

Central Bank Cooperation - The experiences of emerging and developing economies

Speech by Dr. Emsley Tromp on the occasion of CEMLA's 60th anniversary commemorative conference - Mexico City, July 19, 2012

Good afternoon ladies and gentlemen,

First, allow me to congratulate CEMLA on its 60th anniversary. For the past 60 years, CEMLA has consistently promoted better knowledge of financial and monetary topics in Latin America and the Caribbean through cooperation among the region's central banks. This cooperation has evolved according to the prevailing economic conditions, developments in economic thinking, and political views. Against this background, I would like to discuss the experiences of emerging and developing economies in the area of central bank cooperation.

Central banks have a long tradition of cooperation. Over time, the objective of cooperation has shifted from monetary stability towards the more comprehensive issue of financial stability, and, the intensity and forms of cooperation have changed. During the 1920s, central bank cooperation was aimed primarily at sustaining the gold standard. In the 1960s, central banks cooperated mainly to maintain the Bretton Woods system of fixed but adjustable exchange rates. Because of the disappointing experiences with foreign exchange rate interventions in the 1970s, central banks became more inclined to preserve monetary stability through domestic monetary policy actions than through international policy coordination. As financial markets became more integrated because of technological developments and financial innovations, in the 1980s and 1990s central banks cooperated largely on development and introduction of international standards for prudential regulation and coordinated financial sector supervision. During the international financial crisis that started in 2007, central banks coordinated their efforts to fight systemic liquidity risks and, through monetary policy coordination, attempted to reduce the risk of deflation and prevent a deep global recession.

Cooperation among central banks is important both at a global and regional basis. Cooperation is encouraged at a global level and carried out at a regional level to account for regional differences. In the case of emerging and developing economies, cooperation among central banks follows by and large policies agreed upon by multilateral institutions. The Bank of International Settlements is of course the best example of a global organization for discussion, consultation, and cooperation among central banks. Meanwhile, CEMLA promotes cooperation between central banks on a regional level. In fact, as mentioned by Javier Guzman this morning, CEMLA has played a key role in the promotion of regional coordination through a global perspective. Hence, CEMLA has become a global regional player.

Over time, the number of central bank organizations in our region has increased and includes organizations such as the Central American Monetary Council (CMCA), the Fondo Latinoamericano de Reservas (FLAR), and the Caribbean Centre for Money and Finance. The main reason perhaps, for the increasing number of regional organizations is that certain exchange rate and financial stability issues are regional in nature and directly impact a particular region. Such issues can be best addressed regionally. Also, some emerging and developing economies have claimed that the global organizations are overwhelmingly oriented towards the Western economies. However, the risks always exist that a proliferation of regional organizations may result in fragmentation of our coordination and cooperation efforts leading to less effective results.

Cooperation and coordination of central banking activities is very important for emerging and developing economies. Central banks in industrialized economies usually have just one responsibility, that is, conducting monetary policy with the single objective of maintaining price stability. In contrast, central banks in emerging and developing countries usually have several tasks in addition to monetary policy. These tasks include debt management, advising the government, and financial sector regulation and supervision.

As a consequence, these central banks have to pursue several objectives in addition to exchange rate stability and promotion of economic growth. At the same time, the resources of these central banks, in particular financial and human resources, often are limited. Therefore, cooperation and coordination with other central banks can be very beneficial for these institutions.

Central banks are willing to cooperate as long as they pursue common goals. This cooperation can take several forms, the simplest of which is the exchange of information and experiences. In the case of the emerging and developing economies, cooperation between central banks in this area is crucial given their relatively limited human and financial resources. First, central banks exchange data and forecasts, which enable them to compare and discuss economic and financial conditions and trends. In this context, the standardization of concepts and the availability of data are crucial. Second, central banks share and discuss theories, empirical studies, and research. This exchange will enhance their understanding of economic issues such as inflation targeting, potential output, exchange rate behavior, the transmission mechanism, and equilibrium interest rates. Also, central banks exchange information about their policy choices and approaches, which can stimulate policy coordination between central banks.

CEMLA has played an important role in our region in the area of dissemination of information and experiences among central banks. Over the years, the organization has organized several seminars on statistical methodologies and theoretical approaches. In addition, the CEMLA regularly publishes and distributes empirical studies by central bank researchers in the region and organizes seminars and conferences to discuss the empirical findings.

A second area of cooperation between central banks is the provision of emergency assistance in exceptional circumstances. Over time, central banks have supported each other in situations such as liquidity crises in order to mitigate systemic liquidity risk. This emergency assistance has included, among other things, coordinated foreign exchange operations. In the past, several central banks in the emerging and developing economies received emergency liquidity assistance. For example, during the debt crisis of 1982, the US Federal Reserve offered the Bank of Mexico a \$700 million swap agreement. During the currency crisis of 1994, the Bank of Canada offered Mexico a short-term swap of US\$ 1 billion. Furthermore, Brazil received financial support from the Bank of International Settlements in 1998 in the context of an IMF stabilization program. During the recent international financial crisis, a new form of cooperation emerged in the provision of emergency assistance. Major central banks, including the US Federal Reserve and the European Central Bank, opened up inter-central bank swap facilities and repurchase agreements to provide central banks with emergency liquidity.

In my view, the third and most ambitious form of cooperation between central banks is coordination of monetary and exchange rate policy. The rationale for policy coordination in these two areas stems from the potential externalities that domestic policy in one country can have on other countries i.e., the “beggar thy neighbor” policies. For example, monetary tightening in one country to reduce inflation will lead to exchange rate appreciation and hence may cause inflationary pressures in a trading partner of that country. As a result of increased globalization, these spillover effects have become more apparent.

However, after the fall of the Bretton Woods system in 1971, the appetite for coordinated monetary policy and exchange rate intervention declined. Central bankers had a common belief that the best way to achieve monetary stability was through domestic policies. As a result, central banks became less inclined to trade off their policy autonomy for global or regional policy coordination in the areas of monetary and exchange rate policy.

However, the recent international financial crisis has resulted in an intensification of monetary policy coordination. In October 2008, the US Federal Reserve together with the Bank of Canada, the Bank of England, the European Central Bank, the Central Bank of Sweden, and the Swiss National Bank announced a reduction of their policy interest rates to counterbalance deflationary pressures and an economic slowdown in these countries. In my opinion, this joint intervention signaled the return of monetary stability

as an important objective of central bank cooperation. Hence, today, central bank cooperation is aimed at maintaining both monetary and financial stability.

Finally, financial sector regulation and supervision is a fourth area of cooperation between central banks. While most industrialized countries have separate authorities in charge of financial sector regulation and supervision, in most emerging and developing countries this task is concentrated at the central bank. Hence, this area of cooperation is very relevant for our region.

As I mentioned, because of technological advancements and financial innovations, the financial markets have become more integrated across countries. To promote financial stability, central banks have been cooperating in the area of financial supervision and prudential regulation. Besides central banks, policymakers and other market players also have been involved in these international efforts. One example of successful cooperation among central banks in this area is the Basel Committee on banking supervision. In addition, central banks participated in the Financial Stability Forum. In our region as well, we have several central bank organizations aimed at promoting financial stability.

Notwithstanding these efforts, the world economy experienced a major financial crisis in 2007. We are still experiencing the effects of this crisis. In an effort to prevent a collapse of the global financial system, authorities, particularly in industrialized countries, took unprecedented measures aimed at supporting demand and reducing uncertainty and systemic risk in financial markets. Meanwhile, through multilateral cooperation and collective policy actions among for examples the members of the G-20, the effects of this financial crisis were mitigated. This multilateral cooperation and policy coordination has reshaped the cooperation among central banks in emerging and developing countries.

Economists and policymakers worldwide agree that the weaknesses that led to this financial crisis should be addressed. Financial regulation and supervision need to be strengthened to prevent a similar crisis in the future. This will require a number of steps. (1) Regulation should be broadened to include all activities that pose economy-wide risks. (2) Financial regulation will have to focus on strengthening financial institutions' management of liquidity and risks. (3) Conflicts of interest should be reduced by making bonuses more consistent with long-term success than with short-term profits. (4) The transparency of the financial system should be improved. In the area of financial supervision, the focus should be on detecting developments in the financial sector that might lead to a systemic crisis.

An important lesson of the last international financial crisis is that international cooperation and policy coordination are crucial to maintain financial stability. Hence, these issues are currently being addressed on a global and regional level.

International and regional cooperation in this area is very important for the Central Bank of Curacao and Sint Maarten to promote financial stability in our monetary union and to strengthen our position as an international financial centre. Our Bank is currently a member of several international and regional organizations aimed at promoting financial stability. These include among others, the Association of Supervisors of Banks of the Americas (ASBA), the Group of International Finance Centre Supervisors (GIFCS), the Caribbean Group of Banking Supervisors (CGBS), the Offshore Group of Insurance Supervisors (OGIS), the International Association of Insurance Supervisors (IAIS), the Council of Securities Regulators of the Americas (COSRA), the Caribbean Group of Securities Regulators (CGSR), and the Offshore Group of Collective Investment Schemes Supervisors (OGCISS).

Colleges of supervisors are an important example of regional cooperation providing an effective and efficient supervisory oversight on cross-border financial institutions. Therefore, within the Dutch Kingdom, which comprises the Netherlands, Aruba, Curaçao, and Sint Maarten, we also are increasing cooperation and coordination of our policy initiatives in the areas of financial sector supervision and regulation. We have created a financial supervisory structure in which each country within the Kingdom has its own supervisory institutions complemented by a standard-setting body at the Kingdom level: the Committee of Kingdom Supervisors.

This Committee consists of the presidents of the respective central banks and is charged with preparing legislation in line with international best practices, the timely implementation of rules and regulations, and monitoring compliance. Such a structure while regional, guarantees compliance with international supervisory standards. In addition, it creates a level playing field with uniform rules within the Kingdom and promotes credibility and transparency.

In my opinion, a new economic order has emerged as a result of the international financial crisis. This new economic order has reshaped cooperation between central banks. First, the scope of central bank cooperation has broadened and deepened. For the past 30 years, the main focus of central bank cooperation was financial stability. Today, central bank cooperation is aimed at both monetary and financial stability. Second, while industrialized countries were the key players in global governance before the financial crisis, today, emerging economies also are actively involved in the international decision-making process with regard to efforts and interventions for monetary and financial stability. The emerging economies have gained this position thanks to the many structural reforms they have introduced over the years. As a result of these reforms, these countries remained a source of strength for the global economy during the recent crisis.

In conclusion, during its 60 years of existence, CEMLA has witnessed several forms of central bank cooperation. Today, the aim is to promote both monetary and financial stability. Also emerging economies, including those in our region, are now playing a key role in the governance of central bank cooperation. The 60th anniversary of CEMLA is an occasion for not only celebrating but also reaffirming our commitment to close cooperation in order to achieve monetary and financial stability, crucial for sustainable economic advancement of our countries, the region, and the world in general.

I thank you for your attention.