7 What Role for Central Banks?

By Arturo O'Connell

The Need for a New International Financial Architecture

The world is confronted with one of the worst crises in terms of financial disruption, cuts in output, income and jobs witnessed in more than half a century. The way out of such a crisis both in terms of a reorganization of the financial sector and a recovery of economic expansion, stability and job prospects is still unsure. Temporary upswings in financial markets have come and gone, and forecasts for the performance of output and employment have been repeatedly downgraded. Procedures applied by governments to sort out the financial crisis have thus far failed to revive credit, and subject to public scrutiny, have unleashed a bitter debate about the implied—somewhat less than transparent—results in terms of social fairness. The more vulnerable sectors of the population both in advanced and underdeveloped countries are confronted with sudden and drastic cuts in income and job prospects. Worst of all, expectations of a way out have become gloomier with each passing day.

A New International Financial Architecture (NIFA) should address the need to support a balanced expansion of the world economy as well as the development of all countries and the advancement of all sectors of the population, most specifically those with lower levels of income and welfare. A NIFA should also establish rules and procedures that could cope with the tendency of financial markets to run into crises. And, if in spite of efforts in such a direction, a crisis should crop up, resources should be available for each and every country to avoid the worst consequences of a crash.

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On the other hand, a NIFA should overcome the present-day limitations of the network of formal institutions, fora and generally-accepted rules that make up the one Architecture we have today. The problem is not only that some fields of action remain uncovered or ill-addressed—like tax havens or the "shadow banking" sector—or that an element of lack of coordination leads to some *cul-de-sacs*, like contradictory accounting and desirable prudential rules in banking. Most crucially, a pro-cyclical vein runs through the system that allows excesses in the upswings of the world economic cycle while—with notable but partial exceptions—rushing to impose predetermined strictures on the conduct of government policies in the downswing. Only the most powerful nations—and then only occasionally—will dare to risk opposing such limitations, and in this they are not always successful. For underdeveloped or peripheral countries there are no options; the bitter medicine has to be swallowed, and the most vulnerable sections of the population are bound to suffer the consequences

The Development of Central Banking and its Place in International Financial Architecture

Central banks are national institutions created at specific historical junctures in the life of their home countries to sort out a variety of problems. These problems have not always been the same. More than a few of the first central banks were supposed to facilitate the financing of government in exchange for being granted a monopoly on the issuance of fiat currency. Other central banks were created right after a serious crash had led to massive and generalised bankruptcies to act as the domestic banking system's "lender of last resort", providing almost unlimited liquidity to cope with a run on deposits. Still more central banks, particularly in underdeveloped countries, were created to centralize not only bank reserves but also foreign exchange reserves, so as to cope with balance of payments crises.

Furthermore, although there are some exceptions, central banks are typically in charge of managing currency issues and dealing with foreign exchange questions as well as ensuring the fundamental stability of the financial system. In this last task, central banks are charged with supervising other banks, precisely in the attempt to avoid crises that—it has been taken for granted—are recurrent. In fact, devoid of any grand theory to explain why, there is a consciousness that markets for financial instruments demand much more public intervention than an "invisible hand"-inspired theory of a market economy would suggest.

In addition, although, today it sounds almost outlandish, most central banks have also been an instrument of development policy and international competitiveness—and in a very few cases—of supporting the development of a powerful financial sector for either domestic purposes or—as has been surmised in the case of Great Britain—to become and remain a world financial hub.

Central banks, therefore, under formal or consensual agreement with authorities, have become potent instruments of national economic policies—and in the case of some of the more powerful nations—this includes foreign policies. The question of which specific national interests dominated the orientation of such policies, however, is a matter of much debate. Under gold standard rules, for instance, the maintenance of gold parities under adverse movements in the balance of payments led central banks to raise interest rates, resulting in deflation and/or unemployment. By the beginning of last century, this practice would be increasingly challenged by agrarian or workers movements and political parties, leading to a failure to reinstate the gold standard after WWI.

In the era of the first globalization, dominated in the financial sphere by the gold standard (GS) system, an international financial architecture of sorts did arise. Central banks were part of this architecture—the most powerful of them playing at the edges of the system—even though they were developed as instruments of national policy. Here and there they worked in cooperation to provide each other loans in moments of crisis that were massive enough to be beyond the powers of any single institution to cope with. In doing so, they also combatted possible contagion. After WWI central banks became active participants in an attempt that as already mentoned was eventually frustrated to re-establish the GS system on a permanent basis. In addition, some of the major central banks participated in rescue operations for newly-born nations pre-announcing IMF operations. Their participation in international affairs also included giving advice on the creation of

central banks along the lines of what—in the late decades of the 20th century—would become conventional orthodoxy, that central banks should be “autonomous” of governments and devoted to preserve monetary stability above any other consideration.

The domestic and international financial crises of the interwar period—associated with widespread banking failures and the collapse of stock exchange prices –pulled banking and consequently the central bank’s role in a different direction. Deposit insurance was introduced to avoid bank runs: in the United States, for instance, which had become the world’s major economy, with New York becoming the most important world financial center, deposit-taking institutions were placed under the strict supervision of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). In addition, deposit-taking institutions were separated from investment banking activities. Floating exchange rates, competitive devaluations and the introduction of exchange controls became rampant.

Only a couple of instances of international cooperation involving central banks may be recollected, e.g., the creation in 1930 of the Bank of International Settlements (BIS). Originally the BIS was supposed to handle payments associated with German reparations (that stopped under the 1931 Hoover moratorium), but it also was granted statutory power to promote “central bank cooperation”. In fact, attempts were made early on to organize support for the Bank of England before sterling left the Gold Standard. The Tripartite Agreement of 1936 was struck between France, the UK and the US—and with explicit central bank participation—as an attempt to stabilize exchange rates involving sterling, the US dollar and the French franc, after the last one was devalued under the Popular Front government that came into power in 1936. The BIS became instrumental after the Second World War in setting up mechanisms of cooperation like the European Payments System (EPU) before the return to convertibility of European currencies in early 1959.

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WWII brought a further tightening of bank regulations and government control of finance. Previously private central banks were nationalised and placed under the strict control of governments that were handling international economic and financial affairs more closely than ever before. In both advanced and underdeveloped countries central banks were instructed to support not only government finance but also credit policies orientated toward reconstruction and development as well as balance-of-payments support. This was done by establishing differential reserve requirements and applying sectoral credit allocations, credit and interest rate ceilings. Of course, central banks would also apply the more general instruments of monetary market intervention through overall reserve requirements, open market operations on the basis of government paper and not only private debt instruments plus intervention in foreign exchange markets. Also, a good many of the existing central banks, particularly after the massive unemployment experience of the interwar period, were asked, either informally or formally, to promote full labour employment.

In terms of International Financial Architecture, war cooperation and the urge not to allow the international turmoil of the interwar years to make a comeback, led to the creation of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). The Bretton Woods era that followed (1945-1971), was one of limited financial development both domestically and internationally. Exchange rate parities were mainly fixed, even if some of them eventually devalued against the US dollar that had become the true pillar of the

system. Financial systems were fundamentally bank-based but at the same time strict controls placed on their operations resulted in the near disappearance of crises and, therefore, of the need for emergency central bank intervention. -Private flows of finance across borders were very limited. The Bretton Woods Institutions (BWIs) took first place as well as Multilateral Development Banks in various regions of the world and also official bilateral flows of finance, as either aid or export credits played an important role.

Central Banks exchanged information and received or provided technical assistance to each other mainly through the means of the IMF mechanisms. Some of the more important banks also started using BIS—and informal fora under its umbrella, reinforced by a less reluctant US participation—to start exchanging views on policies and desirable institutional reform, both of the banking sector at large and of their own institutions. The ground was thus laid for building up the rules that would be instituted in the later decades mainly on the matter of financial supervision.

The Transformation of Banking and Central Banks and the Comeback of Financial Globalization

The last quarter of a century has witnessed major changes in the character of banking—and consequently of the power of central banks over financial markets—as well as in the orientation and responsibilities of central banks within such a context. In its turn, the inter-play between national and international concerns became much more intense in the financial sphere during this period, additionally eroding the sovereignty of nations and the power of single central banks.

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Financial systems have since become ever more market-based and less dependent on bank loans, particularly in the more advanced "Anglo Saxon" countries, the proportion of financial instruments in the hands of commercial banks having declined. Banks, also, with the official "blessing" of central banks and governments have adopted the so-called "originate and distribute" model under which loans do not remain for long in their portfolios. Once granted, these loans are packaged and sold directly to the public or to other specialized intermediaries in the so-called "securitization" process. A distant relation was thus created between borrower and ultimate creditor that weakened what had traditionally been a direct relation between and bank and customers. The loss of information and dispersion of responsibility that resulted made a significantly negative contribution to financial stability. At the same time both governments and companies started avoiding banks as lenders and went "over their heads" directly to the markets to place their debt obligations. Banks also resorted to markets—including the interbank market—to handle liquidity and to complement the resources provided by depositors.

Far from being a "natural" development, such an evolution was to a great extent the result of specific policies followed by the authorities and by the same central banks. International Financial Institutions also played an important role by promoting the "Anglo-Saxon" model over the "Continental European", bank-based model. Consequently, central banks found themselves commanding an ever shrinking part of the financial system. Also, as central banks relinquished some of their traditional prerogatives in supervising the financial system, in exchange many of them obtained the long cherished aim of "independence", *vis-à-vis* governments. These same central banks then began to refrain from lending to their government,

although they continued to trade in government paper in order to manage interest rates through open market operations and "repos" or "reverse repos" (transitory purchase operations carrying the obligation of a future, short-term repurchase).

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The recent history of central banks, in both advanced and underdeveloped lands—with very few exceptions—has been one of reforms with the single-minded task of keeping goods-and-services inflation low. Central banks have followed and promoted this framework while congratulating themselves repeatedly on their success in this endeavour. Inflation did actually come down all over the world, ushering in what has been called the era of the 'Great Moderation".

But that same era—even in spite of the brave warnings coming from everyone from independent observers to some of the institutions of the existent Architecture—was also one where crises returned with a frequency matched only by the interwar period, even in advanced countries like some of the Nordic ones. The world was thrown into an unprecedented era of financial de-regulation in which "markets" became masters in charge of an increasingly complex system arising out of the "securitization" and "disintermediation" processes. "This time is different", argued the protagonists of the recent era, as well put across in the title of a recent contribution by Kenneth Rogoff and Carmen Reinhart to the examination of several centuries of financial crises. Risk had supposedly been washed away from the system by "atomistically" distributing it among so many agents that a disruption here and there would not bring down the whole system, even if some individuals or institutions could be badly hit.

Individuals and institutions who were encouraged to estimate risks on their own by closely tracking market prices and modelling past behaviour, adopted similar rules all around or relied on ratings produced by less than a handful of agencies that also followed the same modelling of risks. Thus, the rules of behaviour for different agents became remarkably similar and—when linked to the behaviour of market prices—in fact, ended up encouraging all agents to act in the same ways. The "atomistic" dispersion of risk therefore became a mirage.

Financial markets do recurrently enter into crisis. This has been verified by the experience of many centuries but has also been consistently ignored, even when—as in recent times –a scientific explanation for such crisis has been provided. Therefore, prices in markets that repeatedly fail, surely cannot furnish good guidance for pricing financial instruments. Worse, the same experience and scientific reasoning indicate that financial market failures bring along phenomenal, economy-wide, negative effects that have always required massive public intervention. Consequently, de-regulation on the premise of well-functioning markets was always a mistake, a mistake in which central banks took on in their other role besides that of inflation fighting, that of banking supervision.

Not that inflation fighting, at least when taken to the extreme, is necessarily an objective that if reached could ensure that the economy would work to expand jobs and opportunities or promote rapid growth in underdeveloped countries. The Federal Reserve System—the central bank of the US—after all, operates by a double mandate under which it has to fight both inflation and unemployment. For instance, the previous Governor of the Bank of England, who adopted "inflation-targeting" as the main guideline for the Bank's policies, is on the record stating "we are not inflation-nutters", i.e., other considerations like employment levels were still a valid consideration. But consider the dominant mandate adopted in the last few decades,

as consecrated in the European Central Bank (ECB) statutes: "The primary objective of the ESCB [European System of Central Banks] shall be to maintain price stability". This statute comes with a kind of escape clause linking this article (105) to Article 2 in the Consolidated Version of the EU treaty that instructs the Bank to "…support the general economic policies in the Community with a view to contributing…" to "…promote economic and social progress and a high level of employment and to achieve balanced and sustainable development". Nevertheless, the overarching objective of the ECB has been to ensure a low rate of inflation.

Additionally, the single instrument necessary to achieve that end was supposed to be intervention in the short-run interest rate market. Reserve requirements were not used, let alone applied to either macroeconomic or for industrial policies. The same thing happened with credit controls—overall or discriminatory—in spite of a growing literature that emphasized managing credit levels more than money levels as the more effective instrument for central bank policies.

For all the rigmarole about the need to avoid inflation—and that any rate above low single-digits is bad for the health of the economy and jobs and bound to become explosive through price-wage spirals—empirical work has been most inconclusive, particularly in the case of underdeveloped countries. Trade-offs between high interest rates—raised to counter inflation—and employment or growth have been ignored or explained away by new theories. In fact, the era of the "Great Moderation" has become—with the exception of the immediate phase previous to the present-day crisis—an era of much lower growth and higher unemployment levels than that of the previous quarter century.

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Under such transformations in banking, aspects of the current International Financial Architecture have been designed by central banks. This is at least true of those in the industrialized and most advanced among the underdeveloped countries. Their governors and many of the highest-placed officials attend a multiplicity of meetings among themselves where a common vision of problems facing the world economy is debated. This way, a so-called "epistemic community" has become established, i.e., an informal consensus about what is appropriate for a central bank to do is reached and some rules are accepted, such as the so-called Basel Committee rules on prudential regulations, to be followed by all institutions like capital ratios or risk measures that are applied without any public debate, let alone approval by legislative or executive bodies in a majority of their countries. The fashion for "independent" central banks—independent from publicly elected authorities in each country—has only reinforced such a "community" as they have been granted an authority above political debate that allows those consensual views and rules to be put into practice.

On the matter of the International Financial Architecture, central banks have a tradition of cooperation—or conflict—on specific matters like exchange rate policies or foreign reserve accumulation, leading in the more amicable cases to reciprocal swap lines being established both in the advanced regions (see US Federal Reserve recent swap lines with Europe and a few "emerging market" countries) and more recently among some underdeveloped ones, like the Chiang Mai initiative in East Asia or the Latin American Reserve Fund (FLAR for its initials in Spanish). There is also an active exchange of officials on many specific technical matters that although innocent looking do contribute to a great extent to the development of the above mentioned "epistemic community".

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Among the various objectives and instruments that have been taken away from the terms of reference and toolbox of central banks, is that of an exchange rate objective and the instruments needed to achieve this objective. For underdeveloped countries (and as the experience of the US in the late 1980s and right now also shows), the exchange rate is a crucial price. It not only enters decisively into price formation—and therefore in the cherished objective of inflation control—but it is also a major determinant of the international competitiveness of the economy, as patently shown by the serious consequences to countries that allowed currency overvaluation. Massive damage to their industrial structure, external deficits, debt accumulation and eventually a balance of payments cum foreign exchange cum debt crisis accompanied in many cases by a domestic financial sector crash and serious fiscal difficulties, all of which resulted from allowing their own currency to overvaluate. Those multiple crises resulted in a drastic fall in output and incomes, sudden increases in poverty levels and socio-political turmoil.

Moreover, under the present-day international "rules of the game" (for instance as consecrated in the Articles of Agreement of the IMF) countries in exceptional circumstances, but still under the obligation to avoid any obstacles to external payments in their current account are authorized to place controls on capital movements. The use of this prerogative was habitual, even in advanced countries, until very recently, but it lost support and—to the contrary—became a matter of conviction to advocate capital account liberalization. This conviction was exercised so strongly that in the late 1990s significant progress was made to amend the IMF Articles of Agreement to establish that members—encompassing most countries–should eliminate each and every instrument of capital movements administration. The onset of the Asian crisis, as well as those that followed, led to a postponement of the question. Various governments pursued the idea through bilateral means, notably the US, which introduced clauses to that effect in Free Trade and Investment treaties it signed with a number of countries.

The idea that "hot-money" flows were behind many of the problems of the interwar period—particularly under the attempt to rebuild a somewhat mythical pre-WWI, liberal international economy –resulted in the above-mentioned sections of the IMF agreement. Unstable flows searching for better profit opportunities had played havoc with balance of payments and resulted in the resort to protectionist and deflationist measures to compensate for the effects of those de-stabilising forces. Today global balance of payments imbalances are rampant, and the counteracting capital flows are unstable, even when they come out of foreign-exchange-reserve accumulation by central banks trying to self-insure themselves against foreign shocks after the experience of the 1990s.

Instability induced by "hot-money" flows is only one consequence of their liberalization. Research from impeccable sources—such as work produced at the Research Department of the IMF under the direction of two of the last Directors- has shown that capital account liberalization is not a sufficient condition for growth of underdeveloped countries, even to the point of becoming a negative force on its own. Most explanations for these negative effects blame either the raising of limits to consumption (by providing easy finance rather than increasing investment) and/or the forcing of currency overvaluation in the upswing, with negative consequences for international competitiveness and a deleterious impact on external instability.

Central Banks have allowed these processes to prevail by abandoning management of exchange rates and relinquishing—with the acquiescence of governments—their

capacity to control capital movements. The consequence has been repeated and serious crises as well as lower rates of growth for their economies.

The Role of Central Banks in a New International Financial Architecture

A NIFA cannot be a straight-jacket with the narrowminded objective of avoiding inflation without regard for the cost in terms of growth, jobs and general welfare. It is clear that the present Architecture—which to a great extent is responsible for the present day crisis—has to be fully overhauled and lessons drawn about the myth of "self-regulated" financial markets. On the contrary, a NIFA should prioritize the promotion of full employment and development of the less-favoured nations. It should also establish stern rules both for domestic and cross-border financial activities. A NIFA should produce a decisive shift in central bank priorities and terms of reference. Since central banks are national institutions, a tension, will no doubt always be present between their internal obligations and those related to cooperation in the international sphere. International cooperation and common rules for the NIFA—at both a global and a regional level—it is necessary to avoid "free riding" and "regulatory arbitrage".

Some of the shifts and changes in central banks, which should be included in a new NIFA are:

1. Central banks should re-build their regulatory controls over the banking system, including the "shadow" banking system. No agent or institution involved in leveraged financial intermediation should be beyond its reach;

2. Regulations should be based on macro as well as micro considerations to preserve the system rather individual institutions;

3. Most specifically, provisions should be introduced to counter the pro-cyclical character of the banking and the financial system in general;

4. Regulations should also support the development of each and every country by allowing and actively promoting credit allocation and overall control of credit as part of a development policy rather than only concentrate on passive deposit accumulation;

5. Regulations cannot be based on the notion of "self-regulated" markets but on the general welfare of the population and their enhancement. The mandate to disregard the whims of the financial market and to fight their pro-cyclical tendencies should be handed down from regulators to the regulated;

6. Central banks should recover their capacity to intervene in the exchange markets, not only through the back door—as is practiced in many countries—but as an objective as valid as that of inflation or financial stability, in fact, all of them quite tightly interrelated;

7. Capital controls in the form of direct administrative measures and/or taxes à la Tobin have to be introduced, if not by all countries, at least for those conscious of their need; and

8. Support for government enterprises and public works should be utilized as springboards for development rather than being curtailed.

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Although the author is a member of the Board of Governors of the Central Bank of the Argentine Republic, the views expounded in this paper should not be construed as the opinion of the Central Bank neither of the Argentine Government authorities but only an expression of his personal ideas.