

**PRIVATE CAPITAL, CENTRAL BANKS, AND INTERNATIONAL MONETARY
GOVERNANCE**

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Most blueprints of the new international financial architecture award a central role to the International Monetary Fund (IMF), even if its role is more narrowly defined. This widespread assumption of an IMF-centered system of international monetary governance has persisted for nearly three decades, despite the end of a fixed-exchange rate system overseen by the IMF and the emergence of G-7 policy coordination that has marginalized the organization. Well before the currency and financial crises of the 1990s, however, Padoa-Schioppa and Saccomanni argued that a preferred alternative to an IMF-centered system exists in the network of central banks, institutionalized in the Bank for International Settlements (BIS). Rather than a reinforcement of the IMF, they claim that the forty-year transition from a government-led international monetary system to one that is market-led calls for a “central banking function” at the global level, though not a global central bank.¹ In their view, the present system is one in which critical policy functions “either are carried out in an ad hoc manner through sporadic intergovernmental action, are left to the spontaneous initiatives of market participants, or simply do not exist.” (1994, 236)

These arguments for institutional change appear to be confirmed by recent developments. The Asian crisis has redirected attention to the critical role of banking regulation and supervision in containing international financial contagion. Creation of the Financial Stability Forum—the only new institution to emerge from the financial turmoil of the last decade—suggests that a shift toward central banks in international financial governance may be underway. The new Forum will be housed at the BIS in Basel, not at the Bretton Woods institutions in Washington. The foundation of the Forum—along classically networked and

¹ They avoid making detailed institutional recommendations, but they clearly favor the BIS as the core of their new framework of governance. Their arguments are echoed, for international regulatory and lender-of last-resort functions, by Fratianni and Pattison (2000).

informal central banking lines—follows twenty-five years of expanded international cooperation at the BIS on financial regulatory and supervisory issues.

Further support for an association of expanded private capital flows with governance by central banks is offered by a simplified periodization of international monetary governance over the past century. Central bank governance appears to dominate during periods of international financial openness (the periods of the classical gold standard and the gold-exchange standard). Conversely, imposition of capital controls and a decline in capital mobility has been associated with intergovernmental institutions (or simply intergovernmental bargaining) at the core of international monetary governance. If the association can be grounded in a causal model, increased capital mobility could plausibly predict movement from the present hybrid system of governance toward one centered on central banks.

Investigating the causality that may underlie this apparent association is the first aim of analytic comparisons that follow. Rather than presenting the history of international monetary governance as Before Bretton Woods and After Bretton Woods, however, this account presents three alternative forms of governance that have competed and co-existed over the past century: a central-bank, private finance model; an institutionalized intergovernmental model (Bretton Woods to 1973); and an intergovernmental bargaining model (the Tripartite Agreement of the 1930s or the current G-7 framework). These alternatives have consistently varied on three dimensions: legalization (the level of obligation and precision of rules and delegation to a third party for interpretation, monitoring or enforcement), methods of rule-making (incremental, “bottom up” versus contractarian, “top down”), and the boundaries of public and private participation in governance (from exclusively public to varying degrees of joint public/private).² Across historical periods, central bank governance has consistently inclined toward collaboration that is not legalized, is guided by conventions that evolved incrementally over time, and involve participation by private financial actors.

²² On the definition of legalization and its application to international monetary affairs, Abbott et al. (2000) and Simmons (2000).

Explanations advanced for the selection of these institutions of governance are familiar from the literature on exchange-rate regime choice. (Eichengreen 1995). Functionalist explanations as defined here do not rely on an institution's ability to fulfill a specified list of systemic requirements. Rather, demand for a system of governance arises from an evaluation by agents of its prospective costs and benefits. Agents choose institutional alternatives because of their intended effects. If capital mobility drives those choices, choices among these competing models may be influenced by their promised solutions to heightened policy interdependence (increased spillovers) and their approach to two arms of the policy trilemma that remain under capital mobility: exchange rate stability and monetary policy autonomy.

Domestic politics and political economy offer a first cut at the preferences in functionalist models. These include factor endowment models based on relative abundance of capital and labor as well as specific factor models that posit sectoral preferences over exchange rate levels and fixity under conditions of capital mobility. (Frieden and Rogowski 1996, Frieden 1991, 1994) Other domestic political explanations assign policy preferences to broader, typically class-based, political coalitions and parties in order to predict national preferences over international monetary arrangements. Each of these pathways to national preferences raises issues of interest aggregation and collective action within domestic political institutions. (Simmons 1994)

Political economy accounting models of this kind have two shortcomings. First, the weight assigned to particular groups or sectors in specifying national preferences can only be estimated if a domestic institutional filter is specified. The institutional filter is particular important in this case, since the international governance alternatives in question are centered on different domestic institutional anchors: national executives (finance ministries) or central banks. Groups or coalitions may choose one arrangement over the other because of the privileged access or predominant influence that they may enjoy in a particular setting as compared to other institutional alternatives. Private finance, because of its multiple links to central banks, has typically preferred central-banked centered systems to intergovernmental models, for example.

At a particular point in time, only a restricted menu of governance alternatives is available to political actors. The supply and restriction of alternatives on that menu is another issue for empirical investigation. The determination of the menu of choice is both cognitive and political. Policy alternatives are ruled off the agenda by powerful intellectual and political consensus. Leaving the gold standard assumed this status among the major economies of Europe before 1914. Devaluation became the unmentionable in Britain and the United States during the waning years of Bretton Woods. Capital mobility and the risk of speculative attacks explain only part of the truncation of public discourse. Choice is also biased by historical filters that emphasize certain economic risks rather than others. In certain instances (a return of the Great Depression), these interpretations are not difficult to explain; in other cases (fear of inflation during the Great Depression), they are important explanations for policy decisions that would otherwise remain puzzling.

One explanation for variation in international monetary governance can be set aside: the distribution of international economic power. The existence of a dominant economic and financial power—Britain during the pre-1914 gold standard; the United States during the Bretton Woods era—cannot explain the dominance of one of these alternatives over another. To the degree that the dominant powers had some influence over the outcomes, their preferences must have differed. These two periods, similar in the distribution of power, produced very different governance structures, one squarely based on national legal commitments and central banks, the other on a formal intergovernmental agreement.

In testing explanations for the selection of one model of international monetary governance over another, a final development shaping choice should be noted. Over the century a proliferation of international and regional institutions indicated a secular increase in government acceptance of delegation to those institutions. The choice of formal multilateral agreement as a means of governance became more likely. Central banks also evolved as institutions, from a diverse institutional array before 1914 to convergence on a common model of activities and organization by mid-century. Finally, although democratization did not increase in

a monotonic fashion over the century, the relative number of democracies, particularly among the industrialized countries, was higher at the end of the period than at the beginning. Economic policymaking was transformed by the advance of democratic institutions. Each of these developments would affect the content of the institutional alternatives in question.

Evaluating alternatives in international monetary governance

Functionalist explanations depend on the evaluation that agents make of alternative governance choices. Those evaluations are made within the context of particular historical periods. In addition, governments or other agents may miscalculate the benefits and costs of particular alternatives because of unanticipated consequences. A final part of this analysis, therefore, is a tentative evaluation of these alternatives along criteria that are less time-bound. Economists have often evaluated alternative monetary institutions in terms of their economic consequences. Here, three criteria are used to evaluate competing international institutional designs. The narrowest criterion assesses systems of governance for the incentives that they offer for actors to consider the prospective consequences of their actions on others and the likely feedback effects of their response on their own interests. The governance alternative does alter of national policies, only ensure that self-interested behavior incorporates system awareness. A second criterion of evaluation is compliance with recognized formal or informal rules or norms. Such compliance, over time, can create credibility for government policies vis-a-vis other governments and financial markets. The third and broadest criterion, cooperation, is important across a range of financial and monetary issues. Political scientists typically define cooperation as mutual adjustment of policies in the interests of joint gains; policy coordination and cooperation are used interchangeably.³ Economists often define cooperation to include a wider range of behavior, using the previous, narrower definition for policy coordination. The political science convention is adopted here. As policy interdependence deepens under conditions of capital mobility, the demand for cooperation can be expected to grow. When rule-governed systems are

subjected to political or economic shocks, cooperation may be required to stabilize them. The ability of competing models of governance to promote such cooperation is a final criterion of evaluation.

Evaluations of intergovernmental and central bank models of international monetary governance often hinge on the advantages and disadvantages of delegation, particularly after the emergence of central bank independence as an issue after World War I. A persistent strand of analysis in international monetary and financial relations as well as foreign policy endorses the advantages of agents who have been “removed” from short-term political calculation. Independent central banks are viewed, not only as more credible agents of national monetary policy, but also as more capable of forging cooperative bargains with their peers in other countries. Others have criticized this view, arguing a potential conflict between strategies for increasing credibility and flexible behavior required for cooperation. (Simmons 1996) This potential for conflict between credibility and international cooperation, between binding rules and willingness to adjust policies, is central to an evaluation of governance based on central banks, particularly as they become “nationalized” over the course of the twentieth century.

Central banks, capital mobility, and the gold standard before 1914

The decades from 1880 to 1914 combined international capital mobility, stable exchange rates, and few convertibility crises among major currencies, a combination that the world economy has not seen since. Conventional views of the gold standard award central bank cooperation a key role in this system of monetary governance. Any intergovernmental or contractarian alternative was implausible in international monetary affairs before 1914, as it was in most other areas of international economic relations. Nevertheless, the significance of central banks, their credibility, and their cooperation in the success of the pre-1914 gold standard requires assessment. After World War I, the role of central banks in the brief life and abrupt end of the gold exchange standard is even more controversial. Efforts to assert central bank

³ For a recent example, Milner 1997.

independence and subservience to new political demands by central banks have both been implicated in the breakdown of the gold standard; both have also been cited as barriers to the international cooperation required for the system to survive.

On most measures, capital flows and capital market integration in the pre-1914 world economy—particularly the Atlantic economy—were very high; direct controls and restrictions on foreign exchange and capital flows were rare. (Obstfeld and Taylor 1998, O'Rourke and Williamson 1999) Central banks mediating between those capital flows and national economies were diverse, if a central bank existed at all. A more precise model of central banks and their operations—including the rules of the game that linked those central banks to the gold standard—was a product of the 1920s, not the pre-1914 period.

During the nineteenth century, the principle of exclusive territorial currencies took shape throughout the industrializing world; currency competition within national boundaries was gradually eliminated. (Cohen 1998) At the same time, modern central banking evolved from a past in which private, for-profit banking operations were important. Ownership remained in the hands of private shareholders in many cases, although the emergence of state-owned banks--the central bank as yet another state monopoly--was regarded by some as the wave of the future. The United States Federal Reserve represented yet another distinct and highly decentralized model. Private banks were represented on the regional bank board, but the Federal Reserve Board of Governors was dominated by government officials. (Broz 1997) In their governance structures, the Bank of France and the Reichsbank, two of three key supports of the gold standard, were not highly independent on contemporary measures. Neither was purely state-run, but governmental appointees played a major role in their direction and management. A number of significant economies adhered to the gold standard in the absence of a central bank, among them the United States (until 1914), Canada, and Australia. Italy only sporadically adhered to the gold standard; in the absence of a single monetary authority (until 1926), its governments' policies often mimicked adherence to the gold standard regime. (Fратиanni and Spinelli 1984) For those countries adhering to the gold standard, important differences existed in

how they adhered, such as domestic circulation of gold coin and the required gold “cover” for currency and coins. (Eichengreen 1985, 5) Central banks also varied (and continue to do so) in their responsibility for the stability of the financial system.⁴ Those responsibilities, the inclusion of private shareholders, and residual private banking activities gave central banks in the pre-1914 era close links to the financial sector.

Institutional diversity among central banks before 1914 (and the absence of a central bank in some economies) suggests that credible national commitments to the gold standard dominated the pre-1914 international monetary order, not credible or independent central banks. In particular, the commitment to gold of three key countries—Britain, France, and Germany—was essential to the system and apparently unshakeable. (Eichengreen 1992, 30) Mixed governance structures, in which the ultimate principals were unclear, permitted them enough discretion in managing the gold standard to avoid politically damaging domestic consequences. Within its commitment to convertibility, the Banque de France was particularly adept at discouraging gold exports. Later, its growing reserves provided a cushion for maintaining its central policy goal: a stable discount rate. Sweden, one of the most successful economies in pre-1914 Europe, also actively managed its link to the gold standard. (Jonung 1984)

The gold standard rested on nationally adopted legislation, in some cases constitutional articles, not intergovernmental agreement. Legalization may have underpinned the gold standard, but it was domestic legalization, not international. An intergovernmental or even internationally negotiated alternative to the gold standard was not on the agenda before 1914. This is hardly surprising since multilateral organizations were rare and limited to technical functions. Those monetary conferences that took place in the mid- to late nineteenth century dealt either with issues of standardization of coinage (in the guise of monetary unification) or with commodity price stabilization (the problem of silver and bimetallism). (Gallarotti 1995)

⁴ As Goodhart (1988) describes, responsibility for micro-monetary management (supervision of the banking system) tended to eliminate competitive and profit-maximizing activities on the part of central banks. However, it is difficult to explain why some central banks retain those responsibilities and others do not. (Goodhart 1988, 10).

Groups with more limited membership—the Latin Monetary Union and the Scandinavian Monetary Union—induced no more cooperation among their members than simple adherence to the gold standard. (Jonung, Fratianni and Spinelli 1984)

If the gold standard relied on a broad political base rather than the credibility of central banks and their commitment to a monetary rule, how fragile was that political substructure? In contrasting this era with the decade of the 1920s, attention is usually focused on labor: the macroeconomic consequences of adherence to the gold standard, in the form of deflation and unemployment, were politically supportable because of restricted franchises and weak labor organization. This argument, however, overlooks the acquiescence in and even support for the gold standard among labor-based political parties. The Social Democrats in Germany and the Labour Party in Britain were significant political movements before 1914, although they had not yet been included in government. Both defended the gold standard; among the Labour Party's leadership, orthodoxy extended up to the Great Depression. Globalization backlash in these decades centered on agricultural trade and immigration. (O'Rourke and Williamson 1999) In years of declining agricultural prices before 1914, opposition to the gold standard was more likely from agrarian interests than from labor. (McGouldrick 1984) In the cases of Germany and France, another policy instrument—trade protectionism—was used to compensate economic opposition. The French central bank deployed the discount rate in the interests of the large number of bondholders among the French peasantry as well. (Broz 1997) Neither protectionism nor low interest rates could placate indebted American farmers, however: their resistance, along with that of silver mining interests, made American adherence to the gold standard less credible than any other major economy through the mid-1890s.

Weak domestic political opposition to the gold standard was more than offset by the growth of internationally engaged sectors in finance, trade, and export-oriented manufacturing that benefited from stable exchange rates. The economic openness promoted by the gold standard created political interests that sustained it, so long as trade protectionism was available to compensate import-competing industries and so long as defense of the standard did not

involve protracted periods of unemployment. Those political conditions would change dramatically after World War I.

Even with a high level of credibility grounded in political constellations within key economies, convertibility crises did occur occasionally under the pre-1914 gold standard. Although central banks in this era may have added little to the credibility of national commitments to gold, they did supply financial resources during times of crisis. The level and importance of this particular form of cooperation is contested, however. For Eichengreen, the gold standard system “ultimately” rested on international cooperation for stabilization. In its ordinary workings, the Bank of England served as a focal point for the policies of other central banks; when the Bank of England itself was under threat or during other crises, more explicit cooperative measures were required. (Eichengreen 1992, 8) Scammell describes the “steady growth of an international financial fraternity” and argues that “the gold standard was in fact quasi-organizational, being operated by a team of central bankers co-operating under the leadership of the Bank of England on behalf of the world business community.” (Scammell 1985, 105) Skeptics have suggested that the pattern of such cooperation—in the Baring crisis of 1890 or the 1907 crisis of the dollar—was ad hoc, bilateral, and “extremely myopic,” leaving no cooperative or institutional legacy. (Gallarotti 1995, 80)

Some of the confusion surrounding central bank cooperation during this era resides in the definition of cooperation. Financial support by central banks before 1914 was limited to a handful of key banks at the center; the periphery was not granted such support. In addition, such support measures were mobilized at moment when the system itself appeared under threat and were not a matter of reciprocal agreement. Most important, actual policy coordination was far rarer: the level of policy interdependence implied by Scammell was rarely recognized. Central banks were unwilling to undertake explicitly agreed policy changes that might undermine perceptions of their own commitment to gold; measures of financial support did not have that effect. Even the central bank linchpin of the system—the Bank of England—was “narrowly concerned with its reserve position,” not with overall system stability. (Eichengreen

1985) Central bank cooperation was more often tacit than explicit, limited in time, and limited in scope to a few counterpart central banks.

Central banks and the interwar gold standard

If central banks were instruments of the gold standard commitment before 1914, after the First World War they became agents for restoring and maintaining that commitment. Their efforts failed in the face of the Great Depression and contributed to the international transmission of deflation that deepened and widened the economic downturn. The behavior of central banks after World War I was marked by an unhappy trip around the trilemma that had been made by the principal economies during and after the war, from controls to floating exchange rates and high inflation. Wartime controls, including foreign exchange and capital controls, were regarded by economic and political elites as temporary expedients that should be removed and were removed after economic stabilization. Although capital mobility would not reach pre-1914 levels, by the late 1920s capital flows were once again largely unrestricted. (Obstfeld and Taylor 1998, 370) Short-term capital flows demonstrated their destabilizing potential throughout the 1920s. Immediately after the war, major exchange rates floated freely, an episode associated with high inflation and one that convinced central bankers, politicians, and electorates that credible anti-inflationary policies were not possible under floating rates. Elite interpretation of the recent past was definitive: inflation under floating exchange rates was the greatest economic risk, an interpretation that would influence central bank policy well into the Great Depression. (Eichengreen 1990, 1992)

Elite consensus after the war, then, strongly favored a reconstruction of the gold standard on prewar parities (although the last goal was more controversial). Peter Temin argues that financial leaders of the period “could not even conceptualize an orderly alternative to the gold standard. The only possible aftermath to economic and political chaos was the ‘ultimate restoration of gold.’” (Temin 1989, 14) Although Temin is correct that an intergovernmental alternative to the gold standard was not part of the postwar economic agenda, central bankers

understood that adherence to the gold standard and their inflation-fighting credibility required reinforcement for two reasons. Structural weaknesses emerged in the gold-exchange system, in particular persistent surpluses (and protectionism) on the part of the United States and France and persistent deficits on the part of Britain. Those stresses increased the demand for some mix of greater credibility and cooperation in order to stabilize international monetary relations. (Eichengreen 1992)

Supply of both was reduced, in what has become the consensus view, by domestic political changes that undermined “a common climate of opinion in governmental and central banking circles,” awarding priority to external balance in support of currency convertibility at the established exchange rate. (Gregory 1955) Instead, monetary policy was increasingly directed toward domestic economic ends. (Eichengreen 1990, 1992, Simmons 1996) Two changes were of particular importance. One was a weakening of the internationalist coalition, based on international finance and export-oriented manufacturing. Postwar protectionism and unrealistically overvalued exchange rates undermined this coalition, particularly in Britain. The City of London’s pressure for convertibility of sterling at the prewar parity, accepted by the Bank of England, plunged the traditional export industries of Britain into steep decline and made the exchange rate an issue in domestic political conflict. In France, the central bank, because of its closer ties to French industry, was unwilling to press for stabilizing the franc at the prewar parity in 1927. (Simmons 1994, 166-7) The position of the Banque de France illustrates differentiation among central banks according to ties between finance and industry.⁵

A second political change followed from wartime mobilization and expansion of the suffrage: increased organizational power on the part of labor and labor-based parties. The effects of this political change on central bank behavior must be carefully delineated, however. Simmons supplies convincing evidence that left-wing (labor-based) representation in parliaments during the interwar years was positively associated with adherence to the gold standard, but adherence was highly conditioned by the business cycle. Although labor-based parties in this

period were not inherently hostile to the gold standard, they were far less willing to endure high levels of unemployment in support of the exchange rate. (Simmons 1994, 116-117, 138) In other words, left-wing governments were far more likely during the Great Depression to override central banks and force depreciation in the interests of economic expansion. A second regularity suggests an additional response to growing labor power on the part of central banks: a more deflationary monetary policy under left-wing governments than right-wing governments. (Simmons 1996, 431) Central banks compensated for the growing power of labor and left-wing coalitions domestically by tightening monetary policy, beyond what was demanded by external balance. This conflict between domestic credibility and international cooperation would weaken management of the gold standard during the 1920s.

Structural weaknesses in the interwar monetary system combined with political change to widen the gap between credibility and cooperation demanded for system stability on the one hand, and their supply by existing domestic and international institutions on the other. The gap could be narrowed in several ways: more explicit international agreement on rules governing monetary and exchange rate policy, shoring up the independence of central banks, and increasing the level of cooperation among central banks, either through informal or contractual means. Each of these techniques were tried in the 1920s; all ultimately failed. Worse, the interwar experience suggests that although central bank independence improved the cooperative record on some dimensions, the need for enhanced credibility domestically also undermined cooperative solutions that might not have saved the gold standard, but could have reduced its deflationary effects.

Central bank independence and the demand for credibility

Wartime statism, postwar inflation, and the declining political base of the gold standard meant that central banks would play a more prominent role in maintaining gold standard. In a world of restored capital mobility, that implied the need for enhanced credibility for monetary policy. The 1920s, far more than the pre-1914 period, saw the installation of central bank

⁵ This effect is confirmed by Henning (1994) for other national cases in recent decades.

independence as a crucial element in monetary order. At the postwar international conferences in Brussels and Genoa, a seal of approval was given to the creation of independent central banks and to monetary policies “freed from political pressure and . . . conducted solely on the lines of prudent finance.” (Gregory 1955, 8). The model set for a central bank was not a public enterprise but the Bank of England. An emphasis on central bank independence and a common model of governance were also reflected in the diffusion of the gold standard to the periphery. In technical assistance missions to Latin America by the “money doctor,” Princeton’s Edwin M. Kemmerer, the formula of an independent central bank was a constant. The motivation was equally clear: signaling sound economic policies to foreign investors. (Drake 1989)

International norms and cross-border diffusion were not the only means for reinforcing central bank independence. National legislatures reinforced monetary rules that would govern central bank behavior. The United States became a “gigantic sink for the gold reserves of the rest of the world” in part because of the rules on gold cover in the Federal Reserve Act. After World War I, the central banks of France and Germany were also constrained by new legislation limiting the monetary policy instruments at their disposal. As Eichengreen points out, “The new statutes sometimes tied the central bankers’ hands so firmly that they were prevented from extending a helping hand to foreign banks in need. Legislative reform designed to enhance the credibility of the gold standard thus had the perverse effect of thwarting cooperation.” (Eichengreen 1992, 9, 194)

Intergovernmental institutions and central bank cooperation

Intergovernmental alternatives (or supplements) to central bank cooperation accompanied the foundation of the League of Nations after World War I. Like other cooperative ventures in this era, the League was weakened by the absence of the United States. Postwar international monetary conferences created neither formal institutions for consultation or coordination in international monetary relations nor agreed rules governing exchange rates. The conferences did promulgate some core principles and practices, endorsing an open trading

system, the holding of foreign currency reserves, and cooperation among central banks. (Pauly 1997, Eichengreen 1990, 1992) The gold-exchange standard continued to operate on the basis of “rules of the game” or norms (Simmons) that were not negotiated and were left to national interpretation. In case of disagreement about the rules of the game, central bank practice tilted toward domestic priorities.

The Financial Committee of the League of Nations played a more direct role in stabilizing individual economies during the 1920s. Lacking resources of its own, it oversaw private loan contracts in high-risk economies (notably Austria and Hungary). Its practices resembled later IMF conditionality without public resources: League officials controlled the disbursement of borrowed funds. (Pauly 1997, Jacobsson 1979) In part because of League oversight, governments turned for financing after 1925 to consortia of central banks and private financial institutions. The quasi-public nature of central banks and an official consensus in favor of greater central bank independence enabled the central banks to engage in cooperative ventures that would have been difficult for their more politically constrained governments. Their close ties to private financial markets made central bankers efficient negotiators of these loans, which relied on private financial resources. These episodes also demonstrated the weaknesses of sovereign lending without delegation to an international institution. Conditionality as administered by the central banks and private financiers could be uncertain and was sometimes influenced by broader foreign policy considerations. The strategies of borrowing countries pitted the central banks against one another and ultimately undermined their cooperation. (Meyer 1970)

Apart from central bank cooperation in the negotiation and oversight of stabilization loans, the overall record of central bank cooperation, particularly in the critical years after 1928, was inadequate.⁶ Although Scammell has argued that cooperation declined from higher levels before 1914, on several indicators, explicit central bank cooperation increased during the 1920s: exchange of information, routinized provision of services, negotiating loans for stabilization, and

⁶ On this point, see Eichengreen 1992, Simmons 1996, Clarke 1967.

managing the problem of German reparations. As Clarke suggests, however, after stabilization, central bankers reverted to their roles as national central bankers.

The shortcomings of central bank cooperation were once again related to the definition of cooperation and its relationship to central bank independence. On the narrow definition of cooperation—compliance with rules—independent central banks were more compliant. Simmons suggests that central bank independence is clearly and strongly associated with capital inflows (stabilizing capital flows) and better current account positions, reducing the pressures on external balance and the need for domestic deflation. Central bank independence was also a powerful predictor of adherence to the gold standard and the scale of depreciations: “Domestic monetary institutions had a great deal to do with the ability and willingness of a country to live up to the norms of the gold standard.” (Simmons 1994, 138)

At the same time, on a broader definition of cooperation—policy coordination—independent central banks did not follow “rules of the game” that would have served to stabilize the system. As Simmons describes, on this dimension, greater independence meant a less cooperative stance. Independent central banks tended to interpret their responsibilities through a “singular focus on domestic prices.” (Simmons 1996) In other words, the gold standard was viewed as contributing to anti-inflationary credibility in cases of balance-of-payments deficits; for countries in persistent surplus, its implications were ignored, rendering adjustment within the system much more difficult. The narrower definition of cooperation overrode the broader. Central bankers embraced the view that their adherence to “agreed rules of behavior, and especially to the principle that the maintenance of exchange rate stability should take precedence over all other economic objectives, was itself a form of cooperation that normally made other forms of cooperation redundant.” (Clarke 1967, 28) Since the gold standard “rules of the game” were neither codified nor the subject of explicit international agreement, this bifurcated view of international obligations was easier to maintain.

Understanding the contributions and shortcomings of central bank cooperation under the interwar gold standard also helps to resolve arguments over the contribution to the Great

Depression of this system governed by central banks. The industrialized economies were subjects of both too much central bank cooperation, as Peter Temin argues, and too little. (Temin 1989) Their common attachment to the fundamental rule of convertibility at established parities served as a deflationary drag on the system. As described, that attachment was rooted in postwar inflation. The gold standard also acted as a brake on the ability of central banks to stabilize their domestic financial systems. At the same time, central banks were unable to deepen their cooperation in order to coordinate either the provision of large-scale balance-of-payments financial support that might have localized the financial crisis or exchange rate depreciations that might have permitted a less chaotic and more rapid reflation of their economies. Their “cooperation” remained, at a crucial moment, narrowly based, with inadequate institutional and financial support.

Would an international monetary alternative that was intergovernmental rather than based on independent central banks have performed better in the face of rising unemployment and financial crisis? Certainly left-wing governments and less independent (more politically subordinate) central banks were more likely to leave the gold standard and depreciate their currencies (i. e., fail to comply with the gold standard rules). (Simmons 1994) In other respects, the counterfactual would be dependent on whether intergovernmental agreement could have been reached, and policy more readily coordinated. Framed in that way, a more effective response would have been unlikely. Governments of the period found it more difficult to cooperate explicitly because of domestic political constraints. The Federal Reserve, despite its erratic attitude toward the internationalism represented in the New York Fed, was at greater liberty to collaborate with its peers than the United States executive. Wartime hostilities faded more quickly in the central banking (and even more, the private banking) milieus. The world economy was in the hands of governments divided by foreign policy conflict and highly constrained politically, and central banks with delegated authority who would not wield in a cooperative fashion.

More internationally minded central bankers were aware of these shortcomings by the end of the 1920s. The Bank for International Settlements, which remains the principal institutional representative of central banks, was founded in 1930 to facilitate the conversion of German reparations to commercial debt. Both the underlying bargain, in which central banks played a central role, and the formation of the BIS itself, suggested that central banks were more open to cooperative innovations than their governments. (Simmons 1993) (The United States government prevented the Federal Reserve from joining the BIS, an action that Clarke (1967) labels extra-legal.) In addition to its role as trustee for the Young Plan, however, the BIS represented a “club of central bankers,” explicitly organized to respond to a “long-felt need” for greater central bank collaboration. (Jacobsson 1979, 95; Auboin 1955) Unfortunately, the resources that the BIS and its central bank members could mobilize were limited. More ambitious innovations failed, such as the “international corporation” proposed by Montague Norman, a plan that resembled the later architecture of the World Bank. In its contribution to the World Monetary and Economic Conference in June 1933, the BIS advocated central bank cooperation that incorporated policy coordination, urging central banks to recognize “that in addition to their national task they have also to fulfil a task of international character.” (Auboin 1955) The failure of the conference marked the failure of the gold standard and its central bank pillars, even though the gold bloc continued for a few more years. The Great Depression marked a great crash in influence for central banks, as governments reasserted control of the full range of their economic policies in a world of shrunken capital movements.

Monetary order by government agreement: the formation of Bretton Woods

A decades-long expansion in international financial markets, temporarily set back by World War I and postwar turmoil, was finally reversed by the Great Depression and World War II. Capital flows dropped in response to the downturn in economic activity, the increase in political risk, and the reappearance of exchange and capital controls after 1931. Some governments used the controls to maintain both a fixed exchange rate and domestic policy

autonomy; others depreciated or floated the exchange rate. (Obstfeld and Taylor 1998) In both groups, controls widened the degree of national policy autonomy, a gain that governments would be reluctant to concede. War again brought an intensification of controls. Persistent controls reduced private international capital flows for the first two postwar decades.

Leaving the gold standard restored a measure of monetary policy autonomy, which was reinforced by controls. That increase in policy discretion was not awarded to central banks in most instances, for the period from 1933 to 1950 witnessed an assertion of political control over central banks, whatever their previous level of independence. Measuring increases and declines in central bank independence is difficult, since legal or institutional measures will only capture a part of actual behavioral autonomy.⁷ Nevertheless, all indicators in this period pointed toward greater political control. Public ownership, which had been viewed with great skepticism in the 1920s, now became the norm. In the early 1930s only ten central banks were government-owned (including the Soviet Union). By 1951, forty-nine out of seventy-five central banks were entirely government-owned. (Gregory 1955) The Banque de France was characteristic. The Popular Front government substituted a Council of Regents dominated by government appointees for one dominated by shareholders. In addition, the government mandated central bank lending toward industry at particular rates of interest. (Eichengreen 1992, 376) In the United States the Treasury Department gained influence over monetary policy and the exchange rate, despite changes in formal governance that appeared to reduce the role of executive branch officials. Centralization of the Federal Reserve's operations in Washington also circumscribed the role of the New York Federal Reserve Bank, a bastion of internationalism that was distrusted as "an instrument of the private interests of New York bankers." (Calomiris and Wheelock 1998)

As the major currencies left the gold standard and instituted controls, governments created the financial instruments required to manage a floating exchange rate. Britain created the Exchange Equalisation Account in 1932; the United States followed suit with the Exchange Stabilization Fund in 1934. (Henning 1999) World War II increased the financial powers of

Ministries of Finance (Treasuries) as the government share of the economy and its presence in financial markets expanded. Central banks had become a diminished and subordinate part of government policymaking, described by one central banker in the late 1940s as “nothing more than superior printing-house establishments.” (Gregory 1955) Perhaps the only institutional gain made by some central banks during the Great Depression was an expanded role in regulation and supervision of the financial system.

*Bretton Woods and the triumph of intergovernmental agreement*⁸

With the imposition of exchange and capital controls, exchange rate cooperation became politically feasible again. League of Nation studies in the 1930s acknowledged that the political basis for a reconstructed gold standard no longer existed. An emerging intellectual consensus proposed restraining government policies through “negotiated codes of conduct.” (Pauly 1997) Governments were not yet willing to constrain their policy autonomy through multilateral and legalized institutions, however. Instead, they were prepared to engage in ad hoc bargaining to achieve exchange rate stabilization. The Tripartite Agreement, negotiated among the British, French, and United States governments in 1936, marked a resumption in international consultation on exchange rate policy in weakly institutionalized form. At American and British insistence it remained a “gentlemen’s agreement” whose broad public commitments were neither precise nor legally binding. Effective bargaining and consultation on exchange rates followed these public statements. (Clarke 1977) Both process and outcome reflected a progressive marginalization of central banks and the exchange rate and monetary rules that they had represented.

The Bretton Woods agreements that created the International Monetary Fund and the World Bank were a sharp break with past patterns of monetary governance. Understanding the

⁷ For a comparison of measures of independence, see Eijffinger and De Haan 1996.

⁸ This section is based on “Institutional Choice in International Monetary Affairs: Bretton Woods and its Competitor,” a contribution to David Andrews, C. Randall Henning, and Louis Pauly, eds., *Organizing the World Economy* (forthcoming)

Bretton Woods outcome requires an understanding of why its institutional competitors—ad hoc bargaining among the largest economies and the gold standard—lost. Those competitors might also have produced a system of stable exchange rates, although with very different economic prerequisites and domestic distributional outcomes. Unlike the model of the Tripartite Agreement, based on great power bargaining, Bretton Woods was a legalized agreement among governments. Its obligations were precise, and substantial powers of monitoring and sanctioning were delegated to its public organizational core, the IMF. The Bretton Woods institutions were also explicitly multilateral, although that global membership was tempered by decision-making rules (weighted voting and special majorities) that preserved the influence of the largest economic powers.

Unlike its other institutional competitor, a gold standard centered on central banks and private finance, Bretton Woods preserved the predominant role of governments in monetary and exchange rate policy. Although the new system retained a role for gold, curbed the unilateral management of exchange rates, and aimed to eliminate controls on current account transactions, both the United States and United Kingdom delegations were firmly agreed that domestic economic policy goals were in other respects paramount. In order to permit adjustment without severe deflation, the new monetary order permitted change of exchange rate parities (with international oversight) and provided public financing of balance-of-payments support. According to one of its architects, avoiding the rigidity of the gold standard through fixed but adjustable par values was the central novelty of the new order. (Black 1991) The rules of the system were not designed to provide a backing for credible monetary commitments in the manner of the gold standard. (Giovannini 1993) Although reserve credits were provided to governments on an ad hoc basis under the gold standard, those credits had often confirmed financial market judgments, rather than being deployed to shore up governments under speculative attack. (Simmons 1994, 282) The Bretton Woods system was constructed by governments, for governments. The architects of the Fund structured its organizational incentives to bias governments, whatever their current external position, toward a more generous

financial response to their peers than might be expected from private financial markets or prewar central banks. The model of the Fund as a credit union introduced an element of potential symmetry over time, whatever the lack of real sanctions against persistent surplus countries.

Both the range of institutional choice before the negotiators at Bretton Woods and the new institutions that emerged were dependent on an accommodating stance toward foreign exchange and capital controls. Policy autonomy under the new regime was expanded under the lengthy transitional period permitted before full convertibility on current account transactions required under Article VIII. The eventual transition for the industrialized economies was even longer than envisaged at Bretton Woods. Both the United States and United Kingdom governments accepted the need for capital controls in the postwar environment, and the final articles of agreement (Article VI) explicitly allowed national controls on capital movements.

The Bretton Woods emphasis on domestic policy autonomy at the cost of capital was confirmed by the dominant role awarded to national governments and finance ministries in governing the new institutions. Private finance and central banks were not a part of the new order. John Maynard Keynes and the United States delegation had a final clash over these governance issues at the Savannah conference. Keynes had aimed at technocratic institutions that would be closely tied to national policy networks, including central banks and private financial institutions. New York, not Washington, was their preferred location. The United States government insisted on full-time Executive Directors appointed by their governments, at institutions based in Washington, D. C. American preferences, which carried the day at Savannah, were rooted in "New Deal suspicion of the private commercial banker. . . intent on keeping not merely the control but the day-to-day organisation of the International Monetary Fund in the hands of governmental representatives." (Van Dormael 1978, 302) The British Treasury representative in Washington noted that "the words 'central banks or monetary authorities' were never once mentioned at Savannah. As if these did not exist." (Jacobsson 1978, 184) The Bretton Woods conference also moved to abolish the Bank for International Settlements. The BIS was accused of transferring looted gold from central bank in collaboration with Nazi

Germany. The BIS was also regarded as an unwanted institutional competitor, however, representing central banks and private finance. As a regional (European) rather than global organization, it was also suspect in the eyes of American negotiators.⁹

Explaining Bretton Woods

Bretton Woods represented a striking innovation in international monetary governance, a departure on each of the dimensions of institutional variations described earlier: a legalized, multilateral arrangement among contracting governments that was not dependent on the transnational network of central banks and private finance for its operation. Remarkably, the new monetary order was negotiated by the world's two leading financial powers, countries with substantial investments in alternative institutional designs.

Functionalism combined with a misreading of recent history explains some of the institutional choices made at Bretton Woods. Both British and American negotiators were concerned with maximizing policy autonomy while constraining that autonomy on one dimension—exchange rate management. Despite weak evidence that tit-for-tat depreciations were common in the 1930s, the architects of Bretton Woods interpreted recent history as a collaboration problem.¹⁰ In their view, the threat of defection in a cycle of competitive depreciation required institutional restraints in the form of precise obligations and delegation to an organization with capabilities to monitor and sanction.

A functionalist account combined with another misreading of the international economy also explains why the great powers of international finance moved beyond the relatively successful bargaining model of the Tripartite Agreement and created a multilateral agreement. Multilateralism appears, on the basis of fragmentary evidence, to have served two purposes. First, White seems to have overestimated the economic weight of the smaller countries in the postwar economy. He argued in one of his early memoranda that rounds of depreciation among

⁹ On the Bretton Woods debate over the BIS, Jacobsson 1978, 186-187; Van Dormael, 1978 204-206; Blum 1967, 268; Schloss 1958, 120.

¹⁰ On the pattern of exchange rate depreciation in the 1930s: Eichengreen and Sachs 1985, Simmons 1994.

smaller economies would affect the larger countries if they were not restrained by an international institution. (Blum 1967, 254) Even if the IMF were based on a minilateral core of great power collaboration (the shape that it eventually assumed), other smaller powers could not be permitted to free ride. Multilateralism also provided a foreign policy benefit as a convenient veil for American economic predominance; delegation to the IMF relieved the United States of a number of conflictual bilateral financial relationships.

Sectoral explanations for the preferences of Britain and the United States encounter two serious anomalies in the Bretton Woods innovations. First, those giving priority to domestic policy autonomy were ascendant during the 1930s. Closure and controls had weakened financial internationalists in particular; their institutional representatives, the central banks had been subjected to direct control by national governments. Those same interests, so suspicious of the gold standard, accommodated themselves to a fixed-rate regime under Bretton Woods, indeed, on the American side (but not the British) they provided core support for its ratification. This apparent about-face could be explained in two ways. The disintegration of international capital markets and widespread imposition of capital controls (accepted at Bretton Woods) had reduced the tradeoff between domestic policy autonomy and stable exchange rates (but those conditions had existed since the early 1930s). The war may also have internationalized sectors of the American economy, transforming their definition of economic interests in the face of a world economy devastated by conflict and demanding American exports.

A second anomaly centers on the behavior of the weakened financial internationalists. Wall Street bankers and the New York Federal Reserve were at the core of opposition to the IMF; the Bank of England was equally skeptical. Stability of exchange rates was not the key dimension of cleavage over the new institutions. The issue was not fixed versus flexible exchange rates but whose system of fixed exchange rates: one managed by central bankers and their collaborators in the world of private finance, or one managed by the Treasuries of member governments. The issue of defining the principals in the new system was central to Roosevelt's negotiations with the New York Federal Reserve and the American Bankers Association. The demands of the New

York financial establishment all pointed in the same direction—curbing the ability of the executive to act autonomously in exchange rate and monetary policy and inserting the representatives of private finance into the oversight of policy.

A more satisfying explanation for the government preferences revealed at Bretton Woods is based on the political record of the 1920s and 1930s. Bretton Woods served as a convenient solution to the international policy dilemmas of left-wing, labor-based coalitions. Governments based on such coalitions had been cooperative (liberal) on trade issues before World War II and equally predictable defectors from the monetary rules of the gold standard under conditions of high unemployment. (Simmons 1994) Bretton Woods created monetary institutions that permitted left-wing coalitions intent on full employment to cooperate on exchange rate stability through limited flexibility and finance. Although the British wartime coalition was headed by the Conservative, Winston Churchill, the trend of wartime policy was clearly in the direction of its Labour partners, a trend confirmed in Labour's overwhelming victory in the 1945 parliamentary elections. Never before (or since) had two labor-based coalitions been in such a dominant political position in the world's two dominant financial powers. Much of the institutional design of Bretton Woods (and the International Trade Organization) reflected that particular political moment. Had coalitional realities been different on either side of the Atlantic, the postwar monetary accord would have had a very different outline.

Despite apparent consolidation of intergovernmental institutions at the pinnacle of international monetary governance, the institutional competitors to Bretton Woods did not disappear. Despite its sentence of execution, the BIS survived its sentence of execution and flourished after World War II, finding a valuable niche as a clearinghouse for European central banks. It gradually rebuilt transnational ties among central bankers in an era of reduced capital mobility. Big power monetary clubs also remained a tempting institutional alternative as the IMF gained dozens of newly independent members. Finally, the success of the Bretton Woods monetary order contributed to its own weakening in two ways: by encouraging international trade liberalization and pressing for the removal of exchange controls, it set the stage for

increased capital flows that would undermine the exchange rate regime. An alternative view adds that the new system failed to provide credible monetary rules, biasing postwar economic policy in an inflationary direction, a second source of exchange rate instability in the late 1960s. (Calomiris and Wheelock 1998) Increased capital mobility and higher inflation also promoted demand for the institutional rivals of national finance ministries—central banks in both their domestic and international roles.

International capital mobility and “the triumph of central banking?”

The transformation of central banks and their international collaboration has been dramatic over the past three decades. Although the title of Paul Volcker’s 1990 Per Jacobsson lecture (borrowed above) retained a question mark, Volcker conceded that “central banks are in exceptionally good repute these days.”¹¹ (Volcker 1990) As capital mobility increased after the 1960s, both the independence of central banks and their role in international monetary and financial governance grew. Their new prominence was founded on different roles than those during the last period of central bank pre-eminence, however. Until the formation of the European Monetary System, most central banks were no longer crucial links to a system of fixed exchange rates. Their attitude toward policy coordination under floating exchange rates was ambivalent at best. Central bank cooperation developed most rapidly in the coordination of banking regulation and supervision, and, to a lesser degree, international crisis management. Governments demonstrated their willingness to delegate anew to central banks in specific functional areas, but not in others. The result was a system of shared governance in which newly empowered central banks and their counterparts in the executive confronted the management of increasingly integrated global financial markets. This pattern of shared governance was replicated in the international roles assumed by the IMF and BIS.

¹¹ Volcker’s lecture and its title also stood in striking contrast to the Jacobsson lecture given by Arthur Burns eleven years earlier: “The Anguish of Central Bnnking.” (no question mark)

Increasing capital mobility and the breakdown of Bretton Woods

The Bretton Woods order was founded on slow transition to current account convertibility and widespread capital controls. Controls multiplied after World War II as the dollar shortage became apparent. European central banks constructed the European Payments Union at the insistence of the United States; its cooperative management of their payments provided an initial stimulus to central bank cooperation and the BIS. European currency convertibility launched the next stage of central bank cooperation. Trade liberalization and current account convertibility led to increased international capital flows, putting pressure on sterling and the dollar in particular. Exchange rate defense mobilized a complex network of international cooperation in which central banks, for the first time since the early 1930s, played an essential part.¹² The BIS expanded beyond Europe: the United States Federal Reserve participated officially in the BIS for the first time in the wake of the 1960 dollar crisis, followed by Canada and Japan later in the decade. Another defense mounted by the United States Treasury—capital controls—encouraged the formation of the first offshore capital markets. The imposition of capital controls demonstrated the continuing political weakness of international finance in the United States; the encouraging attitude of the Treasury and the Federal Reserve toward participation in the incipient Euromarkets illustrated close sectoral ties between the major banks and these agencies. (Helleiner 1994)

Intensified international cooperation supplied additional financial resources to support the dollar and sterling. Those resources combined with capital controls could not prevent periodic balance-of-payments crises during the 1960s and the final breakdown of fixed parities in 1971-73. Even a relatively low level of capital mobility hindered the adjustment process, providing too little liquidity to deficit countries for a politically sustainable adjustment and allowing surplus countries to sterilize capital inflows. (Obstfeld 1993) The relative importance of

¹² A key decision was that of the Federal Reserve's Open Market Committee in February 1962, authorizing foreign exchange operations "to help safeguard the value of the dollar in the international exchange markets." The panoply of defense mechanisms and cooperative efforts is described in Coombs 1976.

capital mobility in the end of the fixed exchange rate regime is still debated. Assessments mirror contemporary debates over the feasibility of intermediate exchange rate regimes under similar conditions. Governments and central banks, particularly those of the United States, were unwilling to sacrifice an independent national monetary policy to maintain the existing exchange rate parities. The choices available under the trilemma were shifting. Central banks were confronted with a world of increasing financial integration for the first time since the 1920s.

The end of Bretton Woods demonstrated that, despite extensive international cooperation and a growing capability to mobilize balance-of-payments support, central banks remained subordinate within national economic policymaking, particularly international monetary policy. They had been thoroughly “domesticated” despite their revived cooperative infrastructure. The Banque de France participated in cooperative efforts to shore up sterling and the dollar in the early 1960s. When De Gaulle determined to use gold purchases to undermine the central role of the dollar, however, the central bank collaborated loyally. (Coombs 1976) In 1970-71 the Federal Reserve Board offered little support to the internationalist position of the New York Fed, replicating its position in the late 1920s. (Gowa 1983)

The 1970s were a difficult decade of adjustment for central banks as they accommodated themselves to financial deregulation domestically, growing capital mobility internationally, and high rates of inflation that further undermined their credibility. By the early 1980s, new strategies had emerged: of re-establishing anti-inflationary credibility, deepening international regulatory coordination, and participating in international financial crisis management. Each contributed to the new hybrid model of monetary governance in an era of increased capital mobility.

Central bank independence and international policy coordination

In rebuilding their anti-inflationary credibility, central banks in the industrialized countries took two different paths in 1979: the Federal Reserve and the Bundesbank built anti-inflationary reputations in their management of monetary policy; most other European

economies joined the Exchange Rate Mechanism of the European Monetary System, using a system of fixed but (initially) adjustable exchange rate pegs as a commitment technology. In both cases, disinflation was the domestic policy priority. In both cases, the institutional outcome was greater central bank independence, a trend that was particularly pronounced in the 1990s. The shift toward greater independence was as marked as the movement toward political control after the Great Depression.¹³ As Maxfield (1997) describes, considerable regional variation in the trend could be observed: highest in Europe (west and east) and Latin America, moderate in Asia, low in the Middle East and Africa. This rough correlation with the degree of regional integration in global financial markets suggests that central bank independence is linked to increased capital mobility in two ways. First, using a nominal exchange rate peg as an anchor for monetary policy becomes difficult with increasing capital mobility: by the mid-1990s only four countries outside the ERM maintained pegged exchange rates without capital controls.¹⁴ An independent central bank provided an alternative path to policy credibility for countries with liberalized capital movements and flexible exchange rates. Maxfield (1997) suggests a different link for developing economies: central bank independence serves as signaling device to foreign investors. When political elites with secure political tenure perceive the need for capital inflows, greater delegation to central banks is likely.

Central bank independence had mixed implications for international monetary cooperation in the 1920s. Similar implications can be observed following this latest trend toward independence. Blinder's short definition of central bank independence can be accepted: instrumental autonomy (ability to choose the means to pursue its goals) and high obstacles to political override of its decisions. (Blinder 1998) Widespread increase in central bank independence has occurred during decades of widespread democratization. Independent central banks can be made compatible with democracy through more transparent decisionmaking and through a clear mandate of central bank goals by political principals. Both of these may

¹³ For measures taken in the first half of the 1990s, Cottarelli and Giannini 1997, Table 7, pp. 18-19.

complicate international cooperation. The latter in particular may sharply constrain central bank actions by defining its mission narrowly in legislation.

Growing central bank independence coupled with convergence on price stability as the core central bank mission have affected G-7 policy coordination since the late 1970s. Among the major economies—Japan, the United States, and Germany (now Euroland)—central banks evinced little interest in an agreement to stabilize exchange rates or weaker target zone proposals that might complicate monetary policy. Such agreements would impart little added credibility to these central banks and might undermine their reputations. The record of G-7 policy coordination shows few monetary policy commitments (although the commitments made were carried out). (Dobson 1991) For proponents of target zones or other models of exchange rate stabilization among the major economies, central banks are seen as obstacles: unwilling to defer to finance ministries except in those instances when formal intergovernmental agreements have been made. (Bergsten and Henning 1996) The European Central Bank, the most independent of central banks, inspires the same concerns. (Henning 1997)

Financial integration, regulatory cooperation, and crisis management

As offshore financial markets grew, the need for the international extension of regulatory oversight became apparent. A series of banking crises, following on failures of the Bankhaus Herstatt and the Franklin National Bank, led to agreements among central banks on coordination of international banking supervision. The Basle Committee on Banking Supervision (BCBS) at the BIS is the core of this system of coordination. Through the initial Concordat and subsequent revisions, central banks have attempted to insure that banks do not escape supervision in their international operations.¹⁵

Central bank policy coordination in banking regulation and supervision is not highly legalized. Until the capital adequacy agreement, understandings reached in the BCBS were

¹⁴ Cottarelli and Giannini 1997, 30. This excludes from the sample countries that use a foreign currency or have a currency board.

designed to extend national banking supervision in an agreed fashion to offshore and international financial markets. Although the BCBS has developed standards of good practice, it has not attempted to harmonize supervisory practices. Only in establishing minimum capital requirements for banks active in international financial markets (in the Basle Capital Accord of 1988) did BCBS members move in the direction of harmonization. The agreement was not driven by the logic of regulatory coordination at the international level, however. Its sources lay outside the central banks and the BIS. The United States Congress precipitated the negotiations by mandating minimum capital standards for United States banks in the wake of the Latin American debt crisis. The Federal Reserve grudgingly took its mandate to the BIS, since American banks declined, on competitive, “level playing field” grounds, to accept such minimum capital standards on a national basis. The United States quest for minimum capital adequacy standards only succeeded after an alliance with the Bank of England and the deployment of market access as a lever to win broader international approval. (Kapstein 1991)

Central bank cooperation in regulation and supervision, then, has largely meant coordination (or extension) of national supervision into international financial market according to agreed principles. The development of binding international standards has been limited, although BIS standard-setting has been influential in shaping national practices. Enforcement ultimately rests (among the G-10) on reputational considerations and, the possible withdrawal of market access. The significance of central bank cooperation on regulatory and supervisory issues is threatened by continued evolution of international financial markets (securitization, the growing importance of non-bank institutions) and by the narrowing mandate of the central banks. Argument continues over the appropriate role of central banks in oversight of the banking and financial system. (Peek, Rosengren, and Tootell 1999) Variation among central banks on this question has been substantial, with most OECD central banks having some responsibility for banking supervision. In several important cases, however, delegation of greater central bank independence in setting monetary policy has been accompanied by removal

¹⁵ For a more detailed description, see Fratianni and Pattison 2000

of most regulatory and supervisory functions from the central bank. The United Kingdom, Japan, and South Korea are recent cases in point. The European Central Bank, in line with the German model, has only a weak supervisory role, and no mandated role as a lender of last resort. (Prati and Schinasi 1999) Here, once again, an increase in central bank independence has been joined to a narrowing of the politically mandated aims of the central bank.

The largest financial crises to affect the developing countries in recent years—the Latin American debt crisis of the 1980s and the Asian financial crisis that began in 1997—were crises of commercial bank lending. Central banks were drawn into these crises when and if they posed a threat to domestic financial stability. The exposure of large commercial banks in the debt crisis of the 1980s was defined as such a threat. Both the strengths and weaknesses of central banks as crisis managers were on display. Longstanding relationships between central banks (particularly the United States and Mexico) provided early warning of crisis and reliable economic intelligence. Since central banks could mobilize financial resources more quickly than the rule-governed and multilateral IMF, bridge loans were often the first assistance offered to debtors in crisis. Central banks with regulatory responsibilities, such as the Federal Reserve, were able to exercise suasion over banks in order to prevent defection and a complete collapse of lending: ties to private finance helped, as they had in the 1920s. Despite these strengths, however, central banks depended on an eventual IMF program to guarantee repayment, just as private creditors did. Central banks did not possess an equivalent of conditionality. The scale of financing that the central banks could mobilize (or chose to mobilize) was significant, but it alone was not adequate to restore confidence. Most important, central banks in these emerging market debt crises were ultimately lending to preserve the stability of their financial systems and the soundness of their financial institutions. Although they might take a broad systemic view of what those effects could be, they bore no obligations, informal or formal, for the well-being of the debtor economies.

Financial crises in the developing world were only one part of the lender of last resort role of central banks. Far more important has been their cooperation in managing crises in global

financial markets on two occasions: October 1987 and September-October 1998. On both occasions, central banks moved in a coordinated fashion to add liquidity to the financial system at a time when confidence appeared to be collapsing. The New York Federal Reserve's intervention in the failure of LTCM demonstrated the flexibility of central banks in interpreting their responsibilities as lender of last resort. The Federal Reserve had no clear regulatory or supervisory mandate for the hedge fund. On both occasions, the crisis was contained with no more than temporary damage to the world economy. Although governments participated in these rescues, central bank cooperation was crucial. The contrast with 1929-31 was stark.

Financial crisis management now appears to have three tiers; central bank cooperation plays a central role in two of them. Lender-of-last-resort responsibilities for individual financial institutions operating in international financial markets are governed by the Basle framework of central bank cooperation (and a policy of "constructive ambiguity"). Lender-of-last-resort responsibilities for economies facing currency or financial crises lies with the IMF. Changes proposed as part of the new international financial architecture will reinforce the IMF's concentration on this crisis management role for emerging market economies. Finally, when the global financial system is under threat (the 1987 or 1998 scenarios), key central banks have mobilized to protect the stability of the system through coordinated provision of liquidity.

This model of shared governance—central bank cooperation and intergovernmental institutions—is likely to persist. Its emergence—and its differences with preceding models—requires both explanation and evaluation.

Conclusion: Central banks, governments and international monetary order

As a growing number of economies removed capital account restrictions after 1970, international capital flows have increased. (Obstfeld 1995, Obstfeld and Taylor 1998) As in previous eras of increased capital mobility, this one has been associated with an enlarged role for central banks in international monetary and financial governance. The present system of shared governance, which combines intergovernmental institutions and central bank collaboration,

differs from earlier models of governance and their links to capital mobility. Those differences are grounded in part in three developments that span the century: growing acceptance of delegation to international institutions, institutional evolution of central banks, and democratic control of economic policy.

In the financially open world of the classical gold standard, central banks began to assume their modern institutional form. Attachment to the gold standard through national legislation and sturdy political support provided more credibility to the monetary and financial order than these still-developing monetary institutions. (The Bank of England was an important exception to this generalization.) In the absence Central bank cooperation was episodic and was not institutionalized; the underlying gold standard commitment compensated for a relatively low level of explicit cooperation. The reconstructed interwar gold standard looked back to wartime foreign exchange controls and and postwar inflation. Central banks were now placed at the center of international governance, but their credibility, given structural weaknesses and political change, was in doubt. Their collective strategy of returning to gold, removing wartime controls on capital movements, and building their credibility as monetary authorities was an unstable mix. Cooperation to stabilize and expand the gold-exchange system was not followed by the close policy coordination or mobilization of financial resources that might have salvaged the system. Institutionalization came too little and too late in the BIS.

The Great Depression transformed central banks into monetary arms of their governments. Intergovernmental cooperation replaced the combination of central banks and private finance that had governed monetary and financial relations. In its limited first steps, intergovernmental cooperation took the form of great power bargaining to stabilize exchange rates under the Tripartite Agreement. The legalized, public and contractual format of the IMF Articles of Agreement presented another clear alternative to preceding models based on informal central bank cooperation, hard exchange rate rules, and private finance. Bretton Woods represented a particular solution to the assertion of national policy autonomy within a reading of recent history that argued for curbs on both exchange rate depreciation and capital flows. The

Bretton Woods formula also reflected the incorporation of labor in the embedded liberalism of postwar economic regimes.

The current system of international monetary governance, a hybrid of central bank and intergovernmental models, represents a retreat from legalization (precise obligations and delegation to international institutions). Rules have given way to discretion. Incremental change rather than formal agreement dominates. Private finance plays a preponderant role in international flows, but the incorporation—“bailing in” --of private finance into financial governance remains incomplete. Relatively high levels of cooperation have persisted in some domains (crisis management, regulatory coordination), while others (exchange rates among the major powers) have reverted to a pattern of episodic bargaining and cooperation. Central banks have gained delegated power over a more restricted domain, monetary policy. Delegation in exchange rate management, on the other hand, has been carefully guarded by governments, even in the European EMU.

One explanation for this pattern centers on those central banks that managed to reduce inflation from moderate to low levels without re-establishing an exchange rate peg. Their credibility, exported to others, was purchased with a generalized move toward central bank independence that limited central bank cooperation at the international level. Unlike the era of Bretton Woods, democratic governments and electorates once again delegated substantial independence to central banks, but over a more restricted policy terrain than the 1920s.

A second group of central banks—importers of monetary credibility—found that exchange rate pegs, bilateral or regional (the EMS/ERM), retained their usefulness, until undermined by the end of capital controls. As capital mobility increased, these central banks—including most central banks in emerging market economies—could build credibility domestically (in some cases through politically designated rules) or accept their low-credibility status and moving toward more rigid exchange rate constraints, such as currency unions or

dollarization.¹⁶ The current debate over exchange rate strategies in emerging market economies ask whether these economies can become Australias or will accept the status of Ecuadors. In any case, given the preferences of the dominant high-credibility central banks and their governments, it is unlikely that a more stable system of exchange rate management at the top will support their choices.

The political economy underlying the current system raises a central question that is not answered by this account: In an era of increasing trade and financial openness, why have economic interests that supported a rule-based exchange rate system (whether managed by central banks or governments) not exerted their political weight in favor of a similar system at the turn of the new century? Several explanations present themselves. Democratization of economic policymaking, underway since the 1920s, elevates the political risks of curbs on domestic policy autonomy in a rule-based system of monetary governance. The existing pattern of delegation to central banks does indicate that governments have husbanded policy instruments. There have been many exceptions, however, particularly in Europe. Nor does this general argument explain why one of those instruments, capital controls, was given up in the 1980s. A second explanation is that the trade openness of the major economies (Japan, Euroland, and the United States) is not that high: the weight of internationalist economic interests is therefore reduced. More important, however, capital mobility and the development of international financial markets redefined the interests of key parts of the internationalist coalition. International finance discovered that it could profitably provide financial services without the benefit of stable exchange rates. Large-scale manufacturers were able to hedge foreign exchange risk in the financial markets and through foreign direct investment. The scale of foreign direct investment is perhaps the greatest difference between the current globalized system and the pre-1914 international economy. Exchange rates are not insignificant to cross-border production, but trade and capital openness are more important.

¹⁶ On paths to credibility, see Cotarelli and Giannini 1997, pp. 5-6.

Evaluating shared monetary governance

The present system of international monetary and financial governance, a hybrid in which central banks enjoy increasing, though carefully delimited, independence and governments tilt toward domestic economic goals, has evolved since the rebirth and expansion of international capital markets three decades ago. The record to date raises several questions by way of evaluating its past and prospective performance. Shared governance has meant an informal division of labor between central banks and governments, between the BIS and the IMF. If increased capital mobility means persistent financial crises (Krugman 2000), the design of crisis management procedures and lender-of-last-resort responsibilities will be central to the system's survival. The international division of labor described earlier may serve as an adequate crisis management model if close cooperation is sustained between governments and central banks in the major financial centers and among those centers. One tension in the existing arrangements arises from the slow erosion of central bank supervisory and regulatory authority, through movement away from bank-centered financial systems and overt transfer to other agencies. The untested Financial Stability Forum was designed in part to address that development.

In exchange rate management, the division of labor has worked less well in the eyes of those who prefer macroeconomic coordination targeted in part on the exchange rate. Those advocates have recommended a more clearly defined division of labor in which governments reach informal agreements on exchange rate target zones and central banks are delegated the authority to maintain those zones. (Bergsten and Henning 1996) The lack of interest in such exercises on the part of central banks, however, is not a simple reflection of institutional jealousy. Rather, their increasingly circumscribed delegation in monetary policy—aimed at price stability—has made deviation in the interest of exchange rate goals more difficult. Credibility—a notably slippery concept—has been assigned a positive value in both international relations (credible commitments to other nations) and the making of monetary policy. International monetary governance offers a more ambiguous evaluation. In the 1920s and again (with less disastrous consequences) in the 1980s and 1990s, the quest for credibility has made cooperation

with other nations sometimes more difficult. Tightly constrained behavior renders policy coordination—the mutual adjustment of policies—difficult or impossible. A world of central banks aiming at credible commitments toward private agents in their own economies may not have the ability to forge bargains internationally.

Global monetary and financial governance is unusual in its retreat from legalization since the early 1970s. Neither the major governments nor their central banks have demonstrated sustained interest in rebuilding a rule-governed monetary system. From their status as the chief guardians of gold standard rules, central banks have become the principal paragons of informal cooperation under the BIS, to which they have delegated few responsibilities. Central bankers emphasize the values of this anti-legal approach to cooperation—its ability to reach self-enforcing bargains quickly, its absence of bureaucratic inertia, its confidentiality. Squabbling over capital adequacy standards within the BIS, however, suggests that precision of obligations and delegation of interpretation may add value even to this flexible instrument. As banking supervision and regulation assume a central place in the new international financial architecture, the conflict between more informal and more legalized approaches to these issues is likely to grow. Ideological attachment to informal modes of governance may not serve collective interests in financial crisis management.

Finally, although the overall level of international monetary and financial cooperation has remained high in an era of growing financial integration, the national orientation of central bankers and other policymakers that sharpened in the 1920s has arguably deepened. Although central bankers in their lender-of-last-resort role must be attentive to systemic consequences of their actions, incentives to concentrate on domestic audiences and domestic implications of policy choice remain preponderant, at least in the large (most influential) economies. One of the great strengths of central banks in the governance system is precisely their systemic awareness, built on current intelligence about financial markets and a resilient transnational network of collaboration. Nevertheless, the long-run incentives for central banks in the system may point

toward greater concentration on the national rather than the global. The dynamics of delegation and credibility may run counter to the demands of globalization.

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