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## THE BANKER'S BANKER'S BANK: THE BANK OF INTERNATIONAL SETTLEMENTS



### The Power of Money

"You mean to tell me that the success of the program and my re-election hinges on the Federal Reserve and a bunch of f-ing bond traders?" This was the response of Bill Clinton, newly elected but yet inaugurated as US President, when on January 7 1993 he was briefed by his economics team on the limited financial power he would have as President. Other entities would guide his destiny.

What is significant in this quotation (from Bob Woodward's book *The Agenda: Inside the Clinton White House*) is that Clinton had spent two years talking about economics but had not learnt all that much about the real world of economics. In 1991, President George Bush won the Gulf War and seemed impossible to beat in the 1992 presidential election. Clinton, then an obscure politician from an obscure state, decided to campaign for the presidency. He avoided foreign policy (where the president was strong) and instead concentrated on the economy (where the president was weak). "It's the economy, stupid" was the campaign slogan. But despite all the speeches and campaigning, he failed to grasp the power of the US Federal Reserve and the bond traders over any president.

In 1998, with Clinton in trouble over the Monica Lewinsky affair, financial commentators were happy with the lack of presidential power. Whatever happened to the President over his Congressional problems and the threat of impeachment, the economic boom would continue. The markets had confidence in Federal Reserve Chairman Alan Greenspan and Treasury Secretary Robert Rubin. The president's fate was irrelevant.

Standing behind the US Federal Reserve (which is the US banker's bank) is yet another bank: the Bank of International Settlements (BIS). This is the banker's banker's bank. This is least known part of the global banking system.

Once a month, the world's 11 most powerful central bankers gather in the Swiss city of Basle to discuss common problems. The meetings are not open to the public and are not publicized. This is not a sinister organization aimed at global financial domination (though some extreme left-wing and right-wing American political groups have argued that it is). But in the cosy

world of banking, it is part of the final line of defence when there are runs on national banking systems. It is a bit like the International Monetary Fund - but it rarely receives the IMF's publicity.

## ✓ Central Banks

The BIS is the central banker's bank. Most national banking systems now have some form of a central bank or reserve bank to co-ordinate some of their activities (such as the Bank of England in the UK). A central bank is a banker to other banks. The final daily cash settlements within the banking system and between the banks and the central authority take place through a number of accounts held by the central bank. This means that the commercial banks involved must keep sufficient funds in the accounts held with the central bank.

A central bank also supervises the national banking system to ensure that banks do not operate fraudulently and that their customers' deposits are secure. The basic concept is "capital adequacy": the need for enough realizable assets within a bank or other financial institution to enable it absorb losses and thus avoid the risk of insolvency. Countries used to set their own capital adequacy levels. This has changed and a system was created by the BIS: the 1988 Basle Accord.

## ✓ The BIS

The BIS was created in January 1930. It is the world's oldest international financial organization. Although based in Switzerland, the BIS is an international entity and Swiss officials have no right to enter the building without permission. It has immunity from Swiss criminal and administrative jurisdiction. The BIS is owned and controlled by the central banks. According to its charter, it is "to promote the co-operation of central banks and to provide additional facilities for international financial co-operation".

The BIS was originally created to handle the payment of German war debts. Following Germany's defeat in World War I, the Allies and the US (which regarded itself as separate from the Allies) said that Germany had to pay for the war under a system of "reparations". The repayment system never functioned fully. In 1930, with yet another attempt to get the reparations system working, the BIS was created to handle what were supposed to be flows of money from Germany into the Allies and US. When Hitler came to power in 1933 he stopped the system of repayments entirely.

However, the central bankers liked the BIS idea and kept it going. The need for such a banker's banker's bank had become clear a century ago, with the increased expansion of national economies and the important role of stable banking for those economies. With the similar increase in international trading, there had to be a system for co-ordinating the role of banks across borders.

Indeed, there had been the October 1929 Wall Street crash and there were fears (accurately as it turned out) that the world was heading for a major financial crisis. The Great Depression began in 1930 and was one of the major economic events of the 20th century. These events reinforced in the minds of the central bankers the need for an international central bank to stand behind the national central bankers.

The BIS's Board of Directors is drawn from the Group of 10 (G 10), which actually now has 11 members: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK and US. Another 34 central banks are members of the BIS, who are invited to the annual meetings in June each year. Another 80 central banks use the BIS as their international central bank. Thus almost all the world's central banks now work through the BIS.

### ✓ **The BIS's Functions**

The BIS has three main functions. First, it manages about seven per cent of the world's foreign exchange reserves. The bank is more concerned with liquidity than profitability, so that its central bank clients can withdraw funds without publicity at a moment's notice. None the less, the BIS has about US\$8.5 billion accumulated through the movement of monies in helping central banks manage their external reserves.

Second, it is a forum for international financial co-operation. The monthly G 10 meetings are the elite seminars for central bankers. More generally, the BIS enables central bankers to meet together out of the public eye to discuss matters of common concern. The 1988 Basle Accord on how banks are to maintain adequate capital reserves grew out of these private discussions.

Third, the BIS undertakes research into the international financial system. The research is not geared to find particular investment opportunities or particular investments to avoid, but instead on how best to maintain international financial stability in an era of globalization and great change. Some of the research papers are published.

### ✓ **Above National Politics**

The BIS is not a government institution. It was created in an era when national governments had very little role in running economic policy. The prevailing belief in 1930 was that an economic recession was like an earthquake or flood - an act of god that had to be endured. There was nothing that governments could do to avert them or reduce them. Nature had to take its course.

That worldview was to change in the later 1930s, with support for the views of the British economist John Maynard Keynes. He argued that governments should play a far greater

role in shaping national economy policy, such as through tax cuts and employment-creating public works projects in recessions. He argued that government intervention would assist accelerate an economic recovery. When the recovery was underway, the additional funds should then be taken out of the economy by increased taxation to avoid inflation.

Some of Keynes' bitterest critics came from the national banking communities. They did not trust politicians with money. First, they argued that if politicians were to be allowed to print extra money, then they would use that power to bribe voters and so there would be a loss of the financial discipline imposed by adherence to strict banking principles. They predicted (accurately, as we saw in the early 1970s), that there would be the inflation of national currencies.

Second, bankers did not think that politicians would have the courage to increase taxation rates (especially near elections). This would mean that financial problems - particularly inflation - could drag on through a lack of political courage. Central bankers saw themselves as above the day to day turmoil of politics and so in a much more important position to guide interest rates.

Despite these objections from bankers, western governments after World War II became more involved in national economic policy. The Great Depression was seen as one of the reasons why Hitler came to power and so it contributed to the onset of war. Voters expected more from their governments to set national economic policy and to reduce unemployment.

But the BIS remained outside that ambit. The central bankers have kept it as their institution. This helps explain its lack of publicity. Politicians - much more than central bankers - issue media statements, and they have little need to comment on an institution which is not directly under their control. The BIS is happy with the lack of publicity.

## ✓ Criticisms of BIS

The BIS is criticized for four main reasons. First, it claimed by some people that the BIS is a secret organization. This is not quite accurate. It is not a secret organization because its existence is known to people who comment on banking matters and it has its own website ([www.bis.org](http://www.bis.org)). But it is a secretive one. Central bankers do not court publicity in the way that politicians do. They do not need to. Indeed, it is a nuisance for their work if they do court publicity. The world now seems to hang on the utterances of the US Federal Reserve Chairman Alan Greenspan (one of the G 10). A slip of his tongue can cause problems for financial markets. Central bankers usually do not like the excessive media scrutiny they now occasionally attract.

Second, the BIS is a clubbie European institution. Eight of the 11 of the G 10 are European. When central banks are admitted, they do not get admitted to the inner body. For example, in 1996 Brazil, China, Russia and South Korea were admitted but they are not part of

that inner circle - even though each of them has a larger national economy than, say, Belgium (which is part of that inner circle).

Third, the BIS conducts research into financial stability but it has to be careful about how that research is used. For example, the BIS was correct in its mid-1997 assessment of the problems of the South Korean banking system. The BIS had detected signs of the Asian financial meltdown before it took place. But the BIS had to be careful about how it presented its research. If it publicised its warning too much, then it could have been criticised for bringing about an Asian crash. It took a more low-key approach, which has meant that it has been criticised for not doing more to warn about the problems in the South Korean banking system.

Finally, there is the BIS's role in relation to the International Monetary Fund. The IMF was created to handle short-term financial problems. The 1944 Bretton Woods System (created at an international conference at Bretton Woods, New Hampshire, USA) formed the post-war international economic system. The system was based on the US\$ (which was linked to gold) and all western currencies were then linked to the US\$. If a country had a balance of payments problem, then it went to the IMF for financial assistance. (The World Bank was also created at Bretton Woods but that was for long-term development projects, such as Australia's Snowy River dam/ hydroelectric power scheme, which was the World Bank's first project).

The Americans tried to use the IMF's creation as a reason to get rid of the BIS. They saw it as too "European". Also, the BIS continued operating in World War II and the US suspected that the BIS had handled Nazi German finances and so it was a tainted institution. They preferred an international financial institution that would be more accountable to politicians and open to media scrutiny. But the other central bankers saved their BIS. They liked the political independence and lack of media scrutiny of their bank. Therefore, the BIS survived.

## ✓ **The Future of the BIS**

Ironically, the BIS's future is as now just as troubled as the IMF's. What is the role of international financial organizations (such as the BIS and IMF) in an era of globalization? The main drivers of change are now transnational corporations rather than national governments. The corporations have created an international consumer market, where national boundaries are no more significant than the Equator. Money, ideas and fashions cross from one country to another. A person with access to the media or the Internet can see what other people are enjoying and seek to get it for themselves. Oil companies, car companies, CNN, Coca-Cola, MacDonald's, Microsoft, and IBM are refashioning the global economy. A decade ago, when Coca-Cola opened its first factory in former communist Albania, the country's president did the opening ceremony as a sign that Albania had shed its closed communist economic thinking and was now part of the global economy. Revolutions go better with Coke.

Second, a banking era has ended. Credit used to be, in effect, rationed by banks. For example, it was very difficult to get a big bank loan such as a mortgage (and single women need not even think about applying for one). Now banks are awash with funds and go to great lengths to encourage people to borrow. The philosophy of “saving for a rainy day” is now seen as old-fashioned and discredited. People live from one credit card statement to the next. (In the US a person trying to pay cash for ordinary items, such as a hotel bill, is viewed with suspicion: they are possibly too poor to get a credit card).

Third, the really big economic wave has yet to strike: the economic impact of the rise of China. China is now, according to the World Bank’s calculations, the world’s second largest economy (ahead of Japan). In 2003, China accounted for about 25 per cent of global steel demand, 30 per cent of oil consumption, and 50 per cent of cement demand. In 2003, the global economy grew by 3 per cent. Europe (“old” and “new”) was 0.2 per cent; Japan was 0.2 per cent; and the United States was 0.7 per cent. China alone was 1 per cent. (The rest of humanity – rest of Asia, Pacific, Latin America and Africa – represented about 0.9 per cent). On current indications, China will be the world’s number one economic power by 2050. Never before have so many people grown so quickly in so little time.

There are problems here for the BIS’s traditional role. Central bankers are now more the observers of international finance rather than the controllers of it. Frank Partnoy in his important if complicated book *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* warns about the immense sums of money being speculated each day. For example, he recalls the exploits in the mid-1980s of financial dealer Andy Krieger who, though based at Bankers Trust in the United States, speculated on the New Zealand dollar to the equivalent of the total money supply of New Zealand. Krieger had personally nothing against New Zealand (a country about which he knew little) but he had a job to do. The instability in the New Zealand dollar was very lucrative for him.

There are also problems for the transnational corporations themselves. A lot of financial power is being devolved to young screen jockeys who do the day to day trading. They operate in an environment of advanced economic thinking that is beyond the comprehension of the ordinary person whose pension funds are being used. The collapse of Barings, one of the world’s oldest and most respectable banks, is an example of a screen jockey (28 year old Nick Leeson) in 1995 speculating with the bank’s assets. Leeson lost US\$1.4 billion, more than the bank’s capital. International Nederlanden Groep (ING) bought the bank for one British pound.

Partnoy also recalls the 2001 loss of US\$826 million by American Express, with the admission by the chairman that his firm “did not comprehend the risk” of some of its investments. If the chairman of one of the world’s greatest commercial financial institutions did not understand this form of finance, what hope is there for the ordinary person? In early 2004, Australians were shocked to learn that one of the country’s biggest banks had also sustained major losses due to young screen jockeys (and the disaster forced both the bank’s chair and CEO to resign).



In short, the world's international system of finance is heading for a new era – and one with little supervision or control. The BIS – or an expanded version thereof – may be needed to guide the globe safely into the new era. It remains to be seen how the BIS could be developed. A starting point would be more public and media debate on what the BIS does, the problems it seeks to solve, and what else needs to be done about guiding the globe into the new era of international finance.

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