



BANK OF ENGLAND

Speech

Building on strong foundations: Why central banks bank for each other

Remarks given by

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Introduction

1917 was not a quiet year.

In April, the United States joined World War 1. In July, the British royal family changed its name from 'Saxe-Coburg and Gotha' to 'Windsor'. And in Russia, the October Revolution ushered in the most momentous political change of the twentieth century.

Against that backdrop, the agreement by the Bank of England and the New York Federal Reserve in Spring 1917 to provide banking services to one another was never going to leave the same historical footprint.

But that superficially unremarkable act was actually part of a seminal moment in the development of the international financial system. Those correspondent relationships between central banks, forged at a time of war but replicated widely in the years ahead, would achieve three key things:

1. They gave central banks **safe, confidential and reliable access to overseas reserve currencies, assets and payments**, and intelligence on the operation of those markets – and in so doing:
2. They **helped underpin the international monetary framework** (which in that era meant closely-managed exchange rates, with or without the gold standard); and
3. They provided **channels through which funds could continue to flow in conditions of financial emergency**.

Much has changed since 1917. Sterling and the dollar have traded places as the world's leading reserve currency. The gold standard is a distant memory. The major global currencies have swapped fixed for flexible exchange rates. And the scale and sophistication of international trading and capital markets, and the number and diversity of reserves-holding countries, have expanded greatly.

But amidst all that change, those three goals of financial co-operation between central banks remain fundamentally the same. Of course, the central banks of today collaborate on a much wider range of policy, supervisory and macro-prudential issues. But at our heart we are still banks – and it is our balance sheets, and the financial interdependencies they give rise to, that frame everything else we do.

It is therefore an honour to celebrate with you the centenary of the events that really gave birth to it all. In my remarks today, I want to give a Bank of England perspective on those events, to describe the services that we provide today, and to touch on some of the challenges and opportunities for the future.

Days Past: correspondent banking at the Bank of England in the years running up to 1917

Our story centres around Benjamin Strong, the first head of the New York Federal Reserve, who took a long 'scouting trip' to Europe in the Spring of 1916 – little more than two years after the formation of the Federal Reserve System.¹

The Bank of England, of course, had been around somewhat longer – 222 years longer, to be precise. But for much of that period it had seen little need to establish banking arrangements with fellow central banks, sitting as it did astride the enormous global sterling area, with no major alternative currency in sight. The first account, for the Bank of Japan, wasn't opened until 1896 – and only three more (Greece, Australia and Spain) followed in the pre-War years.² As the American banker Willard Straight acidly put it: 'the British idea of co-operation was that the other fellow does what the Britisher wants him to do'.³

World War 1 changed all that.

The declaration of war in July 1914 precipitated a severe financial crisis as confidence in banks collapsed. To ensure that European Allies and neutral countries retained access to London markets and had a safe place to deposit assets and the proceeds of their rapidly-increasing wartime borrowing, and pay for supplies, the Bank of England opened ten accounts in the early part of the war (for France, Belgium, Italy, Serbia, Romania, Portugal, Egypt, the Netherlands, Norway and Switzerland).

The United States had the opposite problem. The War had led to a huge increase in the demand for US exports from Europe, paid for by foreign assets, typically gold. These massive capital inflows risked driving excessive domestic US credit expansion, threatening inflation and undermining the fixed exchange rate between the dollar and gold, unless the excess could be recycled overseas. But the United States of the time lacked what Strong termed the international 'banking machinery' needed to effect this recycling. And the sheer scale of capital movements risked overwhelming the traditional system of physical gold transfers, given the limited global supply of gold, and the significant cost and risk involved with gold shipments in wartime.

Strong noted that the desired machinery could take one of three possible forms: the US could lend directly to European banks; it could lend indirectly through private brokers; or it could retain the central banks of Britain and France to act as its agents, purchasing commercial bills, gold and deposits in European markets. Developing such machinery was no social service: Strong was clear that he was acting in American

¹ In the preparation of these remarks, I have drawn heavily on the papers of Benjamin Strong, and in particular 'Foreign Countries: Trip to Great Britain and France' Parts 1 and 2, available at <https://fraser.stlouisfed.org/archival/1160>.

² The Imperial Ottoman Bank also carried out certain central bank functions and had an account opened with the Bank of England in 1858. See Chapter 8 of 'The Bank of England 1914-21 (Unpublished War History)' by John Osborne at <https://www.bankofengland.co.uk/-/media/boe/files/archive/www/boe-1914-1921-vol3-chapter8.pdf>.

³ Quoted in 'The City of London: Illusions of Gold 1914-1945' by David Kynaston.

interests, to protect its economy and strengthen its financial system. But he did hope it could be done in ways that also supported the global economy. As Strong told London's senior bankers in a speech in March 1916, even if the new order involved 'the surrender of some part of the world's banking to New York', he hoped it could be done 'upon fair terms, on fair competitions' and with 'those who spoke [the same] language, believed in the same institutions and had the same high ideals of honour and integrity'.

Strong's reception in France was extremely warm. He visited castles in Cannes and Napoleon's tomb in Paris. He received silver medals at the Banque de France, and was treated to lavish lunches and dinners. The French Governor himself entertained Strong at the Ritz, and begged him to start his scheme as soon as possible. Before Strong left France, the Governor presented him with more medals, a copy of correspondence between Talleyrand and Louis XVIII, and an advance printing of the new ten franc note.

The British proved a little harder to read. Lord Cunliffe, the Bank of England's Governor, had a certain reputation. As the Bank's own official history puts it, 'Cunliffe in his prime was an aggressive character, who enjoyed a game of bluff, even when he lost it. He evidently had the advantage of knowing his own mind, perhaps not a very difficult mind to know'.⁴ Strong had been warned by private bankers that Cunliffe was 'mentally very slow to act'. And in their first meeting, Cunliffe – no doubt deliberately – left Strong unclear whether he was annoyed with him (for failing to forewarn him of his visit and 'stirring up' the local bankers with his speech about business moving to New York), or merely 'joshing'.

Despite this typically ambivalent British welcome, Strong rapidly developed a good understanding with Cunliffe. His bond with Montagu Norman, then an Assistant to the Deputy Governor Sir Brien Cokayne and later its longest-serving Governor, proved closer still. Both sides quickly concluded that providing each other with access to their domestic markets would help ensure the orderly recycling of the other's foreign reserves. Such arrangements had three key advantages. First, each could commit to provide the other with a safe, reliable and confidential service based on the best independent intelligence about trends in their respective markets, untainted by commercial motives. Second, as the owners of the dominant reserve currencies of the day, each understood the need of the other to maintain 'exchange stability', ensuring that potential borrowing or lending needs were met, but in a way that did not 'antagonise' the policy goals of the other.⁵ And, third, such arrangements could help protect financial instability, by reducing the reliance on the increasingly strained system of physical gold movements, and providing a channel that could be used even if private banking linkages were impaired.

Between 23 and 30 March 1916, Strong and Norman drew up a confidential 'Memorandum of Conversations' setting out a framework in which the two central banks would provide each other with mutual accounts, undertake to purchase bills on the other's behalf in local markets, to ' earmark' gold for one another, and

⁴ 'The Bank of England 1891-1944' by R S Sayers, page 66.

⁵ Britain briefly experienced concerns about policy antagonism itself when its attempts to borrow in dollar markets using short term Treasury Bills were forcefully censured by the Federal Reserve Board in late 1916.

exchange information ‘respecting credit matters and financial conditions’.⁶ The framework could not be implemented while the US remained neutral in the War, and the Federal Reserve Act prevented the provision of accounts to a foreign power. But within little more than a year, both obstacles had been removed. The Bank’s Court of Directors ratified the agreement in May 1917 – and the accounts were opened shortly afterwards.

In the years that followed, Strong and Norman used these financial foundations to build a much broader conception of central bank co-operation, summarised in their 1921 ‘General Principles of Central Banking’.⁷ Many of those principles, including the merits of operational independence for central banks, the need for appropriate supervision of financial institutions, and the importance of balancing national and international interests in the development of policy, show extraordinary foresight and remain highly relevant today.

Days Present: correspondent banking services at the Bank of England today

Much has changed since those days, of course. World War 1 brought about a profound shift in the balance of global financial power, setting the US dollar on its ascent to top slot. Strong and Norman’s beloved gold standard ended ignominiously in the Great Depression. And even its post-World War 2 successor – the Bretton Woods system of fixed exchange rates – is long gone.

Yet despite all that change the three key benefits of financial co-operation identified by Strong and Norman remain at least as relevant today as they did a century ago:

- First, more central banks than ever before value the safe, confidential, reliable access to overseas reserve currencies, assets and payments offered by their peers. Safe – because central banks are free from insolvency in their domestic currency, are rigorously focused on minimising operational risk, and settle all payments in central bank money. Confidential – because central banks treat the information they receive with the greatest discretion, and are not subject to commercial incentives or conflicts of interest. And reliable – because central banks understand the policy priorities of their peers, and stand ready to provide the highest level of continuity of service. Today the Bank of England provides banking services to over 150 central banks and international financial institutions around the world – ten times more than in 1917. Those services include sterling payments, call and term deposits, and custody of securities and gold. The Bank’s gold repository remains the most active central bank service in the world, reflecting the United Kingdom’s lasting role as the pre-eminent wholesale gold trading centre.
- Second, access to central banking services underpins the international monetary system. Although the major economies no longer maintain fixed exchange rates, the international trading system relies

⁶ A version of the original March memorandum is held in the Bank of England Archives.

⁷ Recorded in John Osborne’s unpublished War history of the Bank, *op cit*.

on ensuring ready access to currencies that are freely convertible and tradable in deep and liquid financial markets and widely used in goods and services trade, security issuance and reserves holdings. Using a range of such metrics, the dollar and sterling currently account for 42% and 8% respectively of the IMF SDR basket. Of course, central banks do not have to use their fellow central banks for such services: they can (and do) also use private sector providers (as they could in 1917). But confidence in those currencies is critically reliant on the knowledge that, subject to appropriate terms and conditions, central banks of issue stand ready to provide safe, confidential and reliable access to their currencies if asked to do so – whether by retail customers wishing to exchange notes, or by fellow central banks wishing to undertake wholesale transactions.

- Third, access to central banking services provides an important safety valve in conditions of financial instability. Although private sector cross-border banking and capital markets are highly developed, deep and liquid, they can still be subject to periods of dysfunction – as the financial crisis vividly illustrated. The network of central banking relationships provides the infrastructure, expertise, legal and personal contacts required to ensure the global system can continue to operate in such extreme tail events. Just as the major central banks acted a century ago to keep the system functioning when the system of physical gold transfer failed, so they made use of bilateral swap lines in 2008 when short-term dollar markets froze at the height of the financial crisis. Those measures were converted into permanent standing swap arrangements in October 2013.

On behalf of central banks represented here today, and those further afield, I want to express our gratitude to the Federal Reserve Bank New York for the part it plays in these broader arrangements on behalf of the Federal Reserve System as the central bank of issue for the dollar.

Days Future: opportunities and challenges for central banks' banking services

The huge increase in the number of central banks accessing services from one another underscores just how lasting Strong and Norman's vision for central bank co-operation was.

But with greater access also comes greater risk – and in recent years central banks, in common with commercial banks, have had to come to terms with the sharply-increased threat from money laundering, terrorist financing and cyber-attack. Once again there is an echo with 1917: at a time of war, the Bank of England and New York Fed were obsessed with the possibility that their communications might be intercepted, and spent months debating the relative merits of the charmingly-named 'Lieber five letter code' and 'Bentley's complete phrase code'.⁸ But the potential sophistication of today's attackers, and the financial, reputational and legal risks they pose to central banks are far greater than a century ago.

⁸ The Bank of England Archives hold a number of letters between Cunliffe, Cokayne and Strong on this subject.

As Simon Potter has already said, that is why it is so important that, just as central banks co-operate to provide the services they need to another, they must also co-operate in raising the standards and controls applied to those services to the highest possible levels – because we are only as strong as our weakest link.

Raising standards means:

- Within our own organisations – having robust risk-based processes for assessing counterparties and transactions, in compliance with relevant law and guidance; for controlling the access, people and system risks in central banking processes; and for monitoring and responding to potential risks if and when they crystallise.
- And, externally, it means sharing intelligence and promoting best practice; and complying and attesting promptly, and with candour, to relevant international standards.

Making progress in both of these areas is vital if the expansion in access to central banks services of recent years is to be maintained.

I want to end on a positive note. The international system is constantly evolving. Policy regimes come and go. And the importance of specific reserve currencies may rise and fall: the minnows of today can be the giants of tomorrow. That is why it is so important to co-operate, as Strong and Norman clearly recognised at a previous critical switching-point in world affairs.

Of course, the concept of co-operation can be pushed too far. During his time in London in 1916, Strong reported an ‘astonishing suggestion’ during a dinner with the British press ‘that the Reserve Bank System was really the Bank of England, and that if we would only promote the right kind of relationship, we ought to be able to consolidate the English and American system, and in some way or other work out a complete cord. This caused some amusement, but was roundly cheered. I did not find the gentlemen present at the dinner particularly well posted in regard to the American financial system.’

I am not so misguided as to repeat that suggestion here today! But I will end with Norman's comment to Strong as they were formulating their principles of central banking in 1921: ‘if ever you should feel downhearted just you remember that, economically speaking, there is only hope through a community of interest and co-operation between all central banks.’

Thank you – and I look forward to sharing the rest of this Commemoration with you.