

The Case for a Global Central Bank

With world finance increasingly intertwined, we'll need one sooner or later

By [Jeffrey E. Garten](#)

When the finance ministers and central bankers of the world's 20 largest economies gather in Pittsburgh on Sept. 24, they can congratulate themselves for averting a 1930s-type meltdown. But nothing the G-20 has done, or is likely to do, will prevent or substantially moderate the next global crisis. That will require deep-seated, global financial reforms. And for such change to take root, something else will be needed: the establishment of a global central bank.

I can hear the howls of critics. World Government! A Conspiracy of Bankers! In the U.S. Congress the aversion to such an institution would make the dogfight over health care look like a genteel dinner party. So right now there is zero chance that the U.S.—and other countries, such as China, that zealously guard their sovereignty—would support the idea. But if critics could suspend the hyperventilating for a few minutes, they'd realize a global central bank is becoming a necessity in today's complex, interconnected world economy.

Why? Think about the responses to previous financial meltdowns—the Latin American debt crisis of the 1980s, the Asian financial crisis and the collapse of Long-Term Capital Management in the 1990s, the Internet stock implosion early in this decade. Following each crisis, governments promised to create new rules and institutions—a fresh "financial architecture," in the parlance of pundits. But little was done. As a result, each successive crisis has been worse than the last. Each has involved more countries and asset classes. Each has been more globally synchronized. Each has more clearly shown that private financial institutions compete too fiercely for markets and profits to regulate themselves. Bottom line: The cost of failing to implement a global structural response—the lost economic growth, the lives destroyed—has escalated dramatically.

At the heart of this reality is a simple fact: Governmental oversight remains national, while financial institutions are more globally intertwined. No top official denies this dichotomy.

Jean Claude Trichet, president of the European Central Bank, recently bemoaned the lack of international coordination needed to manage the "deeply integrated global economy." U. S. Treasury Secretary Timothy Geithner warned that "we need a common global solution to these markets, not separate regional solutions."

As the current credit crisis has shown, the degree of global interconnectedness in finance is astounding. According to McKinsey, annual cross-border capital flows increased to \$11.2 trillion in 2007, more than 20% of global gross domestic product. That's up from \$1.1 trillion, or 5.2% of global GDP, in 1990. Far-flung investors own one in three of the world's government bonds, one in four stocks, one in five corporate bonds. And some \$450 trillion worth of impossible-to-value derivatives is sloshing around the globe.

The G-20's agenda correctly identifies many of the problems. But executing and sustaining oversight, especially as the recovery reduces the pressure to take painful steps, is what counts. And the record shows that the reaction of governments working together, even in good faith, is too slow, diffuse, and compromised by national political pressures to result in anything but actions that are too little, too late.

How would a global central bank do better? Here are some of the ways:

First, the bank would be the focal point for bringing together the different regulatory approaches of the U.S., the EU, and China in such areas as the oversight of banks and hedge funds, the quantity and quality of reserves, and the relationship of risk management to executive pay. We're a long way from resolution on these issues.

A global central bank would also oversee any major financial institution—a bank, securities firm, insurer, hedge fund, private equity firm, or sovereign or commodity fund—whose failure could bring down the system. (About two dozen of these exist today.) It would be responsible for restructuring these institutions, if necessary, or safely winding them down. Had such oversight existed before Lehman Brothers' collapse, the credit crisis might have been far less cataclysmic.

Another job: setting standards for debt-to-equity ratios for the biggest institutions. Past efforts, accords known as Basel and Basel II, took ages to conclude and were outdated before the ink was dry. We need a sustained process for pushing banks to acquire more reserves in boom times, the better to weather the inevitable downturns.

Currently, no central bank or finance ministry has the ability to look at such key determinants of growth and stability around the world, let alone the clout to sound alarms that would be heeded. (Or the motivation: The tendency is to try to give one's own institutions an edge.) But if a global central bank had existed before the meltdown, banks might not have been free to take on \$35 of debt for every \$1 of equity—and much less deleveraging would thus have been required in the crisis' aftermath. So lending in the past 18 months would have been less restrictive.

Finally, a worldwide central bank would engage in crisis simulation—running scenarios to heighten awareness of new dangers and sharpen the responses of government and private financial players. Such exercises in 2005-07 might have helped us anticipate how quickly a problem such as the subprime mess could spread. We are still desperately in need of such war-gaming. A new crisis could emanate from China's opaque financial system. Or we may need to prepare for a major currency debacle as Washington acquires trillions in new debt without a visible way of servicing it beyond devaluing the dollar.

Now for what a global central bank wouldn't do, at least until it was well established: It wouldn't create a global currency but would manage instead a world of dollars, pounds sterling, euros, yen, and renminbi. It wouldn't set monetary policy for individual nations, leaving that to existing central banks. Other questions remain, of course. To whom would this global regulator be accountable? How would it be funded? What would be its relationship to the IMF and the Bank for International Settlements (a club for central banks, albeit it a weak one)?

Outside of finance, the world has already moved toward stronger global institutions. Without a World Trade Organization, bringing China into the global trading system and managing its growing clout would have been much tougher. Absent a World Health Organization, we could not have contained SARS and other epidemics. And soon we'll need a world environmental agency to deal with climate change and other issues that far exceed the governing capacity of any one country.

Unfortunately, we are probably years away from high-level discussions about a global central bank. At its meeting the G-20 won't announce the formation of a panel of experts to study the idea. But it could do worse than create such a commission at some point. Sooner or later—perhaps after the next crisis, or the one after that—there will be an acknowledgement that the time has come for a global central bank.

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