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We Need a Bank Of the World

The financial crisis is global, and only an international central bank can deal with it.

By **Jeffrey E. Garten** | NEWSWEEK

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If George W. Bush's upcoming global summit on how to fix the world's broken financial system—an event proposed by several European presidents and prime ministers—is to be a serious effort, the leaders should begin laying the groundwork for establishing a global central bank.

The idea of such an institution would have been a political nonstarter before the current debacle. The crises of the last several decades—the Latin American debt meltdown in the early 1980s, the stock-market crash in 1987, the savings and loan collapse of the early 1990s, the Asian financial blowup of the late

1990s, the Internet-stock collapse earlier in this decade—did not involve the extent of global linkages among financial institutions or the mind-boggling consequences of complex securities that we are seeing today. In none of these previous blowups did the global credit system shut down, as it did in recent weeks; in none did governments in both the industrialized and developing world intervene so massively, coming close to nationalizing the entire global banking system.

And in none was it so clear that there is no effective governing authority at the center of global finance. There was a time when the U.S. Federal Reserve played this role, as the prime financial institution of the world's most powerful economy, overseeing the one global currency. But with the growth of capital markets, the rise of currencies like the euro and the emergence of powerful players such as China, the shift of wealth to Asia and the Persian Gulf and, of course, the deep-seated problems in the American economy itself, the Fed no longer has the capability to lead singlehandedly.

After World War II, the IMF was designed to be a central financial institution, too. But over the decades it has had less and less influence on the rich industrialized nations. Its credibility with Asia and Latin America has also waned. It is still involved in bailouts for countries such as Iceland and Pakistan, but its once central role in protecting global stability is clearly over. And most important, its political legitimacy is deeply flawed, because its management structure reflects the 1950s, with Belgium having more voting power than China.

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In the future, a global central bank is needed to oversee the rudderless global financial system. There are a number of critical functions it could perform.

It could be the lead regulator of big global financial institutions, such as Citigroup or Deutsche Bank, whose activities spill across borders. It could monitor risks that are building in the global market and create an early-warning system that alerts banks and national regulators that trouble is coming, and pushes them to modify their policies.

It could act as a bankruptcy court when big global banks that operate in multiple countries need to be restructured. It could oversee not just the big commercial banks, such as Mitsubishi UFJ, but also the "alternative" financial system that has developed in recent years, consisting of hedge funds, private-equity groups and sovereign wealth funds—all of which are now substantially unregulated.

A new institution could have influence over key exchange rates, and might lead a new monetary conference to realign the dollar and the yuan, for example, for one of its first missions would be to deal with the great financial imbalances that hang like a sword over the world economy.

A global central bank would not eliminate the need for the Federal Reserve or other national central banks, which will still have frontline responsibility for sound regulatory policies and monetary stability in their respective countries. But it would have heavy influence over them when it comes to following policies that are compatible with global growth and financial stability. For example, it would work with key countries to better coordinate national stimulus programs when the world enters a recession, as is happening now, so that the cumulative impact of the various national efforts do not so dramatically overshoot that they plant the seeds for a crisis of global inflation. This is a big threat as government spending everywhere goes into overdrive.

The IMF could continue to exist, but its board would have to be restructured, its bailout role for smaller nations carefully defined, and its directions—including the severity of the conditions it imposes on borrowers—would have to come from the new central bank.

To give it legitimacy, a global central bank would have to be governed in light of political realities. That means that its board would include not only the top financial officials of the United States, the U.K., the euro zone and Japan, but also China, Saudi Arabia, Brazil, South Africa and perhaps a few others.

If a global central bank had existed before today's financial crisis, it could have sounded a shrill warning about irresponsible financial transactions much earlier; and if it had been set up with the enforcement teeth it deserves, it would have had the clout to demand, perhaps as early as 2005, that banks and other financial institutions start building reserves when times were booming, rather than allow them to maintain lower reserves precisely because profits were soaring. It would have seen that financial institutions were accumulating debt that was 30 times their capital and imposed—or caused national central banks to impose—more sober leverage ratios.

A global central bank worth its salt would have reined in not just commercial banks but also loosely-regulated investment banks, because all such institutions would have been obligated to adhere to the

global banks' regulatory standards or else be blacklisted in global markets. It would have intervened to deal with Lehman Brothers and AIG, both with truly global reach, and thereby put the burden not just on American taxpayers but also taxpayers of other countries who used these institutions' services.

Had it existed, a global central bank would have acted without the air of panic that has been exhibited by national central banks and finance ministries in this meltdown. Ideally, it would have gathered its governing board well in advance of a financial blowup to execute a coordinated rescue and global-stimulus plan, part of what should be its ongoing role of preparing for crises.

It would be hard to overestimate the political pushback that any official proposal for a global central bank would draw from various constituencies, most especially within the United States. Among their many charges, critics will protest the establishment of "world government." But we have a World Trade Organization with legally binding powers over trade disputes. We have a World Health Organization for communicable disease with the ability to quarantine entire countries. And a World Court functions today that has considerable legal and moral clout.

No one should want too much globally centralized oversight. But the world's gathering misery shows that too little leadership from the center can be equally dangerous. The November summit itself won't solve anything, but if it gave instructions to finance ministers and central bankers to explore what a new central bank could do, with a deadline to come back with concrete ideas shortly after a new U.S. president is inaugurated, it will have made real progress on one of the great problems of our times.

Garten is the Juan Trippe Professor of international trade and finance at the Yale School of Management.

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