandate. When central bankers want to share their specific experiences and concerns with like-minded professionals, they naturally turn to other central banks. Moreover, and more importantly, globalisation, common risks and cross-border interdependence have made international cooperation a necessity for central bankers – particularly now when there is a worrying tendency towards fragmentation and re-nationalisation of financial markets.

The Bank for International Settlements was created in 1930 by a generation of forward-looking central bankers. They made sure that "the promotion of central bank cooperation" was listed as one of the key objectives in the BIS's Statutes. For over 80 years now, the BIS has played an active role in international central bank cooperation. It is from this perspective that I would like to share with you some reflections on the past and future of central bank cooperation.

In this complex and interdependent world there is, and will continue to be, a clear need for structured, institutionalised central bank cooperation. But also, that to be effective and legitimate, such cooperation must continuously evolve and adapt to an evolving international monetary and financial environment, with financial and economic crises serving as catalysts for change. Put differently, the evolution of central bank cooperation is inherently linked to the challenges presented by the evolution of the international monetary and financial environment, changes in institutional frameworks and advances in economic thought.

Let me develop this overriding theme, first by looking at the historical experience of central bank cooperation since the interwar period, and then by tentatively outlining some of the challenges and prospects ahead.

Global central bank cooperation: evolution and experiences

Broadly speaking, until the 1970s central bank cooperation was dictated by the belief that a fixed exchange rate system was a desirable goal that advanced the key domestic objective of price stability. But within this general conceptual framework, the prevailing monetary and financial regime underwent significant changes which led to important differences in the targets and tools of cooperation.

In the early days of modern central banking, under the gold standard regime, the scope for central bank cooperation was rather limited. Gold convertibility, provoking “automatic” adjustment of imbalances, acted as the ultimate constraint. The cooperation that did take place happened on a bilateral and ad hoc basis, mainly on the occasion of severe banking crises, as in 1890 to limit the fallout of the Baring crisis, or during the 1907 financial crisis. In both cases, emergency liquidity lending served the overriding goal of maintaining gold convertibility.

The collapse of the gold standard and the international efforts to restore it in the interwar period increased the scope for central bank cooperation. This was partly because of the technical complexity of the exercise, which propelled the major central banks at the core of the system into an advisory role vis-à-vis other central banks. It was also due to the intricate economic and political constraints within which the restoration had to take place – wartime reparations and debts – which presented severe international coordination problems. The creation of the BIS in 1930 responded to these challenges. The BIS, for the first time in central bank history, institutionally embodied multilateral central bank cooperation. However, in the wake of the economic and political dislocations following the Great Depression, most central banks, which previously had enjoyed independence, came under direct control of fiscal authorities, and central bank cooperation receded. The lack of central bank cooperation reflected the global political and economic retrenchment characteristic of the 1930s.

After 1945, under the Bretton Woods fixed exchange rate regime, the management of exchange rates was entrusted to the newly created International Monetary Fund (IMF), an intergovernmental organisation. Gold acted as a soft constraint on the system, and financial repression kept overt financial instability in check. In this relatively stable and safe – perhaps even dull – environment, it was said that central banks did not have to do much, and did it very well. This was so at least in theory. In practice, central banks were very active, as increasing capital mobility and divergent monetary policies required increased central bank cooperation to defend the Bretton Woods system. Despite their ultimate lack of success, these efforts established a lasting framework of institutionalised cooperation among central banks. Much of this took place at the BIS, enhancing its role as a forum for central bank cooperation. The establishment of important regional forums for central bank cooperation, in particular CEMLA in 1952, occurred in the Bretton Woods era.

After the collapse of the Bretton Woods system in the early 1970s, the scope for global central bank cooperation in the field of monetary policy was reduced as the major currency blocs pursued monetary policy independently under flexible exchange rates. However, the lessons of the Great Inflation of the 1970s led to the adoption of modern monetary policy frameworks, with a price stability orientation underpinned by central bank independence. This new consensus was reached in the context of “light” central bank cooperation in the form of regular and frank discussions at the BIS and elsewhere. This is not to say that the desire for deeper cooperation had evaporated. The Europeans were a case in point, when in the 1970s – using the BIS as a coordination platform – they started to plan for regional monetary unification through the so-called currency snake and the European Monetary System. But the general, global trend was clearly towards light cooperation in the monetary field.

The scope for cooperation in the field of financial stability, by contrast, increased strongly. As financial repression gave way to financial liberalisation, international banking and international capital mobility went through a period of rapid expansion fuelled by abundant funding liquidity (including in the form of petrodollars). This was undoubtedly beneficial to the development of the global economy. But the flip side was the return of banking crises with potentially systemic repercussions, of which there had been none since the Second World War. In response to these developments, since the 1970s central banks have cooperated in the pursuit of financial stability. The Basel Committee on Banking Supervision was created at the end of 1974 in direct response to the banking crisis earlier that year, with the highly publicised collapse of Bankhaus Herstatt in Germany and Franklin National Bank in the United States. The BIS and new high-level committees hosted by the BIS, such as the Basel Committee and the Committee on the Global Financial System, played important roles in developing guidelines for the design and implementation of common standards and policies (the Basel I, II and III capital adequacy frameworks), and in compiling data on new markets and instruments. This "Basel Process", which consists of the cooperation of the committees and standard-setting bodies hosted by the BIS, has become essential to promote international financial and monetary cooperation. In that context, already in the late 1970s central banks groped for a "macroprudential" approach to financial stability. This concept would be developed more fully only after 2000, and in particular in the wake of the current crisis, into a policy arm that aims to contain more broadly systemic risk.

The global financial crisis has given new impetus to global central bank cooperation. Central banks took coordinated action, for example by providing ample liquidity after the Lehman collapse in 2008 and by establishing currency swap lines. The extension of such swaps in unlimited amounts represents a turn in central bank cooperation that the founders of the BIS would have found unimaginable. Moreover, the geographical expansion of central bank cooperation was reinforced, as reflected in the expanded membership and enhanced role of the G20, the FSB and the Global Economy Meeting at the BIS – which are a manifestation of the important role that emerging economies play in today's global economy. Today, the "Basel way" of international cooperation and informal exchange of experiences has become a key complement to multilateral surveillance.

This brief review of the evolution of central bank cooperation over the past 80 years shows that the targets and intensity of central bank cooperation have been deeply affected by the global monetary and financial environment, and that crises have catalysed change. But what does this mean for the future of central bank cooperation?

Prospects and challenges

The global financial crisis has ratcheted up central bank cooperation in financial stability matters. And central banks will continue cooperating closely in the context of the ongoing efforts to enhance global financial regulation and supervision. This will involve the implementation of new standards; addressing open issues in the regulatory reform agenda, specifically resolution regimes, derivatives market infrastructure and shadow banking systems; and enhancing financial oversight frameworks, in particular developing macroprudential frameworks in which central banks will play an important role.[1]

At the same time, central banks have intensified, and will need to further intensify, their cooperation in monetary policy matters in order to meet the daunting economic, intellectual and institutional challenges they face. The economic context in which central banks operate has become a very difficult one, with disappointing growth and high levels of public and private debt. In many advanced economies, central banks find themselves pushed to be the policymakers of last resort as the root causes of the protracted economic weakness and financial fragility have still not been sufficiently addressed. Central banks are providing monetary stimulus on a massive scale, supplying liquidity to banks and easing governments' financing burdens. Central banks in emerging market economies are confronted with their own challenges as well as the spillover effects of these policies, which manifest themselves in undesirable capital flow and exchange rate volatility. Amid these economic challenges,

[1] See J Caruana, "Progress and challenges in financial reform", speech at the XXI International Banking Congress, St Petersburg, 6 June 2012.

central banks face significant intellectual challenges as the crisis exposed the limitations of the pre-crisis policy consensus and of the macroeconomic models that underpinned it. And the unsustainable fiscal positions in many countries as well as central banks' new tasks in the area of financial stability raise institutional challenges as central banks need to preserve their operational independence and their credibility.

Central bank cooperation will be essential to foster a common understanding of the nature of these challenges and to forge a new consensus on how to address them. From the point of view of the BIS, such a new consensus would need to incorporate three main points.

First is the need to restore symmetry in the conduct of monetary policy over the financial cycle. Over the past 10 to 15 years, central banks have tended to loosen monetary policy aggressively during a crisis, but to tighten only cautiously prior to crises and in the recovery. As a consequence, interest rates in many economies have gradually trended down – in the core advanced economies, all the way to their effective lower bound – narrowing policymakers' room for manoeuvre. A more symmetrical approach is called for over the financial cycle, with monetary policy easing less persistently during the bust and tightening more aggressively in the boom.

Policy frameworks should be adjusted so that central banks can contribute more effectively to containing the build-up of financial imbalances and increase the strength and resilience of the financial system. In order to do so, central banks will need longer policy horizons than the two years or so typical of inflation targeting regimes. This could reveal the risks to macroeconomic stability that result from financial imbalances, and would give central banks more scope for leaning against financial booms even when near-term inflation is consistent with central banks' target level or range. This means that price stability-oriented frameworks, such as inflation targeting regimes, should be implemented in a flexible way with a systematic assessment of the balance of risks ahead, including in particular those emanating from financial developments. In this context, central banks will also have to address the conceptual weakness of their pre-crisis analytical models, which will need to be further developed to better capture the interplay between financial factors and the real economy.

Restoring symmetry also involves reconsidering the monetary policy responses to the financial busts that follow credit booms. The prevailing view, which prescribes very aggressive and prolonged monetary easing, arguably underestimates the resulting collateral damage. When a crisis erupts, central banks should certainly do everything in their power to prevent the collapse of the system. But once the most severe phases of the crisis have been managed, the policy focus should shift towards promoting the necessary post-crisis adjustments in balance sheets and the economy at large. Prolonged monetary easing buys time for making such necessary adjustments, but also generates incentives that make it more likely that the time will not be used optimally, that the return to self-sustaining recovery will thus be delayed and that distortions will be created in the real economy. Furthermore, the cross-border spillover effects can give rise to additional distortions in financial markets and the real economy, as well as risks for financial and price stability.

This brings me to the second point, the need to better internalise the externalities arising from monetary policy spillovers across currency areas. Tightly integrated markets for production factors and financial instruments across the globe mean that a country's economic and financial conditions are increasingly shaped by global conditions. Persistently low interest rates in the core advanced economies lead to persistently large interest rate differentials supporting capital and credit flows to fast-growing emerging market economies and putting upward pressure on their exchange rates. To be sure, such flows are also driven by better economic fundamentals in emerging market countries, especially their improved long-term growth prospects, the successful implementation of structural reforms and their greater participation in the global economy. Nevertheless, the consequence is that emerging market central banks are induced to raise interest rates only hesitantly in response to buoyant domestic macroeconomic and financial conditions to avoid further widening interest rate differentials and further boosting capital inflows. As a result, monetary policy may have tended to be systematically too loose over the past years.

The prevailing loose global monetary conditions have been fuelling credit and asset price booms in some emerging market economies for quite some time now, creating risks of rising financial imbalances similar to those seen in advanced economies in the years immediately preceding the crisis. They have probably also contributed to heightened commodity price volatility over the past years. Commodity prices are set in global auction markets and are very sensitive to global demand conditions, which are also influenced by global monetary conditions. This sensitivity may have further increased as a result of the growing role of financial investors in commodity markets. The effects of higher commodity price volatility was felt in particular in emerging market economies, where two bouts of rising inflation since 2006 have been associated with increasing commodity prices.

The growing relevance of monetary policy spillovers suggests that central banks need to take better account of the global implications of their actions. In a highly globalised world, monetary policy also needs to take a more global perspective to ensure lasting price and financial stability. Put differently, central banks need to go beyond the “own house in order” doctrine. This does not necessarily mean monetary policy coordination at the global level, but does require central banks to better appreciate and internalise the side effects and feedbacks that arise from individual monetary policies. The first step towards doing so is to recognise such effects. This will require a shift to a more global analytical approach, one that seeks to factor in interactions and feedback effects.

I would therefore tend to agree with the call recently brought forward by prominent academics and practitioners[2] to allow global considerations to play a more explicit role in the monetary policy frameworks of the major central banks and to urge central banks to pay more attention to the global implications of their collective actions. Where I am more sceptical is the proposal to formalise cooperative arrangements through, for instance, a requirement for the major central banks to outline publicly the mutual consistency of their policies. Requiring central banks to publicly lay bare areas of inconsistency and dissent could turn out to be counterproductive as it might damage the atmosphere of mutual trust that is needed for effective cooperation.

The informal but structured nature of the meetings that take place at the BIS has proven to be conducive to ensuring a frank exchange of views on the international dimension of domestic policies. Over the past years, the discussions in these meetings have focused squarely on the key issues in global financial and economic stability, including global spillovers. That said, further progress in central bank cooperation is clearly needed. In this vein, regional forums such as CEMLA will continue playing an important role in the development of more effective cooperative arrangements.

Third, and finally, central banks need to safeguard their operational independence and their credibility. Central banks’ new tasks in the areas of financial supervision, regulation and macroprudential policies raise new institutional challenges in this respect. One argument for assigning financial stability responsibilities to central banks is that they already enjoy, and

[2] Barry Eichengreen, Mohamed El-Erian, Arminio Fraga, Takatoshi Ito, Jean Pisani-Ferry, Eswar Prasad, Raghuram Rajan, Maria Ramos, Carmen Reinhart, Helene Rey, Dani Rodrik, Kenneth Rogoff, Hyun Song Shin, Andres Velasco, Beatrice Weder di Mauro and Yongding Yu, “Rethinking central banking,” Brookings Institution, 2011.

have demonstrated, independence in the conduct of monetary policy. However, this also implies that central banks' new powers need to be underpinned by a clear mandate that includes arrangements that safeguard their operational independence. They need to be compatible with central banks' monetary policy responsibilities and equip them with appropriate tools, authorities and safeguards. In particular, clarity about roles, responsibilities and powers is the precondition for ensuring consistency between what central banks are expected to do and what they can deliver, as well as for accountability and effective policymaking. Both accountability and effectiveness can be improved through a clear policy on communicating the central bank's strategy for fulfilling its mandate.

At the same time, central banks need to beware of the longer-term risks to their credibility and operational autonomy that arise from the current difficult economic environment. Central banks in the core advanced economies may come under growing pressure to provide ever more monetary stimulus and funding support if the economy's weakness persists, markets continue to be dependent on central bank operations, and underlying solvency and structural problems remain unresolved. A vicious circle can develop which would make the eventual exit from monetary accommodation harder. Similarly, continued reliance on export-led growth strategies in some emerging market economies may raise doubts about central banks' determination to pursue price stability and exit from large-scale foreign exchange interventions. These concerns are reinforced by political economy risks arising from the combination of central bank balance sheet policies that have blurred the line between monetary and fiscal policies and the unsustainable trajectory of fiscal positions in some economies.

Conclusions

Let me conclude. The evolution of central bank cooperation over the past 80 years has been inherently linked to that of the international monetary and financial environment, with financial and economic crises serving as catalysts for change. The global financial crisis has raised new, fundamental challenges for monetary policy globally. Close regional and global central bank cooperation in the form of a structured and regular exchange of views will be essential to foster a common understanding of the issues and to converge on solutions. Central banks need to forge a new consensus on how to address the challenges they face. I have suggested that such a consensus should incorporate three main points: more symmetry in the conduct of monetary policy over the financial cycle; more internalisation of global monetary policy spillovers; and safeguarding the credibility and operational independence of central banks. This will be key to avoiding "beggar-thy-neighbour" policies and to increasing the chances for lasting global financial and price stability. Meeting these challenges will also depend on central banks' continued ability to retain and attract talent, as well as on their ability to learn and continuously adapt to changing environments. Cooperative efforts by central banks in training and research, both at the global level and through regional arrangements like CEMLA, will be key for succeeding in this endeavour. I would like to end by congratulating CEMLA once again on its 60th anniversary and highlighting the excellent collaboration we enjoy. We hope to continue to strengthen it in the future.

Thank you very much.