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CENTRAL BANK COOPERATION

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No man is an island to himself -- and neither is a central bank. We all live in an increasingly integrated and interdependent world, and consequently the need to consult, to cooperate, and to coordinate is ever increasing.

In making a distinction between consultation, cooperation, and coordination, I am following the lead of the late Henry Wallich, who introduced this useful trilogy into the central banking literature.

In recent years, issues involving cooperation among countries have become increasingly important and have generated headlines in the popular press. Such issues are likely to become ever more important as economic and financial integration progresses further.

Central banks are important participants in the consultation, cooperation, and coordination process due to their key role in monetary and exchange rate policies.

Today, I would like to analyze the reasons for the ever increasing economic and financial integration of the world economy and explore the central banks' policy response to this challenge. At the end of my talk, I would like to

explore with you what the future might bring with respect to further cooperation among central banks. In that connection, the European debate on a future central bank for the European Community is certainly the most challenging topic for the theoretician and practitioner alike. Several speakers will address the topic of European monetary integration in greater detail; and I would therefore like to take the opportunity to present a modest proposal to further the goal of European integration.

Time being limited, I will not be able to talk about the important role of central bank cooperation in the bank supervision and regulation process. That topic will have to wait for a future occasion.

Types of Macroeconomic Interation among Countries

But first back to Henry Wallich and his trilogy of consultation, cooperation, and coordination.

Wallich defined the most rudimentary form of interaction among central banks as consultation. It involves not only an exchange of information, but also an explanation of current economic conditions and policies. By reducing the information uncertainty, this process enhances the understanding of what is going on in the world at large and thereby can be a useful contribution to the policy-making

process.

In <u>cooperation</u>, countries retain full national sovereignty, but decide voluntarily to allow the actions of other countries to influence their own decisions. While the central banks make sovereign decisions, they may agree to certain mutually advantageous courses of action and even engage in certain joint efforts agreeable to all parties. In certain respects, cooperating central banks behave like families that cooperate in certain neighborhood projects, such as snow removal, agreeing not to use noisy lawnmowers on Sundays, or keeping an eye on each other's houses to prevent burglaries.

Finally, <u>coordination</u> involves relinquishing some or all decision-making powers to other countries or international institutions. Some loss of national sovereignty is inevitably involved. It is like setting up a formal neighborhood association with certain decision- and perhaps rule-making powers.

While these three categories do provide certain useful distinctions, they also introduce somewhat arbitrary divisions into what is, in effect, a continuum. Thus, we should not drive the categorization process to the limit.

Reasons for Increasing Integration

The reasons for the increasing integration of the world economy are manifold: ever lower transportation and communication costs are certainly important as are economies of scale in production. Furthermore, as incomes increase, the resulting demands will naturally tend to transcend national borders more and more. The demands of a person with a per capita income of $200 per year can probably be satisfied within the immediate community. As a matter of fact, it is unlikely that such a person will have the purchasing power to attract goods from far away. With a per capita income of $2,000, certain items may be bought from further away, and they may cross national borders in the process. But with a per capita income of $20,000, it is possible to purchase routinely goods and services from abroad. Finally, if your income is $200,000, the world is your oyster and global portfolio management will become a natural habit.

Consequently, rising incomes have brought -- and will continue to bring -- a rising integration of the world economy.

For central banks that are accustomed to managing their affairs in an independent fashion, this tendency toward greater economic and financial integration will continue

to bring a reduction in de-facto, if not de-jure, interdependence. Thus, the need for consultation, cooperation and coordination will steadily increase.

This increasing interdependence is also clear from the effect that policy actions taken by one central bank have on another. If, for instance, one central bank increases its interest rates, this may cause an inflow of capital into the country. Obviously, one country's capital inflow will be another country's outflow of capital, and the partner country's central bank will now have to make a decision either to let this capital outflow affect their own interest rates, to allow the exchange rate to change, or to take other policy actions. The point is that even in the event that a decision is made to take no policy actions, economic and financial markets will be impacted by the policy change in the first country. Interdependence cannot be avoided.

No-Action Agreements

Let me begin with a most important type of cooperative behavior that paradoxically involves no action at all. In fact, it is a formal agreement of inaction, and constitutes an understanding not to pursue certain policies. Examples include international agreements not to adopt protectionistic policies or to engage in competitive devaluations.

Such agreements can be rather formal, such as the General Agreement on Tariffs and Trade (GATT), which bars a wide range of protectionistic trade measures. In the financial arena, the member countries of the International Monetary Fund agree to avoid competitive devaluations.

There can also be less formal arrangements, such as the understanding among monetary authorities of the major countries that they will not engage in conflicting exchange market interventions. The list of such "negative agreements" could be extended considerably. Like the famous dog that did not bark, these agreements tend to be overlooked but are nonetheless important to assure the smooth functioning of international markets.

Institutional Arrangements

A broad range of international institutions have evolved over time that are dedicated to international consultation, cooperation, and coordination. Central banks are primarily involved with the Bank for International Settlements (BIS), the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), the European Community (EC), and the Group of Seven (G-7).

There are other important organizations that are active in the financial area, such as the World Bank (IBRD), and the various regional development banks. Furthermore, due to the increasing importance of financial services in trade, GATT negotiations increasingly involve central banks as well. Nevertheless, the five organizations mentioned occupy a special position in central bank policy cooperation and merit detailed analysis.

The five groups, the BIS, IMF, OECD, EC and G-7 vary in size, as well as the frequency and formality of their meetings.

The monthly meetings of the G-10 Governors at the BIS are unique in that they involve only central bankers. The meetings typically involve the heads of the central banks themselves, and the discussions are candid and informal. They generally involve an exchange of views regarding the current state of monetary conditions and foreign exchange markets as well as a discussion of the policy stances of the various countries. In addition, bank supervisory and regulatory matters as well as international debt issues may be discussed. Items of particular concern to a country, or any unusual developments, may also be brought to the attention of the group. Informal agreements or understandings may well develop out of the policy discussions, or formal actions, such as a bridge loan to a country in payments difficulties, may be arranged.

In contrast, the regular meetings of the IMF are more formal. The 22-member Executive Board of the IMF, comprising developed and developing countries, meets two or three times a week to discuss issues pertaining to individual member countries or general policy issues of concern to the organization. Formal votes are taken only infrequently, with the Board relying instead upon agreements arrived at by general consensus.

The Annual Meetings of the IMF are even more formal and most of the proceedings are public. It is on these occasions that the Governors of the IMF meet, give speeches, and ratify decisions. The semi-annual meetings of the IMF's Interim Committee focus on ongoing economic and financial issues that have systemic implications.

The focus of the OECD is broader, in that it transcends monetary questions. Meetings span a wide spectrum of issues and officials. They range from groups of experts on forecasting or technical issues to the Economic Policy Committee (EPC) and its various Working Parties all the way to Ministerial gatherings. Central banks are regularly represented in the Economic Policy Committee, which deals with assessing macroeconomic conditions and policies and structural reform issues, and in Working Party Three, which focuses on issues of international adjustment. As the main forum of the OECD to promote cooperation rather than more

ambitious coordination issues, the EPC is primarily a consultative body.

The European Community is increasingly devoting its energies to economic coordination, and has an elaborate structure of parliamentary and governmental groups to accomplish this purpose. The Ministerial Council and the permanent Commission are key decision-making authorities, who can make binding commitments by qualified majority vote. This is an innovation from the original concept of unanimity, which sidestepped the sovereignty issue by requiring unanimous consent of the member countries to any action taken.

In the financial area, the European Monetary System (EMS), plays a central role. It is designed to provide a zone of exchange rate stability within Europe and consists of a set of exchange rate arrangements, intervention rules, and lines of credit available to participating countries. As such, it is a clear example of central bank coordination in the exchange rate area.

One of the key questions facing the EC is whether the EMS should eventually be replaced by a European Central Bank. This is an issue to which I want to return later.

Finally, the Group of Seven is a consultative group that meets occasionally at the ministerial level, with central

bank governors in attendance. The G-7 also meets annually at the Head of State or Government level to set out the terms of cooperation or coordination on a wide range of policies for the major industrialized nations. While expectations regarding new agreements generally run high at summit-time in June or July, the regular gathering of the governmental leaders and their routine exchange of ideas and views is probably just as important. Experience has shown that regular consultation facilitates intergovernmental cooperation and lays the basis for more ambitious coordination efforts.

Exchange Rate Issues

Currency exchange rates are defined as the relative price of one currency in terms of another. As such they play a key role in economic and financial relations between countries as they affect the relative prices at which all international transactions are carried out. Central banks are involved in exchange rate issues in a variety of ways.

There is, first of all, the choice of an appropriate exchange rate regime for the nation. Second, a country's monetary policy may have to take the impact on the exchange rate into consideration. Third, countries have to decide on their foreign exchange market intervention strategy. Even in those countries, where exchange rate issues are the

formal responsibility of the Treasury or Finance Ministry, central banks generally act as the agents of the government in the foreign exchange markets.

Choosing an exchange rate system is one of the most important policy decisions a country has to make. It will influence a wide variety of policy options and may, in fact, determine the course of monetary policy.

At certain times in the past countries have adhered to a common international code of conduct. Examples are the gold standard and the post-World War II Bretton Woods system built around a par-value exchange rate system with IMF guidance and management.

At other times, such as the present, countries are free to determine their own exchange rate arrangements. In fact, countries adhere to a wide variety of exchange rate arrangements. There are many countries that peg their currency to another currency or a basket of currencies. For instance, of the 151 IMF member countries, 38 now (June 1988) peg their currency to the dollar, 14 (mostly former French colonies) peg to the French franc, and 5 peg to other currencies. In addition, 7 countries peg to the SDR and 31 to other currency composites. Furthermore, there are 4 countries that maintain limited flexibility of their currency versus another currency. Due to their pegging

policy, the monetary policies of these countries are in effect determined within narrow limits. That is, the strategy of the country's monetary policy is determined by the goal of maintaining a fixed parity.

However, the country still has latitude as far as the choice of tactics used to maintain the parity. Thus, the country may choose to change the discount rate, engage in open market operations, or intervene in the foreign exchange market. Broader policy options may be open to the country as well, such as fiscal policy, tariff changes, and a wide variety of other measures. But the bottom line is that the strategic decision to maintain a certain par value will force the central bank or other government agencies into a certain broadly defined policy orientation, thereby limiting the options otherwise available to the country.

Of course, the benefits from having a stable external exchange value can be considerable -- especially for a country with a relatively open economy. As the size of the foreign trade sector increases, the advantages of a fixed exchange rate in terms of price stability alone continue to increase as well. Thus, as the world economy becomes more integrated and foreign trade sectors grow in relative and absolute size, the advantages of fixed exchange rates tend to increase. Consequently, the degree of cooperation among central banks is apt to increase as well as more and more

countries have an incentive to maintain fixed exchange rates.

There are also 5 countries that adjust their exchange rates according to a set of indicators, usually inflation differentials. One may argue that the exchange rates of these countries also are fixed in the sense that a certain relationship between the external value of the currency and pre-determined indicators is maintained. It is nevertheless true that central banks choosing such a standard have the freedom to engage in inflationary policies at home without adhering to an external constraint. In this sense, crawling-peg arrangements merely validate any domestic policy pursued through an appropriate exchange rate adjustment. The country does not face a true external constraint that would rein in monetary policy excesses since the central bank maintains the freedom to pursue any monetary policy it chooses. The exchange rate adjustment formula merely serves as a mechanism for assuring that approximate purchasing power parity is maintained in the external sector. If trade and current account balances should come under additional pressures, further exchange rate corrections are usually required.

The 20 countries that maintain managed floating regimes and the 18 countries whose currencies float more or less independently face less pressure for immediate policy

changes in response to developments in the international sector. However, it is well recognized that exchange rate flexibility does not serve as a perfect buffer against external events. Thus, the central banks of these countries also find it useful to cooperate with their colleagues from around the world in exchange rate questions. Incidentally, there is one country, Kampuchea, where no one seems to know what the exchange arrangements are.

A unique exchange rate policy is pursued by the 8 members of the European Community that are members of the EMS. Designed to provide a "zone of stability" for the member countries, the EMS arrangement recognizes that these European countries are closely interlinked in their economic and financial affairs. That is, the degree of economic and financial integration between the members of the group is much higher than the degree of integration with the rest of the world economy.

Consequently, the EMS member countries have found it advantageous to maintain exchange rate stability among themselves while allowing their currency group to float jointly with respect to the outside world. Central banks participating in the EMS arrangement have well specified intervention obligations vis-a-vis each other's currencies. But no such obligations exist toward the outside world. Of course, the largest EMS member countries, Germany,

France, and Italy, are also active participants in the Group of Seven. The G-7 has become the major forum where broad policy decisions regarding exchange market policy for the major world currencies are made. However, the focus of the G-7 extends beyond exchange rate matters.

The Louvre Accord of 1987 set the broad framework of policy cooperation among the G-7 countries. The original Louvre Accord specified a list of policy obligations to be undertaken by the partner countries in furtherance of the objective of enhanced exchange rate stability.

But it would be wrong to see the Louvre Accord as a static set of rules according to which policies have to be adjusted. Instead, it represents a dynamic framework within which policy cooperation can be undertaken to the advantage of all concerned.

The Future of Cooperation

Looking to the future, two questions are of particular interest. First, will the perceived need for economic cooperation among countries increase? Second, will existing institutional arrangements prove adequate? In particular, will there be a need in the near future for a world central bank -- or at least a European Central Bank?

The answer to the first question seems clear to me. I have argued earlier that the potential gains from international cooperation tend to increase as countries become more open and integrated with the world economy. There seems little reason to doubt that the factors that have led to an increasing international integration of economic and financial markets will continue to be operative in the future as well. This should create further incentives for cooperation among governments and central banks.

In this regard, it is worth noting that the effects of country size on the incentives for greater cooperation create somewhat of a paradox. On the one hand, small countries tend to be rather open, and therefore very willing to cooperate. On the other hand, the largest countries, typically being less open, may feel less of an incentive to engage in cooperative action.

However, I believe that we have crossed an important threshold in recent years in that even the largest countries, such as the United States, can no longer afford to engage in a policy of "benign neglect". Not only has the international trade sector grown by leaps and bounds in the last few years, but the increasing integration of world financial markets assures that the United States is no longer insulated from developments in the world economy. Moreover, the increase in international indebtedness of the

United States has also increased the interdependence of the United States with the world financial system to such an extent that the United States can no longer ignore the international ramifications of its actions or events in the world economy on the United States.

Turning to the second question -- whether existing institutional arrangements are adequate for future needs -- a look at history gives ground for optimism. In recent years the international community has shown an impressive ability to modify existing institutional arrangements in response to changing circumstances and new requirements. In important ways, the system is able to adapt and to change in response to new tensions as they arise. That is, the system is flexible enough to adjust in an evolutionary fashion to changing circumstances without a need to resort to economic warfare.

A world central bank, which would unify the monetary policy for the entire world, presents therefore an unrealistically large step in our generation. This does not mean that such a step may not be unrealistic at some future time, when the world economy is even more integrated and regional and sectoral differentials have further eroded. But that time is clearly still decades, if not centuries, away.

Everyday experience shows us that even in a currency area as large as the United States, considerable differences in economic and financial conditions exist between, say, Texas and Massachusetts. Thus, the requirements of a unified monetary policy call for a considerable degree of compromise between the various regional interests. But the unified political and economic structure of the United States makes such a consensus possible. To bring the United States, Switzerland, Peru, and Gambia under the same monetary policy regime still exceeds the realm of the possible.

Europeans are now actively debating the question whether a European Central Bank is needed, or desirable, to further the objective of increasing European integration. Clearly, there are important arguments on both sides of the issue. Proponents of a European Central Bank argue that if the total integration of the European Community is to be achieved, a unified monetary policy becomes a necessity as well. Others are clearly reluctant to yield political sovereignty and control to such a supranational institution. There is the additional question of timing. Some proponents of a European Central Bank argue that it should constitute the final crowning achievement of European integration, while others make the case that moving forward with the establishment of a European Central Bank will accelerate the process of European integration.

I have recently argued that the American experience with central banking in a large diversified continent shows that a central bank can only be successful if all regional and special interests are adequately represented in the institution. Thus, the premature establishment of a European Central Bank might well expose the institution to such grave strains and potential policy conflicts that the new institution may be endangered.

I, therefore, have suggested that a more fruitful approach might be to build upon the existing successes of the EMS and to let the system evolve over time. But to advance the step of European unity in a symbolic fashion, I suggested that all European currency values could be adjusted in such a manner that the value of all currencies henceforth be equal to each other. After the value adjustment, one German mark would be equal to one French franc, one Dutch guilder, and one Italian lira. After a while, shopkeepers and hotel owners throughout Europe would probably accept the various currencies at par--thereby establishing a means of payment acceptable throughout Europe.

Of course, under these arrangements the pressure on central banks to maintain the new par values would become larger. The present need for cooperation among the European central banks would be replaced by a need for ever closer coordination of policies. But this would be even more true

in the case of a European Central Bank, which would by definition conduct a totally unified monetary policy.

Conclusion

In conclusion, I hope that I have given you not only a report on the state of central bank cooperation in today's world, but also have supplied you with some additional food for thought on future cooperation and coordination possibilities.

Above all, central bank cooperation has been successful because the officials involved have been committed to making the process work. They have forged many close personal relationships over the years and are able to consult each other over the phone on a moment's notice.

Economic and financial events in other parts of the world are nowadays routinely taken into consideration in the policy decision-making process, and the potential impacts of policy actions in an interdependent world are carefully considered.

Thus, I would argue that central bank cooperation is alive and well today and will continue to increase in importance in the future.