

Europe Needs a Federal Reserve

By Aaron Tornell and Frank Westermann

AS the world economy teeters again, pressure is mounting on central banks to reopen their spigots, make it even cheaper for companies and households to borrow money, and prop up commercial banks to prevent another financial crisis. On Wednesday, the Federal Reserve, which had already promised to keep short-term interest rates near zero until the end of 2014, extended its latest, modest strategy to keep long-term rates down, too.

The Fed's counterpart, the European Central Bank, was created in 1998 to maintain price stability in the new euro zone. With so many depositors taking their money from troubled banks in Greece and Spain, observers are urging the central bank, based in Frankfurt, to fire another round of the "big bazooka" — the roughly 1 trillion euros in cheap loans that it granted to banks in December and February.

But even if it is willing to do this, the central bank is not equipped to do so without putting Europe's financial system at risk. Its design is flawed. To save the euro, the 17 countries that use the shared currency will not only need a more unified fiscal policy. They will also need a single institution to tide over troubled financial institutions, and a single banking authority to supervise banks and, if necessary, close or merge them.

Bizarrely, although the deutsche mark, franc and lira are gone, members of the euro zone still have their own national central banks, which can step in and lend euros. Since 2007, the credit extended by the central banks of Italy, Spain, Greece, Portugal and Ireland has increased tenfold, in part because the criteria for the collateral put up in exchange for central-bank loans were relaxed significantly in 2008 (and later, in Greece, Ireland and Portugal, almost completely discarded).

What ails the euro zone is not a Teutonic allergy to inflation, or a timidity about extending loans, but what economists call the tragedy of the commons. Here's an example: A group of people go for a drink and agree to split the tab. They tend to drink a bit more than when each goes alone. Each person gets to enjoy 100 percent of the marginal benefit of an additional drink, yet she is responsible only for a portion of that drink's cost. So she has an incentive to outdrink her friends and exploit the common pool of money that will be used to pay the tab.

The central bank system in Europe is akin to letting the government of California issue bonds, pledge them as collateral at

Aaron Tornell is a professor of economics at the University of California, Los Angeles. Frank Westermann is a professor of international economic policy at Osnabrück University, Germany.

The central bank
created in 1998 isn't
nearly powerful enough.

the San Francisco branch of the Fed, and then get fresh dollars to pay for its budget deficit. If this were reality, imagine the strong temptation for California to tap Fed resources to indulge imbalanced spending and borrowing.

If the system isn't fixed, it will lead to another financial crisis. In the past, many countries that pursued expansionary credit policies to avoid economic turmoil precipitated only a deeper crisis. In 1994, for example, Mexico's central bank significantly increased loans to private banks, in an attempt to forestall a recession before a presidential election. The result: capital flight, a speculative attack on the peso and a financial crisis.

Europe is heading toward a similar mess. Since 2008, hardly any banks have been shut down in the euro zone, while American regulators have closed hundreds of institutions. Bank "stress tests" in countries like Spain continue to underestimate the true extent of bad loans. Greek banks were deemed solvent — and therefore eligible for loans from Greece's central bank — even as nervous depositors withdrew hundreds of millions of euros.

Only the European Central Bank, not national regulators, should have the power to decide if a bank is financially sound, and eligible for central-bank loans.

If the European Central Bank were to gain this power, it could shut down insolvent (zombie) banks, limit excessively high levels of central-bank credit, and make it clear to the euro zone's members that help from Frankfurt cannot go on forever.

Under Jean-Claude Trichet and now Mario Draghi, the European Central Bank has forestalled a panic and avoided setting off inflation so far — a priority for Germany, Europe's largest economy. But it has been powerless as bank insolvencies mount, and it has failed to pressure governments to lower their budget deficits and implement economic reforms.

The national central banks — including Germany's Bundesbank and the Bank of France — should become subsidiaries of the European Central Bank like the 12 Federal Reserve Banks (in New York and San Francisco, etc.). Voting rights at the European Central Bank should be reorganized so that they are proportional to the share of the loss that each country would bear in case of default. Those who bear the largest share of the cost should have greater say as to when the drinking should stop.

To bolster ailing banks in southern Europe, some have called for the European Central Bank to insure deposits. Fine, but in exchange, all banks, not only the biggest ones, should be under the supervision of regulators in Frankfurt. They should have the sole authority to shut down, or merge, failing banks. When they offers credit, they should accept only marketable securities as collateral.

Without these reforms, zombie banks represent another financial crisis waiting to happen. □

NY Times
Thurs. June 21, 2012

6241-58006