The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Following the break out of the financial crisis that originated, in 2008, in the most advanced countries, and then spread over to the emerging economies and less developed countries, the President of the United Nations General Assembly convened a panel of experts to discuss the large array of issues related to it.

In the same breath, the President of the United Nations General Assembly established a Commission of Experts whose mandate is to reflect on the causes of the crisis, assess impacts on all countries and suggest adequate responses as to avoid its recurrence and restore global economic stability.

The Commission will seek to identify the broad principles underlying needed institutional reforms required to ensure sustained global economic progress and stability which will be of benefit to all countries, developed and less developed. It will suggest a range of credible and feasible proposals for reforming the international monetary and financial system, in the broad interest of the international community, and identify and evaluate the merits and limitations of alternatives that are at the center of current global debate.

The Commission will thus produce a report on recommendations to be considered in the preparatory process leading to the Conference at the highest level on the world financial and economic crisis and its impact on development called for in the final document adopted at Doha in December 2008 (resolution A/RES/63/239).

United Nations Nations Unies
THE PRESIDENT OF THE GENERAL ASSEMBLY
LE PRESIDENT DE L'ASSEMBLEE GENERALE

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Background

The breakdown of the Bretton Woods system in the early 1970s has been followed by a period of financial market liberalization and deregulation, by a surge of private capital flows and by the increasingly global reach of financial institutions. Even so, no institutions have emerged at the international level to prevent excessive risk taking in cross-border lending and investment, reduce systemic failures or address regulatory rules for creditors and debtors, including financial institutions. In fact, conventional wisdom has maintained by cutting back restrictions on capital movements at the national and international levels. a more stable and more efficient financial system would emerge, of particular benefit to developing countries.

The experience has been rather different. Excessive financial liberalization has created a world of global macroeconomic imbalances and recurrent crises. Until recently, the real damage from those crises was, to a large extent, confined to emerging markets. That has now changed, and in a dramatic way. A financial crisis, originating in the most advanced countries and on a scale not seen since the 1930s, is currently unfolding. Over the past few weeks, several major financial institutions in the United States and Europe have failed and stock markets have plummeted and become highly volatile. Especially in the United States, inter-bank lending has declined sharply. Retail businesses and industrial firms, large and small, find it increasingly difficult to obtain credit as banks have become reluctant to lend, even to longtime customers. The response has been state intervention, including the nationalization of financial assets, on an unprecedented scale.

The crisis has become global. Even emerging markets and less developed countries that have managed their economy well, resisted bad lending practices, did not purchase toxic mortgages, and did not allow their banks to engage in excessive risk taking through derivatives, have become embroiled. Any global solution—short term measures to stabilize the current situation and long term measures to make another recurrence less likely—must pay due attention to impacts on all countries. Without doing so, global economic stability cannot be restored.

Ten years ago, at the time of a series of financial crises in emerging markets, there was much discussion of the necessity of reforms to the global financial architecture. Little—too little, it is now evident—was done. It is imperative that we do not only respond adequately to the current crisis, but also begin making the long term reforms necessary to have a more stable and prosperous global economy.

Composition of the Commission

On 18th October, the President of the General Assembly, Miguel D'Escoto Brockmann, announced his intention to establish a taskforce of experts to review the workings of the global financial system, including major bodies such as the World Bank and the IMF, and to suggest steps to be taken by Member States to secure a more sustainable and just global economic order.

The membership of the Taskforce –now Commission- has been chosen based on the need to include experts with a full understanding of the complex and interrelated issues raised by the workings of the financial system, with a strong grasp of the strengths and weaknesses of existing multilateral institutions, and with a sensitivity to the particular challenges faced by countries from different regions of the world and at different levels of economic and social development.

In addition to the Chair, Professor Joseph Stiglitz (USA), members have been drawn from Japan, Western Europe, Africa, Latin America, South and East Asia.

The rapporteur will be Mr. Jan Kregel (former UNDESA staff; now University of Kansas and the Levy Economics Institute of Bard College).

Scope of the Commission Work

The Commission will seek to identify the broad principles underlying needed institutional reforms required to ensure sustained global economic progress and stability which will be of benefit to all countries, developed and less developed. The Commission will suggest a range of credible and feasible proposals for reforming the international monetary and financial system in the best interest of the international community, identify the merits and limitations of alternatives, and will evaluate in particular those that are at the center of current global discussions.

The Commission will be free to address whatever issues -- of an analytical, institutional or policy nature -- it believes are necessary for advancing the reform of the international financial architecture. A more detailed agenda will be established by the President of the GA.

In its deliberations, the Commission will also bear in mind that in an interdependent world, multilateral rules and regulations in trade, debt and finance will have to be mutually reinforcing if they are to underpin financial stability as well as sustainable and equitable development.

If reforms to the existing architecture are to be credible, they must provide for open and inclusive discussion among the broad range of stakeholders in the international community. The President recognizes that while the discussions of the Commission will need to focus on the specific challenges posed by financial instability, reform of the financial system should not be seen as an isolated endeavour but, where appropriate, must be linked to other challenges facing the multilateral system including climate change, peace and security, poverty reduction and the elimination of hunger. Adjustments to deal with the immediate crisis must not be made at the

expense of the poor and the vulnerable, while their needs and interests must be fully considered in any proposals for long-term reform.

Process for producing the Report

The Commission will hold at least three formal meetings to discuss the issues and to begin drafting the report. At the same time, it will solicit comments and suggestions from a wider body of interested stakeholders including policymakers and government officials, representatives of international agencies, academics and members of civil society. Together, these deliberations and inputs will feed into a final report. The report will be published and distributed to member states, other involved parties and the wider public as part of a larger United Nations General Assembly initiative to achieve the needed reforms. A website will be established to promote the work of the Commission.

Timeline

The first plenary meeting will be held in the New York City 5-6 January 2009 and the second session in Geneva 9-10 March 2009, for two day long sessions. The third and final meeting will be held at the UN HQ in New York to discuss the draft of the report in spring. The President of the General Assembly plans to distribute the final report to Member States in April, at which point it will also be launched publicly at press conferences in a number of locations worldwide.

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Members

- Mr. Joseph Stiglitz (USA) (Chair) University Professor, Columbia University, Nobel Prize in Economic Sciences (2001). Former Senior Vice President and Chief Economist of the World Bank.

- Mr. Andrei Bougrov (Russia) Managing Director and member of the Board of Directors of the Interros Company. Former Principal Resident Representative of Russia, Executive Director and member of the Board of Directors of the International Bank for Reconstruction and Development.

- Mr. Yousef Boutros-Ghali (Egypt) Minister of Finance. Chair of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund.

- Mr. Jean-Paul Fitoussi (France) Professor of Economics at the Institut d'Etudes Politiques de Paris since 1982. Currently President of the Scientific Council of the Institut d'Etudes Politiques de Paris and President of the Observatoire Français des Conjunctures Economiques.

- Mr. Charles A. E. Goodhart (UK) Norman Sosnow Professor of Banking and Finance Emeritus, London School of Economics. Former Chief Advisor to the Bank of England and member of its Monetary Policy Committee.

- Mr. Robert Johnson (USA) Former Chief Economist of the US Senate Banking Committee and former Senior Economist of the U.S. Senate Budget Committee. Former managing director at Soros Fund Management. Member of the Board of Directors of the Economic Policy Institute and the Institute for America's Future.

- Mr. Jomo Kwame Sundaram (United Nations) Assistant Secretary-General for Economic Development, United Nations Department of Economics and Social Affairs.

- Mr. Benno Ndulo (Tanzania) Governor of the Bank of Tanzania.

- Mr. José Antonio Ocampo (Colombia) Former UN Under-Secretary-General for Economic and Social Affairs and Finance Minister, Colombia. Currently Professor, School of International and Public Affairs, Columbia University.

- Mr. Pedro Páez (Ecuador) Former Minister for Economic Coordination, Ecuador.

- Mr. Avinash Persaud (Barbados) Chairman of Intelligence Capital Limited. Member of council, London School of Economics. Founding director of the Global Association of Risk Professionals.

- Mr. Yaga Venugopal Reddy (India) Former Governor of the Reserve Bank of India.

- Mr. Rubens Ricupero (Brazil) Former Secretary-General of UNCTAD. Former Minister of Finance of Brazil.

- Mr. Eisuke Sakakibara (Japan) Former Vice Minister of Finance for International Affairs. Currently Professor at Waseda University, Tokyo.

- Mr. Chukwuma Soludo (Nigeria) Governor, Central Bank of Nigeria.

- Ms. Heidemarie Wieczorek-Zeul (Germany) Federal Minister of Cooperation and Development.

- Mr. Yu Yongding (China) Director, Institute of World Economics and Politics, Chinese Academy of Social Sciences. Former Member of Monetary Policy Committee, People's Bank of China.

- Ms. Zeti Akhtar Aziz (Malaysia) Governor and Chairman, Central Bank of Malaysia.

Rapporteur

- Mr. Jan Kregel - Former UNDESA senior staff member now Senior Scholar, Levy Economics Institute of Bard College and Distinguished Research Professor, University of Missouri, Kansas City.

Special Representatives of the President of the General Assembly

- Mr. François Houtart (Belgium)

- Mr. Ali Boukrami (Algeria)

- Mr. Oswaldo Martínez (Cuba)

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Working groups

Working Group I: Regulation

Mr. Avinash Persaud (Chair)

Working Goup II: Multilateral Issues

Mr. Jomo Kwame Sundaram (Chair)

Working Group III: Macro-economic issues and addressing the crisis

Mr. Jean-Paul Fitoussi (Chair)

Working Group IV: Reforming the Global Financial Architecture

Mr. Chukwuma Soludo (Chair)

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Introductory Remarks by the Chairman
Joseph Stiglitz
January 5, 2009

This unprecedented global financial and economic crisis requires an unprecedented global response. It requires a response not just from the G-7, G-8, G-10, or G-20, but from the entire international community, the G-192. This gives especial importance to this initiative of the President of the General Assembly, which has received so much support from around the world. I am particularly pleased at the quality and diversity of the group of experts that he has been able to assemble. This will help ensure that the interests, concerns, and perspectives not only of the richest countries and the rapidly growing emerging markets and those in the financial markets are heard, but also those of the poorest countries and those from all sectors of the economy. In our work, we hope to draw upon the expertise of the best scholars and practitioners from all over the world.

The current financial crisis, which began in the U.S., then spread to Europe, has now become global. Even emerging markets and less developed countries that managed their economy well, resisted the bad lending practices, held high levels of foreign exchange reserves, did not purchase toxic mortgages, and did not allow their banks to engage in excessive risk taking through derivatives are likely to become embroiled and to suffer as a result. *Any global solution—short term measures to stabilize the current situation and long term measures to make another recurrence less likely—must pay due attention to impacts on these countries.* Without doing so, global economic stability cannot be restored and economic growth, as well as poverty reduction worldwide will be threatened.

The current economic crisis should provide an opportunity to reassess global economic arrangements and prevalent economic doctrines. Large changes have occurred in the global economy in recent years, e.g. in the sources of global savings, reserves and GDP, and these are not fully reflected in our global economic institutions and arrangements. As we address the short run crisis, we should seize the opportunity for making deeper reforms that enable the world to enter into the twenty first century with a more equitable and a more stable global financial system, which could usher in an era of enhanced prosperity for all countries.

In the past, the global financial system often worked to the disadvantage of developing countries. Banks in developed countries, for instance, were encouraged to lend short term to developing countries; while this provided greater liquidity to the former, it led to greater instability in the latter. Pro-cyclical monetary and fiscal policies were often

foisted on developing countries, while developed countries followed countercyclical policies. *The international community must commit itself to developing the institutions and instruments for increasing the stability and equity of the global financial system.*

This expert group is devoted to helping the U.N. fulfill its historic mission. The Commission will seek to identify the broad principles underlying needed institutional reforms required to ensure sustained global economic progress and stability which will be of benefit to all countries, developed and less developed. The Commission will suggest a range of credible and feasible proposals for reforming the international monetary and financial system in the best interest of the international community, identify the merits and limitations of alternatives, and will evaluate in particular those that are at the center of current global discussions.

This will, of course, be one of several similar efforts going around the world, a global conversation on a topic of immense complexity. This Commission is, however, the only one with its breadth of vision and representation. We will, of course, try to learn what we can from these other efforts. But we have a special responsibility to focus our attention on those areas that might otherwise receive inadequate attention—the impacts on developing countries or the distribution of income and wealth within countries.

As an expert group, we have a distinct advantage: we can think "outside the box." We are not constrained to operating within the conventional wisdom. We can ask politically uncomfortable questions. Each of you is here in your personal capacity, chosen for your expertise—though we have made some effort to ensure that there is diversity of perspectives.

I hope, as we proceed in our deliberations, that we do ask some hard questions, though we at least raise the possibility of deeper reforms. We know the usual recitation of prescriptions: the need for more transparency, for avoiding protectionism, for improving governance, for promoting the private sector. Yet, we would be derelict in our responsibilities if we did not note the magnitude of the profound changes that have occurred. Governments have intervened in markets in an almost unprecedented way—and even as some governments call for more transparency, we have to recognize that much of what has been done has been highly non-transparent. With expenditures of this scale, and a lack of transparency of this scope, vast opportunities for corruption and untoward redistributions are opened up. We have been moving in unchartered territory. The distortions created in the market economy will be long lasting. There can be no level playing field, with governments in some developing countries offering multi-billion dollar subsidies to their enterprises, that poor countries simply cannot match. There can be no level playing field in financial markets, with firms in some developed countries receiving hundreds of billions of dollars of assistance, well beyond the GDP of poorer countries. Even the knowledge that failure can be met with a bail-out changes the willingness and ability to undertake risk. The global economic landscape has changed unalterably. We cannot go back to the world before September 15. We have been responding to a crisis. Part of what we will be doing is to discuss how the international community can best respond to this crisis, in ways that are attentive to the concerns of all

countries. But part of the task of the Commission is to help the international community think through the changes that will have be made as we go about the more difficult task of creating a new international economic order.

Many of the flaws in the economic system have been well noted before. For more than forty years, one of the central concerns of modern economics is the development of the theory of market failures that has identified the circumstances in which markets fail to produce Pareto efficient outcomes. Seventy five years ago Keynes explained why markets are not self-correcting, at least in the relevant time frame. Even when markets were Pareto efficient, of course, there was no assurance that what resulted conformed to any principles of social justice—either in terms of outcomes or opportunities. More recently, theories of behavioral economics have uncovered patterns of human behavior in which individuals and groups exhibit systematic irrationalities. Yet, while there was mounting theoretical and empirical evidence concerning the appropriate domains for government intervention, some pushed an agenda downplaying the role of government, including deregulation. The success of this agenda suggests that some of the problems the world faces today can be viewed as much a problem of governance and politics as a failure of economics.

These failures of governance can be seen at many levels. One, which the Commission will need to address, is the design of regulatory systems. Identifying market failures and designing regulations that ameliorate those market failures will do little good if the regulations are not implemented and enforced. In many cases, regulators were appointed who did not believe in regulation, with almost predictable outcomes. Our Commission must address the question of designing robust regulatory systems, resilient against the failure of individual regulators to fulfill their responsibility, sensitive to the obligations of democratic accountability, and aware of the powers that modern technologies may bring, in disseminating information and allowing broader democratic participation in monitoring and enforcement.

But the regulations and regulatory structures adopted in any democratic society are a reflection of political pressures. Though we may all believe in the credo of one person one vote, we all know that some are more influential than others, and that political outcomes have been shaped by campaign contributions. The contributions of those in the financial market have been large, and have helped shaped the current failed regulatory regime.

We may stand at a particularly dangerous point in economic history. Aware of the need for government intervention in certain times such as these, but subscribing at other times to dogmas of market fundamentalism, we create particularly perverse incentives. We pretend that we are in nineteenth century capitalism, though the separation of ownership and control leads to managerial behavior that may not even be in the interests of shareholders. We allow firms to grow too big to fail, which by itself would induce excessively risk taking behavior, but combined with failures in corporate governance, which too lead to excessive risk taking, creates an explosive mixture. There are large

divergences between private rewards and social returns, and given this, it is not surprising that we have seen results that do not serve our societies well.

Countries around the world have been encouraged to adopt similar economic frameworks. The huge gap between the rich countries and the poor means, however, that poor countries are even more exposed to the risks of market failure, but do not have the huge resources required to come to rescue their economies. These and other asymmetries serve to further disadvantage the poor—which we see clearly as capital flees the developing world to the United States, the country from which the current problems originated.

The economic and political failures lead, in turn, to social consequences, and as we address the work of the Commission, we must be especially mindful of these. Much has been written of America's foreclosure problem, but the millions of Americans who are losing their home are not just a problem for the banking system. It is a human tragedy: many of these are among the poorer Americans who are losing, with their homes, their life savings and their dreams of a better future for themselves and their children. But these consequences pale in comparison to what will be happening in the developing world. If history is our guide, educations will be interrupted, those who lose their jobs will have no safety net to fall back upon, malnutrition will increase, governments faced with tighter budgetary constraints will be forced to cut back on health expenditures. There will be lifelong scars.

It is too late to prevent this downturn. But it is not too late to try to mitigate some of these adverse effects. And it is imperative that we take steps to prevent a recurrence of this tragedy.

We cannot, in the work of this Commission, address some of the broader issues that it raises: How do we make our political processes less influenced by special interest groups, and more reflective of broader societal values of global social justice? But there is, today, an awareness that our economic system has failed us. This provides a rare opportunity for reform. Most of the attention of the Commission will be on repairing the economic system, and much of our attention will be on one aspect of that economic system—the financial system. But as we do that, it will be important to see these attempts within this broader context.

Let me again thank you for your willingness to serve on the Commission, and the commitment in time and energy that you have already made. I look forward to our discussions over the ensuing weeks.

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Key Perspectives

The Issues Paper highlighted the large array of issues which the Commission will have to face in its deliberations. This background essay seeks to lay out some key principles that may help inform those deliberations.

1. Markets are at the center of any successful modern economy. But markets, by themselves, often fail to produce robust, stable and sustainable growth which is equitably shared, or even efficient resource allocations. Markets are not self-correcting. In every successful economy and society, there is a need for collective action; the state (at various levels) performs critical functions. What those functions should be, and how they should best be conducted, may differ from country to country and from time to time. Yet, the failure to find the appropriate balance can contribute to economic failure and social distress. The failure of government to perform its responsibilities, or to perform them appropriately, has been a major factor in creation and propagation of the current crisis. Ironically, the attempt to denigrate the role of government has necessitated the government undertaking unprecedented actions.
2. Since the Great Depression, most governments have undertaken responsibility for macro-stability, and all governments take responsibility for regulating the monetary system. But far more than that is required, from the provision of public goods to the regulation of externalities. Modern economic theory has laid out a clear set of principles concerning market failures and public actions that can help alleviate those market failures. This crisis is an example of a macro-economic crisis induced by massive micro-economic failures.
3. A well-functioning economy requires well-functioning financial markets, to mobilize savings, allocate capital, and help manage risk. At the heart of financial markets are information imperfections—and it is well known that under information imperfections and asymmetries markets, by themselves, often fail. They have repeatedly failed to perform their essential functions.
4. Financial markets are a means to an end, not an end in themselves. The failure of financial markets causes large externalities—adverse effects on the real economy. These failures can thus have enormous effects on those outside the financial sector. There have repeatedly been many innocent victims, from workers who lose their jobs, families who lose their homes, children whose education gets interrupted, retirees who see their life savings disappear.
5. Because of these potential adverse effects, governments have repeatedly bail-out financial markets when they have failed, at great cost to taxpayers. The problems have become more severe as particular institutions have become too big to fail. These bail-outs represent only one of the ways in which there is a marked

divergence between private rewards and social returns, at the level both of institutions and individual market participants. Contributing to failures in the design of appropriate incentive structures are failures in corporate governance.

6. These market failures necessitate strong and effective government action, including comprehensive regulation. Well designed regulatory systems can promote efficiency and equity enhancing innovation. The costs of regulation pale in comparison to the costs of market failure, as this and other crises have amply demonstrated. In a world of globalization, if there is not to be regulatory arbitrage, there must be at least some degree of regulatory harmonization.
7. But governments fail as do markets. The current crisis is one in which governments failed to check market abuses; regulatory authorities even failed to use the powers that were within their control. We need to design systems in which we reduce the scope for government failure as well as market failure, and in which societal institutions (government, markets, civil society) provide checks and balances on each other.
8. Democratic processes are an important part of the process of checks and balances. But for democratic processes to be fully effective, there must be transparency; there have to be strong laws, effectively implemented, ensuring citizens rights to know; there has to be a vibrant media providing information to the public, and active think-tanks and a critical academia assessing that information. All transactions between government and private parties must be fully in the public domain.
9. But even were we to solve fully the problems of the financial sector, which have been the immediate impetus to the crisis, the global economy may still face serious macro-economic problems. That is why it is a mistake to limit attention to the "repair" of financial markets. Besides, financial markets cannot be fully repaired if there are deeper problems in the economy, e.g. if homes continue to go into foreclosure or firms continue to go bankrupt. Solving the financial sector's problem may be necessary for addressing the current crisis, but it is far from sufficient.
10. In today's world of globalization, it is necessary to view macro-economics from a global perspective. This is especially true as we see the consequences of America's economic mismanagement reaching even to countries that had prudent financial regulations and sound macro-economic policies. Moreover, as we look across the landscape of countries, and see many countries facing similar structural problems (e.g. real estate bubbles, excesses in financial markets), it is important to ask: Can we explain these global patterns? Can we explain why these problems manifested themselves in some countries, and not in others? The variety of experiences within the global landscape provides a rich opportunity to explore alternative political, economic, and social explanations for the observed diversity in experiences.
11. The excesses of liquidity that contributed to the problem were partly motivated by an attempt to maintain the American economy at full employment, in the aftermath of the collapse of the tech bubble and in the presence of an oil price boom. Economic imbalances can contributed to a deficiency in global aggregate demand. A key question in the short run is, what contributed to these global

imbalances, e.g. in savings and investment, requiring monetary authorities to push for low interest rates and high levels of liquidity. Among the factors that may have contributed are the growing inequality within most countries of the world, the sudden and large transfers of global income to the oil producing countries, and the high level of savings of many developing countries as they tried to build up reserves to protect themselves against the high volatility of global capital markets and their potential loss of economic sovereignty in the event of a crisis (as happened to those that had had to have IMF programs in the late 90s and early days of this decade.)

12. Making matters worse is that some countries have changed economic structures in ways which have reduced their automatic stabilizers, and some have strengthened their automatic destabilizers. For instance, highly progressive tax systems, strong unemployment insurance systems, and defined contribution pension programs help stabilize economies, but in many countries there has been a move away from such tax and social security systems. Moreover, the movement to mark to market accounting in a banking system vulnerable to real estate bubbles and without cyclical adjustments for provisioning and capital adequacy standards and with little scope for forbearance has long been recognized as generating a destabilizing financial accelerator. Forces that may facilitate short run adjustments within one country may lead to a globally more unstable economy. More flexible wages and prices (themselves the result of more competition and weakening unionization, resulting in part from globalization) may result in more cyclical sensitivity in the distribution of income, and even pose a threat of deflation in the event of a severe downturn, such as now.
13. Globalization has resulted in the creation of larger and more integrated economic systems, without circuit breakers and safeguards to ensure that a breakdown in one part of the system does not lead to failures in the rest of the system. Globalization, as it has been managed, pushed for rules that frowned on the creation of such institutional protections.
14. Developing countries have been particularly adversely affected by flaws in the global financial system. They have been forced to pursue procyclical monetary and fiscal policies, which naturally imposed greater variability on these countries than on the countries at the center of the global economic system. They are told that unless they do not raise interests in a downturn capital will lead; and if they do not cut expenditures, capital will leave. Those that depend on foreign borrowing to finance fiscal deficits may find it impossible to finance a deficit in a downturn.
15. Guarantees provided by governments constitute an unfair trade practice: the value of such a guarantee by a small developing country does not match up to that of a developed country. Such guarantees exacerbate the inbuilt economic inequities, and may have played a particularly important role in inducing capital outflows from developing countries to the U.S., the country from which the crisis emanated.
16. Traditionally, developing countries have had to borrow short term in foreign exchange, making them bear the brunt of interest rate and exchange rate volatility. In some cases, improperly informed developing countries seem to have

been preyed upon by international lenders and advisers, encouraging them to take out loans that were ill-suited to their circumstances, imposing high risks of default and/or high levels of hardship.

17. Following the breakdown of the Bretton Woods fixed exchange rate system, exchange rates have been marked by high levels of volatility. It is not easy for small open economies to maintain macro-stability in the face of this exchange rate stability; high costs are imposed upon firms that are engaged in international trade, especially given imperfections in futures and risk markets.
18. The net result of these market imperfections and the policy stances is to disadvantage the developing countries. The system increases the risk imposed on them, and correspondingly increases the risk premium that investors in those countries must receive. But the system does not even work well for the more advanced industrial countries. The huge reserves demanded by developing countries as insurance against this volatility contribute to America's trade imbalances; in the future (unless changes are made) it may contribute to trade imbalances in Europe. America's trade imbalance has contributed to its insufficiency of aggregate demand.
19. The current crisis must be addressed in ways that reflect the realities of the current global imbalances, doing what it can to address the asymmetries in a fair and equitable manner. Unless this is done, there is a risk of growing poverty, with major setbacks in the world's efforts to meet the Millennium Development Goals. Already, the soaring oil and food prices which preceded the crisis constituted a major setback, making many countries even more poorly prepared to face the current crisis. Rising unemployment will confront countries with increased social needs, but decreases in government expenditures will provide them with less resources to meet these needs. If the last global crisis is a guide, cutbacks in social expenditures can have long lasting effects on education and health, with lifelong effects especially on affected youth. We join the World Bank and others calling for at least $500 billion for an improved safety net for the developing countries.
20. The liquidity and financial crises afflicting more developed countries are beginning to show up, sometimes with even greater virulence, in developing countries, but these countries do not have the resources or institutions to respond effectively. It is inconceivable that they respond with, or compete with, the multi-trillion dollar programs of the United States and Europe. Financial market liberalization has meant that many developing countries rely on banks located in the North, and as these face crises they may withdraw funds and restrict lending from foreign branches and subsidiaries. Banks registered in developing countries may have bought the toxic products produced in the United States, or may have tried to imitate the "best practices" of the United States, including their flawed risk management and lending practices, with similar results. Even when they resisted adopting such practices, in the light of the strong guarantees provided by American and European banks and the high level of global uncertainty, funds will flow out of these institutions, unless they raise interest rates to high levels. This means that domestic firms may not be able to obtain credit, or can obtain it only at high and non-competitive interest rates. It is necessary to offset these

contractionary forces by providing more liquidity to the central banks of developing countries, to be on-lent to their banks, or, in extreme cases (as in the United States) to be on-lent to producers and consumers in developing countries.

21. Countries that have large amounts of liquid funds (in sovereign wealth funds or reserves) that might be able to support international efforts to provide this kind of liquidity support have little incentive to provide this money to existing international institutions, like the IMF, in which their representation is inadequate. Though these institutions have recognized the importance of governance, and noted deficiencies in their own governance structures, reforms have been slow and inadequate. Problems in their political legitimacy have often been compounded by a narrowness of economic vision. They pushed on developing countries many of the policies—excessive deregulation, a single-minded focus by central banks on inflation—that are now seen as at the heart of the current crisis. This undermines the ability of existing institutions, without radical reform, to play as effective role in addressing the crisis as they should, and suggests that either there needs to be more radical reforms of existing institutions or the creation of new ones.
22. The more developed countries are embarked on massive stimulation programs, while, without assistance, the less developed countries are going to be forced to have contractionary programs. This will, especially in conjunction with the other asymmetries described earlier, create new imbalances. For instance, the strengthening exchange rate of the U.S. combined with its ability to moderate its downturn may exacerbate already large trade imbalances (as measured by its trade deficit as a percentage of GDP).
23. Worse still, these imbalances may pose a threat of global deflationary pressures, in light of potential excess capacities in China and other manufacturing economies. These manufacturing capacities will, in turn, translated into excess capacities in the production of minerals. Finally, in conjunction with the lower price of oil and the shift back into food production of land previously shifted into the production of bio-fuels, even the price of food may decline. Deflationary pressures increase the burden on debtors, increasing the risk of default and financial stress. This is especially true today as domestic imbalances get translated into price declines in domestic currencies, and flexible exchange rates translate these declining prices in developing countries into even larger price falls in the advanced industrial countries. It is not a matter of competitive exchange rate adjustment, as under the old Gold Standard, but of equilibrium exchange rate adjustments, given reasonable policy stances in the developing countries in the face of global asymmetries.
24. It is thus in the interests of the developed countries to work to maintain better global balances. This may entail not only the safety net expenditures and credit facility support described earlier, but more extensive support for infrastructure and technology.
25. Just as in the North, such short run expenditures can be part of a program of meeting long term needs, so too in the South. The North already has made commitments to devote .7% of their GDP to foreign assistance, and to helping developing countries meet the challenges of global warming. Fulfilling those

obligations would go a long way in addressing the short run problems identified in previous paragraphs.

26. But there are long term problems that have contributed to, and exacerbated, the current economic crisis. Developing countries cannot, on their own, promulgate regulatory standards that are out of line with the norms established in the North. But the consequences of inadequate regulatory standards may be even more adverse on the South. That is why one off the main tasks facing the Commission is assessing appropriate regulatory standards.
27. Other failures of financial markets have particularly adverse effects on developing countries. For instance, poorer countries are less able to manage and bear risk; failures in innovation, in creating appropriate risk products (like GDP bonds or local currency bonds) have particularly severe consequences for them. That is why it is especially important, through strong regulation, to direct the creative efforts of the financial markets to the development of products that address socially relevant risks.
28. Much of the creative energy of financial markets was directed at regulatory, tax, and accounting arbitrage, including in off-shore centers, activities which too can have a particularly adverse effect on developing countries. They facilitate corruption, money laundering, and tax avoidance, undermining democratic governance. This crisis should provide an occasion for finally dealing with these off-shore centers.
29. This crisis will present other opportunities for dealing with long festering problems. It is likely that there will be more sovereign debt defaults. Seychelles has already entered into default. **Ck** Every country has a bankruptcy regime; it is viewed as an essential part of the legal structure, to facilitate allowing individuals and firms to get a fresh start, in a way that imposes as little costs on society as possible. But we still do not have an effective sovereign debt restructuring mechanism.
30. Among the most important problems that the international community must deal with today is the global reserve system. The current system contributes to the volatility in exchange rates that impose such high costs on all countries around the world. The current dollar system is fraying, but the dollar-euro (or dollar-euro-yen) system which is likely to replace it may be even more unstable. The dollar has proven itself not a stable store of value, a prerequisite for a good reserve currency. Moreover, the high level of global instability combined with the failures in the international financial institutions have induced numerous developing countries to accumulate huge amounts of reserves. The built-up of these reserves contributes to deflationary pressures. A one time emission of SDR's in response to the crisis (with an agreement among the countries to allocate the funds to promote development and global public goods, like addressing the challenge of climate change) could be a major help in enabling developing countries meet the challenge of the current crisis. But even more important, the creation of a new global reserve system, with annual emissions of (the equivalent of) SDR's, the development of an idea originally posed by Keynes 75 years ago, would help create a more stable global financial system.

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Memo to the Commission on Liquidity Support and Financial Market Restructurings

Joseph E. Stiglitz

1. It appears that the massive amounts of liquidity support from Central Banks have not had the desired effect of increasing lending.
2. This should not come as a surprise: adequate capitalization of banks is a necessary but not sufficient condition for lending
3. In some countries, much of the money spent on capital injections has been offset, through payments of dividends, bonuses, acquisition of healthy banks for cash, and new holes in balance sheets created by defaults.
4. That is why it is imperative that any capital injections be accompanied with measures to stem foreclosures and that directly stimulate the economy.
5. Moreover, the uncertainties associated with bank balance sheets remain large, given the large derivative positions, the uncertainties about counterparty risk, the on-going risk of defaults, and the continuing uncertainties about the business climate.
6. Many developing countries have faced similar problems of banks with adequate liquidity to lend not doing so. In some cases, this is because they view alternative "investment" opportunities—lending to governments, or lending abroad, speculating on capital gains from exchange rate changes—as more attractive than lending to domestic enterprises. In such circumstances, governments need to change the incentives facing financial institutions to induce them to lend.
7. For instance, financial institutions should not be allowed to earn a spread, beyond a minimal transactions cost, between the deposit rate and the government T-bill rate. There are a number of ways that such a policy can be implemented.
8. Providing interest on reserves held at the Central Bank, while helping recapitalize banks, reduces the incentive to lend by reducing the cost of not-lending.
9. Regulations that restrict currency mismatches between assets and liabilities reduce the scope for foreign exchange speculation. The imposition of heavy taxes on capital gains from currency appreciation affects incentives.
10. There may be other ways by which governments can provide incentives for lending, e.g. by awarding deposits of government balances to financial institutions that offer the lowest (risk adjusted) lending rates and/or that have the best lending performance using other metrics.
11. The injections of equity and the acquisition of troubled assets (or the provision of guarantees), while it may be important for restarting lending, provides large opportunities for hidden redistributions, with terms that do not adequately compensate the public for the risks assumed.

12. These problems are exacerbated when there is less than full transparency in the transactions. Many of the liquidity actions (both by Treasuries and Central Banks) fall short of accepted standards on transparency. Some Central Banks have claimed immunity from freedom of information acts. In other countries, Central Banks have chosen to limit themselves to standard forms of liquidity support, leaving to the political process (through Treasury action) to assume responsibility for lending activities, guarantees, and other actions which provide direct credit to the private sector and/or entail the public sector assuming large risks, beyond the normal levels associated with Central Bank activities.
13. In the past, bank restructurings have often been associated with large adverse wealth redistributions. Such redistributions are of particular concern given the large increases in inequalities in recent years, given the underlying problems of inadequacies of aggregate demand, and given the large increases in national debt in many countries, including those that will be associated with bail-outs and fiscal stimuli.
14. The effects can be partially mitigated by imposing heavy capital gains taxes (in excess of 50%) on the resulting gains in share prices, but implementation of such a tax poses problems.
15. Similarly, direct lending by Central Banks poses large risks on the public purse, as most central banks are not well poised for credit assessment, and poses large opportunities for hidden redistributions, with risk premia less than they should be. These problems are exacerbated by the lack of transparency in the actions of some Central Banks.
16. In providing credit and credit guarantees, governments and Central Banks should be attentive to some of the same criteria used in evaluating stimulus expenditures: (a) The induced spending should have a large multiplier; and (b) the induced spending should help address the country's and the world's long run problems. America, for instance, has been marked by excess consumption. To encourage lending in support of further consumption may be a mistake.
17. Given these problems, it may be desirable to create new lending institutions. This is especially the case under the current circumstances, where financial institutions have not shown adeptness at judging credit worthiness, and where many financial institutions have switched from the "storage" business into the moving business.
18. Given the magnitude of the support provided to American financial institutions, had new institutions been created, the potential for new lending would have been substantially larger than under the TARP program.
19. Guarantees provided to some institutions and not others may lead to large distortions in credit markets. Determining the appropriate risk adjustments may be difficult. In the absence of appropriate risk adjustments, such guarantees represent an unfair subsidy, a trade distortion which can undermine domestic financial institutions in developing countries.
20. Given the limitations of credibility of such guarantees by developing countries, even when there are appropriate insurance charges (which there have not been), the guarantees may represent a trade distortion.
21. Developing countries may have to protect themselves against the effect of these trade distortions, by restricting capital outflows, by imposing countervailing

duties on foreign banks receiving such guarantees (and other subsidies) operating within their borders, and/or by imposing lending restrictions to ensure that more of the benefits of such subsidies are received by those within the developing countries.

22. To reduce the likelihood of a financial sector trade war, it is imperative that developed countries offering guarantees and subsidies to banks operating within their countries extend direct assistance to developing countries, to enable them to offer comparable guarantees and subsidies.
23. Providing a credit facility to developing countries (directly, or through their Central Bank) help support lending by developing countries to their enterprises should, accordingly, be given high priority. Otherwise, there is a risk that existing global inequities will be exacerbated.

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Memo to the Commission on Central Bank Policies

Joseph E. Stiglitz

1. There is now a broad consensus that excessive liquidity supported by major Central Banks around the world contributed to the global financial crisis.
2. The policy error was a result of a systematic flaw in currently fashionable Central Bank doctrines, which encourages a focus on inflation in the prices of goods and services and pays little attention to asset price bubbles and other factors that might contribute to financial market fragility, with severe consequences for the rest of the economy.
3. Ironically, there is little empirical evidence to support adverse real effects from low to moderate inflation; but there is strong evidence—reinforced by the current episode—of adverse real effects from failures in financial markets.
4. There is considerable theory and evidence behind the notion that monetary policy operates at least partially through credit channels, and that accordingly regulations that affect the ability and willingness of financial institutions to lend can have first order macro-economic effects.
5. All policies are made in the context of uncertainty, and while it is true that one cannot be *sure* that one is facing a bubble, there was mounting evidence of the *likelihood* of such a bubble. It was correctly pointed out that the bursting of a bubble could have severe economic consequences.
6. In responding to uncertainties, Central Banks need to be mindful of asymmetries and irreversibilities: it may be easier to dampen an economy that is overheated, than to reignite an economy that has been forced into a recession; and a firm that is bankrupted as a result of too high interest rates will not be unbankrupted when interest rates are lowered.
7. Part of the current problem was that excess burden on maintaining the economy at full employment was put on monetary policy. Had the United States, for instance, passed a tax cut that was designed to stimulate the economy more, there would have been less need for loose monetary policy. One cannot view monetary and fiscal policy in isolation.
8. Monetary policymakers should also be more mindful of the channels through which monetary policy operates, and in particular, whether its stimulative effects are a result of an expansion of consumption (which may not be sustainable) or investment. Policy makers in the United States should have been sensitive to the fact that the effects of monetary policy were being felt mainly through increased household indebtedness and a housing bubble, rather than through increases in real productive investment. Previous episodes of instability have been related to housing bubbles and consumption booms.

9. The conduct of monetary policy is an important responsibility of government, and should therefore be subjected to normal standards of public governance, including transparency and accountability.
10. Monetary policy can have large distributive consequences; especially in times of crisis, there can be significant consequences for the distribution of risk bearing. Even when it is viewed that there should be some degree of independence, Central Bank boards should be *representative* and have some form of political accountability. There is often a risk of capture, e.g. by those from the financial sector.
11. Poorly designed bank regulations can be pro-cyclical, exacerbating downturns, and act as automatic destabilizers. It is important, for instance, to make sure that capital adequacy requirements (or provisioning requirements) are cyclically adjusted.

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Memo to the Commission on the Design of Stimuli

Joseph E. Stiglitz

1. There is by now a well agreed set of principles which should guide stimulus expenditures:
    a. Given the magnitude of the national debt, is it especially important that there be a big bang for the buck.
    b. Given the long delay in undertaking national actions, it is important that the effects are felt quickly
    c. So far as possible, the expenditures should be consistent with a broader national and global vision, and reflect other priorities:
        i. Expenditures on high return investments may actually improve the nation's balance sheets
        ii. Such investments would include those that improve technology, especially of the green kind, and help us adapt to production patterns that reflect greater environmental sensitivities.
        iii. Expenditures that reduce the increasing inequality gap would fall within this category.
    d. There are some obvious examples of programs that fall outside these guidelines
        i. Programs that increase America's already high consumption would not satisfy this criterion
        ii. Tax cuts for upper income Americans are likely to have little bang for the buck and, to the extent that they are effective, increase America's already high level of consumption and inequality.
    e. In implementing these guidelines, there may be trade-offs, with some measures that more directly meet long term national needs having less of a bang for a buck, or taking longer to implement. In some cases, it may be possible to phase in stimuli, beginning, for instance, with school reconstruction (which can be implemented quickly), and moving on to road construction (which make take a while to plan).

2. It may be useful to think of the stimulus program as consisting of several parts:
    a. Preventing the downturn from getting worse
    b. Protecting those hurt by the downturn
    c. Accelerating the recovery
    d. Providing the basis for sustained growth

3. In many economies there are built-in destabilizers. State and local governments will have to contract expenditures unless the Federal government meets their shortfall in revenues. These expenditures should be given the highest priority. Failure to do so will mean that the downturn will get worse.
4. Measures to protect those hurt by the downturn may also have large multipliers. Those receiving extended unemployment insurance are likely to spend it.
    a. In countries with weak social safety nets, it will be especially important to expand social protections, for instance, providing health insurance or assisting families who might otherwise face foreclosure.
5. One of the reasons for the current problem was an excess of liquidity; but one of the reasons that Central Banks provided these excessive amounts of liquidity was that it was necessary to do so to maintain a strong global economy. In the absence of such support, there might have been an insufficiency of American and global aggregate demand. This problem of insufficiency of aggregate demand has to be addressed if there is to be sustained growth. We face a *global* economic crisis, which requires stimulation of global aggregate demand.
6. Increased inequality within most countries of the world and excessive reserve accumulation by some developing countries contributed to the current problems of insufficiency of global aggregate demand. Policies promoting greater equality would thus promote global equity and strengthen global growth.
7. The problem of excessive reserve accumulation can only be addressed by moving to an alternative global reserve system and by providing better instruments for risk sharing, especially between developed and developing countries.
    a. Moving from the dollar reserve system to a dollar/euro reserve system may make matters worse, increasing global instability.
    b. This is an opportune time to expand nascent efforts at creating a more multilateral reserve system.
        i. Such efforts could build on the existing system of SDR's, the Chiang Mai initiative, and other efforts at sharing of reserves and swaps
        ii. While it would be desirable to have a one-time issue of SDR's, this will not address the underlying structural problem. There needs to be an annual emission of a global reserve currency.
        iii. Surplus countries are as much, or more, part of the problem as deficit countries: the sum of the world's trade deficits is simply equal to the sum of the world's surpluses. Countries that consistently maintain trade surpluses exert a negative externality on others. Reducing allotments of new global reserve emissions to surplus countries might provide an effective incentive to reduce surpluses
    c. While there have been improvements in capital markets in recent years, developing countries still bear a disproportionate share of the risk of exchange rate and interest rate volatility—in spite of the fact that efficient capital markets would transfer the burden of such risk to developed countries, who are in a better position to bear the burden

        i. This entails further development of bond markets in local currencies. Members of the Commission may want to discuss alternative mechanisms by which this might be done
        ii. It also may entail the development of innovative risk-management products by the International Financial Institutions
    d. There should be improvements in the way the international community handles the consequences of shocks to developing countries that are beyond their normal ability to bear
        i. This is especially the case when (as today) those shocks emanate from outside the affected country
        ii. While it is natural that those providing funds want to be sure that those funds are well spent, so that the likelihood of repayment is increased, conditionalities have often gone far further
            1. Ironically, it is now recognized that in some cases, the IMF encouraged deregulation measures that enhanced the risk of instability and crises
            2. Fear of loss of (economic) sovereignty provides a strong motivation for countries to maintain excess reserves
        iii. Most countries have bankruptcy laws that allow an individual facing excessive debt burdens to get a fresh start. Yet, we still do not have a sovereign debt restructuring mechanism that allows this to be done efficiently and fairly, in the case of poor countries that face debt burdens beyond their ability to pay.
            1. This problem may become especially important as the world sinks further into a global downturn
            2. The imperative to address these issues is especially important in the context of odious debts
        iv. All countries, but especially developing countries, need flexibility in finding the appropriate responses to this crisis and other crises which they may face in the future.
            1. Current international agreements may limit the scope for such responses. Indeed, some argue that some responses (undertaken, or proposed) by developed countries may violate existent trade agreements, including the Financial Services Agreement. But as noted below, enforcement of such agreements is asymmetric.
            2. Bilateral and multilateral investment agreements may further limit the scope of action in responding to crises, evidenced by suits undertaken in response to the 1997 East Asian crisis and the 2001 Argentinean crisis.
                a. In light of this, key terms in these agreements may need to be renegotiated.
8. Without assistance, developing countries may have limited ability to engage in countercyclical stimulation. But a global economy in which developed countries engage in countercyclical polices and developing countries are forced to engage in pro-cyclical policies will lead to global imbalances and instability and will

adversely affect growth and poverty reduction in developing countries. It is imperative, therefore, that the international community provide developing countries with additional support so that they can pursue countercyclical fiscal policies.

9. Some will worry about the long term consequences of the increased national debt as a result of fiscal stimulus.
    a. As noted, the size of the debts of many countries makes it especially imperative that stimuli packages be well designed.
    b. Developed countries should be aware that funds are limited, and funds used to promote growth in developed countries may reduce the magnitude of funds available to support development in poorer countries.
    c. They need to be particularly mindful that bail-outs of firms and sectors within their own countries may not constitute effective stimuli and give those firms and sectors a distinct competitive advantage over those in developing countries. Most developing countries cannot compete in the provision of these subsidies, which represent a major distortion of markets. The developed countries are in the process of creating an even more unlevel playing field. For years, product and financial markets will be distorted as a result of these government interventions in market processes; they will not be easily undone. Even the knowledge that failure may be rewarded with a bail-out allows firms in developed countries to undertake greater risks, and thus the legacy of these bail-outs will last years into the future.
        i. International trade agreements provide an inadequate framework for responding to these inequities. Even when developed countries are found to be in violation of international trade agreements, there may be no effective sanctions that a developing country can bring. The current system is inherently asymmetric. Moreover, the length of time for adjudicating these disputes is sufficiently great that, even were an effective sanction available, firms in developing countries could face bankruptcy. There are important hysteresis effects, especially important given the inherent scarcities of capital and entrepreneurship.
    d. For most countries, anxieties about future tax burdens as a result of increased deficits are not likely to be sufficiently great to offset the stimulative effects of increased government expenditures. Few econometric studies lend substance to such concerns.
        i. This is especially the case for expenditures on investment, which strengthen a nation's balance sheet. Enhanced prospects of future well-being may actually lead to increased current levels of consumption.
        ii. But such concerns may help explain why tax cuts for upper income individuals often have limited stimulative effects
        iii. Such concerns reinforce the importance of designing programs with intertemporal substitution effects, e.g. temporary investment tax credits

iv. And such concerns reinforce the importance of designing programs that address market distortions, e.g. enhanced availability of credit for small and medium sized enterprises

10. The need for taking countercyclical discretionary policies will be greater in countries with weaker automatic stabilizers (stronger automatic destabilizers). Some countries have weakened their automatic stabilizers in recent years, and this may be an opportune time to reconstruct automatic stabilizers, especially those associated with addressing problems of growing inequality.
11. The focus on short term stimuli should not divert the international community's attention to persistent long run problems, including poverty alleviation (the achievement of the Millennium Development Goals) and addressing global warming. Indeed, as we recognize the need for a *global* stimulus, this may provide an opportune time to increased expenditures directed at these global problems.

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Memo to the Commission on Foreclosures

Joseph E. Stiglitz

With real estate bubbles bursting around the world, many countries are facing a problem with foreclosures. Unless something is done to address the problems of foreclosures, banks will continue to face losses, and there is a risk of overshooting of real estate prices, as the effects of forced sales are felt. Given the externalities generated, government assistance to enable especially poor families to stay in their homes may be warranted. There are large deadweight losses when houses are left vacant.

The underlying problem is simple: banks made loans based on inflated housing prices; the mortgages were beyond many individuals' ability to pay. The following memo outlines a comprehensive approach to dealing with the problem of foreclosures.

1. Dealing with the current foreclosure problem: a homeowners chapter 11

There are a number of easy ways of dealing with the foreclosure problem—such as bailing out the lenders at the same time as writing down the loans—which, in the absence of budget constraints and worries about future moral hazard would make everyone (other than ordinary taxpayer) happy. Individuals could stay in their homes and lenders would avoid taking a hit to their balance sheets. Knowing that the government is taking this risk off of balance sheets would contribute to alleviating the credit crunch.

The challenge is how to save the homes of the hundreds of thousands of those who otherwise would lose their homes, and *not* bail out the lenders, who should be made to bear the consequences of their failures to assess risk. (Clearly, borrowers also share in the blame, but, for the most part, the lenders were, or should have been, far more financially sophisticated than the borrowers, especially most of those taking out sub-prime mortgages.)

One answer is **a** "homeowners' chapter 11"—a speedy restructuring of liabilities of poorer homeowners, modeled on the kind of relief that we provide for corporations who cannot meet their debt obligations. Chapter 11 is premised on the idea that keeping a firm going is critical for the firms' workers and other stakeholders. The firm's management can propose a corporate reorganization which the Courts review. If found acceptable, there is a quick discharge of debt—the corporation is given a fresh start. The homeowners' chapter 11 is premised on the idea that no one gains from forcing a homeowner out of his home. There are large transactions costs associated with

foreclosure. And typically, following foreclosure, there is a deterioration in house maintenance, and adverse effects on the community.

Eligibility standards This relief should be available for households with income below a critical threshold ($150,000) and with non-household, non-retirement wealth below some critical threshold (perhaps dependent on age). But an argument could also be made that it should be more generally available.

Procedures The house would be appraised, and the individual's debt would be written down to, say, 85 to 90% of the level of that appraisal (reflecting the fact that were the lender to have to proceed with foreclosure, that would be substantial transactions costs).

An assessment of the individual's ability to make mortgage payments at the lowered value and current market interest rates would then be made (at a conservative standard—it again does no good to hope that the individual will be able to make payments that are beyond his ability.)

If the borrower could still not make the now reduced payments, the borrower could then get a government loan as described in the next section, which takes advantage of the government's lower cost of funds. (To reduce the likelihood of foreclosure, this possibility could be extended more generally.)

2. Voluntary Restructuring of existing loans

With the government assuming an increasing role in the financial sector (through ownership of Fannie Mae and Freddie Mac and equity injections), it can use its role to push mortgage restructurings (as it has already been doing in some cases.)

The threat of a homeowners chapter 11 action would always promote voluntary restructuring.

In the next section, we discuss how government can use its lending programs to induce restructuring.

3. Expanded government mortgage lending

The usual argument *against* government lending is that the private sector does a better job of screening loan applicants and designing appropriate mortgages. The evidence against that view is now overwhelming. A simple rule based government mortgage program could provide mortgages at better terms and with a lower risk of default than the private sector. There are a number of variants of this proposal (some already in place at a limited scale.) By passing on the government's lower cost of capital, and using the enforcement capacities of the IRS, loans could be provided at lower interest rates, without adversely affecting the government's budgetary situation, and these lower mortgage rates would then lower default rates.

We can think of this as a form of benchmark competition. If the private sector can provide loans at a lower interest rate, so much the better. But there is one not insignificant problem: the government competition will erode profits of the private banks, and weaken the very institutions which, through other efforts, we are trying to strengthen. And it raises a fundamental question: if the government is better at lending, do we really want to replace private sector lending with government lending? And if so, why limit the government lending to housing? There are other areas of even higher social return.

Given the lack of consensus about the appropriate role of government in lending and the downside risk from harm to current good lenders, the government lending program should presumably be circumscribed—focused on low and middle income homeowners, with interest rates consistent with long term interest rates when markets are functioning reasonably well given current long term inflationary expectations (say 5% to 6%). We should not be in the business of giving away large gifts, or of supporting housing prices at levels that are not sustainable. We should be addressing current market distortions, but it is questionable whether we should go beyond that.

Refinancing existing mortgages With long term interest rates at record low levels, it may be possible to refinance large numbers of mortgages in ways which will make them affordable—and still leave the government earning a return. The threat of the government doing so may itself provide an incentive to encourage banks to restructure their loans. For if the government refinances, say, a 6% mortgage, the bank receiving the money may have few good investment opportunities.

The government could, for instance, offer to refinance all mortgages that have not been restructured according to government specifications. The low interest rates have, in effect, given mortgage lenders a windfall gain, though the mortgage may still have a low value because of the risk of default.

In some cases, there is a pre-payment penalty. The savings from the lower interest rate would, presumably, in most cases more than offset the pre-payment penalty, and the government could provide finance for the pre-payment penalty as part of the refinanced mortgage. The government could use the homeowners' chapter 11 to override the pre-payment penalty, or alternatively offer to pay, on behalf of the homeowner, the pre-payment penalty. The costs of such payments are likely to be low, especially in relationship to the costs of the current disruptions in financial markets. Alternatively, the government could combine an override under a version of a homeowners' chapter 11 with a partial payment of the pre-payment penalty in those instances where the lender could establish that he (i) had fully disclosed and explained all the terms of the mortgage to the borrower, including the pre-payment penalty; (ii) had not made any representations about the likelihood of price increases; (iii) had not engaged in other abusive lending practices; and (iv) but for the government intervention, would have had a likelihood of having the loan fully repaid.

Government Subsidies Some have proposed using TARP to provide subsidies to homebuyers, though not to help subsidize refinancing. The argument is that such subsidies (proposals being currently discussed amount to a 10% reduction in price) would encourage more demand for housing, and thus boost house prices. We face a quandary: we want house prices to adjust to the "equilibrium level," which may entail a further reduction from the current level. Resisting that will simply extend the duration of adjustment. (One can debate whether a longer and possibly shallower downturn is preferable to a shorter and deeper downturn. But at the very least, one should be aware of the downside risk associated with interfering with the adjustment process.) On the other hand, we do not want "overshooting." We are not yet at the point where we are likely to have overshot. But we may be at that point within a year or so.[1]

Recourse loans In addressing the mortgage foreclosure problem, there is one modification that should be considered. If the mortgages provided by the government were full recourse mortgages, default rates would be greatly reduced, because individuals would know that they could no longer simply walk away from their debts. This would enhance a "credit culture," which would improve the functioning of credit markets.

A recourse mortgage should, obviously, be less attractive to borrowers, but most borrowers do not plan to default, and therefore they would probably be willing to access such a mortgage at an interest rate little different from that on a non-recourse mortgage.

But this restructuring of debt provides a major gift to lenders, for the reduced likelihood of default increases the value of that part of the mortgage which they retain. They should not be given this "gift" freely. There are social gains from the reduced likelihood of default that need to be equitably distributed.

Here is one way that that could be done: In the case of banks willing to go beyond the framework of the "Homeowners chapter 11" outlined above, and say write down the mortgage to 75% or 80% of current market value, the government would provide a *recourse* mortgage, charging the homeowner a slightly lower interest rate (say 25 basis points lower). Everyone wins from this proposal.

Model bankruptcy restructurings for other cases (e.g. homeowners with an income beyond the $150,000 limit, or who can afford to pay the written down value of the mortgage) could easily be designed.

Separating speculators from true homeowners

[1] The benefits may be limited by the fact that, if the interest rate is too much below rates at which current homeowners have financed their homes, some individuals may be induced to sell their homes, to get the low interest mortgage. Thus, the program may have supply side effects partially offsetting demand side effects.

One of the objections to these restructuring proposals is that speculators as well as true homeowners may reap the benefits. It is the latter, of course, whose welfare is of particular concern.

One way of addressing the problem is to restrict eligibility to those who are and have been living in their home. Only primary residences would be eligible.

But there is a second approach, based on what economists call the general theory of self selection. After the write down, the lender would retain a share (perhaps all) of the capital gain, to be paid when the property is sold. Speculators would have little (or no) interest in participating, since the debt restructuring would take away all of his speculative gains.

There are some technical difficulties. One would have to take some account of investments in the house made subsequent to the restructuring. The effectively high tax on capital gains could lead to a locked in effect. It would make it costly for individuals to move, since they would then have to pay a potentially large sum to the lender.[2]

Note that with such conversion of the former creditors into equity claims, the analogy with the Chapter 11 is complete. In Chapter 11, the equity owners are wiped out (here the equity owner is the homeowner, and, if he retains none of the capital gain, his equity claim is fully eliminated), and the former bondholders become the new equity owners.

One could design variants around this theme. One could, for instance, give homeowners a schedule, with large write downs of the mortgage granting larger fractions of the capital gains to the lender.

4. New Mortgages

Ironically, the financial sector, for all of its claims at innovation, has not innovated in ways which are directed at shifting risk from poor Americans to those who are more able to bear the risk. Indeed, variable rate mortgages shifted risk of interest rate variations to homeowners. Other products with balloon payments were even worse.

There are a number of products which have been developed in other countries which could be introduced into the United States.

For instance, even if mortgages are variable rate, poor Americans struggling to make ends meet need to know what their monthly payments are going to be. One can have fixed payments, even with variable rate mortgages, if one lets the maturity of the mortgage be variable.

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[2] There might also be problems of circumvention: two homeowners in a similar position could exchange their homes after the restructuring, wiping out the future capital gain claim, though it should be easy to restrict or discourage such attempts at circumvention.

The Danish mortgage bonds are an alternative structure which has proved successful for more than two centuries.

The government has repeatedly had to take the initiative in innovating financial products (like making mortgages widely available) that meet the needs of ordinary citizens. When they are proven, the private sector often steps in. This may be another instance where government will have to take the initiative in designing new forms of mortgages and in ensuring an adequate supply of mortgages, because of the failure of the private sector to do what it should.

5. Expanded homeownership initiative

Advocates of the reckless subprime mortgages argued that these financial innovations would enable large numbers to become homeowners for the first time. They did become homeowners—but for a very short time, and at a very high cost. The fraction of Americans that will be homeowners at the end of this episode is likely to be lower than at the beginning. The objective of expanding homeownership is, I believe, a worthy one, but clearly the market route has not worked well—except for the mortgage brokers and investment banks who profited from them. They encouraged individuals to buy housing beyond their ability to afford and to repeatedly refinance, generating large transactions costs for themselves. Now, the problem is that these people are not only losing their homes; as they lose their homes, they are also losing their life savings. Mortgage brokers and lenders should have encouraged homeowners to purchase houses that were appropriate to their income.

The underlying problem is simple to state: median household income has been falling and house prices rising. This means that housing is becoming less and less affordable to more and more Americans. There are no easy fixes to the declining incomes (other than shifting the burden of taxation away from these individuals and towards those who have been doing well. Nor is there any way (short of public housing programs) that we can quickly reduce housing prices. (The market correction currently going on is likely to make housing more affordable.)

In general, most economists worry about the distortions from our tax system in encouraging excessive consumption of housing. But given the magnitude of the current economic crisis, further assistance may be warranted.

A particularly strong case can be made for helping low income individuals with their housing costs. Note that we do this with upper income individuals—tax deductibility of mortgages and property taxes means than the government pays a large fraction of the carrying costs. But ironically, we do not do that with those who need the help the most.

A simple remedy is converting the current mortgage and property tax deduction into a *flat rate cashable tax credit at say 25%*; the reduction in the subsidy to upper income Americans could help pay for the subsidy for poorer Americans. (Even better would be a

progressive subsidy, with a higher rate for the poor than the rich). A 25% tax credit would increase the affordability of housing for many Americans.

6. Regulations

Many countries restrict predatory lending practices and even loans which impose excessive risk burdens on low income individuals (and which, as we have seen, no only risk the well being of those individuals, but also impose systemic risk on the economy). We should do the same. We should not allow mortgages that present a risk that payments might exceed a particular fraction of household income, and mortgage programs that, as a matter of routine (e.g. as a result of patterns of refinancing), generate transactions costs that are in excess of a certain fraction of the value of the mortgage.

The proposed Financial Products Safety Commission might be an appropriate institution for reviewing what are "safe" mortgages, and setting out guidelines on the appropriateness of particular mortgage structures for individuals in different circumstances.

Towards A New Global Economic Compact
Principles for Addressing the Current Global Financial Crisis and Beyond

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The following summarizes my personal views, as well as the views of the Initiative for Policy Dialogue, on key elements of a response to the current global financial crisis.

1. The current financial crisis, which began in the U.S., then spread to Europe, has now become global. Even emerging markets and less developed countries that managed their economy well, resisted the bad lending practices, held high levels of foreign exchange reserves, did not purchase toxic mortgages, and did not allow their banks to engage in excessive risk taking through derivatives are likely to become embroiled and to suffer as a result. *Any global solution—short term measures to stabilize the current situation and long term measures to make another recurrence less likely—must pay due attention to impacts on these countries.* Without doing so, global economic stability cannot be restored and economic growth, as well as poverty reduction worldwide will be threatened.
2. The current economic crisis should provide an opportunity to reassess global economic arrangements and prevalent economic doctrines. Large changes have occurred in the global economy in recent years, e.g. in the sources of global savings, reserves and GDP, and these are not fully reflected in our global economic institutions and arrangements. As we address the short run crisis, we should seize the opportunity for making deeper reforms that enable the world to enter into the twenty first century with a more equitable and a more stable global financial system, which could usher in an era of enhanced prosperity for all countries.
3. In the past, the global financial system often worked to the disadvantage of developing countries. Banks in developed countries, for instance, were encouraged to lend short term to developing countries; while this provided greater liquidity to the former, it led to greater instability in the latter. Pro-cyclical monetary and fiscal policies were often foisted on developing countries, while developed countries followed countercyclical policies. *The international community must commit itself to developing the institutions and instruments for increasing the stability and equity of the global financial system.*
4. Just as part of the reason for the current problems in the advanced industrial countries are related to failures in governance (corporate governance structures that led to non-transparent incentive schemes that encouraged bad accounting practices), part of the reason for the failure to create a stable and equitable system are long recognized problems in global governance. There is inadequate and in some cases no representation of emerging markets and less developed countries. *There needs to be reform in the governance of the international economic institutions and standard setting bodies, like the Basle Committee on Banking Regulation.* The reforms undertaken, for example in IMF governance, so far have been inadequate. Unless far more fundamental reforms are undertaken, it will not be possible for these institutions

to play the role that they should. And while discussions among informal groupings of countries will necessarily play an important role in developing a global consensus on key and complex issues, decision making must reside within international institutions with broad political legitimacy, and with adequate representation of both middle income countries and the least developed countries. The only institution that currently has that broad legitimacy today is the UN. Historically, the UN has played a central role, e.g. in convening the "United Nations' Monetary and Financial Conference," at Bretton Woods which established the Bretton Woods Institutions. But the world has changed a great deal since that conference 64 years ago. We are now at another "Bretton Woods" moment.

5. Addressing the problems presented by the global financial crisis requires expertise, of the kind associated with specialized agencies like the IMF and the World Bank. But in the past, these institutions have been too wedded to particular economic perspectives, which assumed that markets were self-regulating; they paid too little attention to economic perspectives which had pointed out the risks in the kinds of policies pursued in recent years by advanced industrial countries. Contrary to the policies that they and other international economic organizations have often pushed on developing countries, capital and financial market liberalization has often not brought the promised benefits of enhanced growth, but has increased instability. The systematic support of pro-cyclical macro-economic policies in developing countries, while developed countries continue to pursue countercyclical policies is not only disadvantageous to developing countries, but contributes to global instability.
6. Any economic policy has large distributive consequences, and policy makers need to be attentive to those consequences. It is not necessarily the case that what is good for financial markets is good for the economy. But inevitably, the international financial institutions, closely linked to financial markets (through governance linked to finance ministers and central bank governors) will reflect interests and perspectives of those in financial markets. These problems are exacerbated by conflicts of interest arising, for instance, through revolving doors. The credibility, legitimacy, and effectiveness of these institutions requires a restoration of confidence, and that means that greater attention needs to be paid to generally accepted principles of democratic governance.
7. In the current crisis, the advanced industrial countries need to be sensitive to the inherent asymmetries in the economic positions of developing and developed countries and to the fact that similar policies adopted in developed and developing countries can have markedly different effects; for instance, government guarantees provided by developing countries may not have the credibility that those provided by developed countries have, inducing major flows of funds from developing to developed countries..
8. Consideration should be given to the creation of a new international financial facility, financed particularly by countries (like China and Japan, and some oil exporters) that have large reserves. This facility could be used to help developing countries and emerging markets finance guarantees for the debt of their corporations, forestalling the risk of a run on these corporations. If necessary, it could also finance guarantees for trade credit channeled to banks in developing countries. Such an institution would have a distinctly different governance from existing global financial institutions, reflecting the new sources of global funds and the necessity of greater voice to

emerging markets and the less developed countries. IMF facilities for compensating for the developing countries' deterioration of the terms of trade need to be significantly expanded and their conditionality sharply reduced or eliminated.

9. All countries, but especially the developed countries where the crisis originated, will need to give immediate consideration to reforming their regulatory structures. Self-regulation will clearly not suffice. Nor will stronger transparency and disclosure standards. Attention needs to be paid to ensuring better incentives, reducing scope for conflicts of interest, imposing counter-cyclical restrictions on leverage, imposing adequate provisioning, and imposing speed limits. Other reforms need to address broader social and economic issues. Competition is at the heart of a successful market economy, but there has been inadequate and lax enforcement of anti-trust laws; financial institutions have grown to the point where they are too big to fail. Regulations also have to address issues of consumer protection and access to financial markets by all groups in socials. Reforms focusing on safety and soundness are particularly imperative in the core part of each country's financial system, its commercial banks and those that deal with it, and there needs to be adequate ring-fencing of these core financial institutions from other institutions that are less tightly regulated. However, regulation should be comprehensive, to avoid regulatory arbitrage, which can generate high levels of systemic risk. Consideration should be given at the national and international level to the creation of commissions to establish the safety of new financial products and their appropriateness for various parties; and to commissions to assess systemic stability, at the national level and international level. A substantially reformed Financial Stability Forum might be able to be transformed into the global body responsible for assessing systemic risk. The creation of a global financial regulator should be studied urgently; this would imply coordinated regulation of all financial centers, including offshore ones.
10. Central banks need to give consideration to changing their mandates, recognizing that price stability is not sufficient to maintain economic stability and prosperity, and an excessive focus on price stability may actually contribute to slower and more unstable growth. Due attention should be paid to the stability of the financial system, and its interactions with macroeconomic trends.
11. It is not enough to have good regulations; they have to be enforced. Countries need to design regulatory institutions that are immune from capture by special interests and where the voices of those that are hurt by a failure of regulation are adequately represented.
12. There is a need for more global cooperation in setting regulatory standards and in coordination in macro-economic policy. Instability in exchange rates have been particularly costly to developing countries, and reforms, such as creating a global reserve system, which hold out the promise of reducing such instability, should be given immediate consideration. Again, one cannot rely on industry associations for the setting of standards, nor on financial institutions and credit rating agencies for risk assessments.
13. Financial institutions in countries that refuse to comply with international standards should be barred from dealing with those in well regulated economies. In particular, it needs to be recognized that bank secrecy can not only provide finance for terrorism,

but also can aid and abet tax evasion, drug dealing, money laundering, and corruption, all of which can be particularly harmful to developing countries.

14. Consideration should be given to longer term reforms that enhance the stability and equity of the global financial system. Such reforms include reform of the global reserve system, a sovereign debt restructuring mechanism, the creation of a global financial regulator and further development of bond markets in local currencies.
15. Enhanced surveillance may be called for, but current surveillance faces two critical problems. The first is that it has been too narrowly focused. Too often, good macro-economic performance has been associated with maintaining low inflation. The second is that it seems to have little impact on the U.S. and other advanced industrial countries—the source of the current economic disturbance. At the very least, future surveillance efforts should look at employment, the stability of the financial system, as well as inflation, and should involve not just the IMF, but other international organizations, such as the ILO.
16. Ten years ago, at the time of the Asian financial crisis, there was much discussion of the necessity of reform to the global financial architecture. Little—too little, it is now evident—was done. It is imperative that we not just respond adequately to the current crisis, but that we begin the process of the long run reforms that will be necessary if we are to have a more stable and more prosperous global economy. We must try to avoid future global crises.
17. The General Assembly, working with ECOSOC and other agencies in the UN family, such as the ILO, needs to take a lead role, in monitoring these multilateral financial institutions and bodies, their governance, their decisions, and their consequences, to assess broader social and economic impacts, including on growth, unemployment, and poverty. To fulfill these new responsibilities, there have to be reforms in the relationship between the UN General Assembly and the Bretton Woods, as well as regulatory institutions, to enhance the latter's accountability to the international community.
18. The Doha Review Conference on Financing for Development provides an opportunity to make progress both on the institutional issues, including those related to governance, as well as on the substantive issues.
19. During the General Debate last month, many heads of state and government called for the United Nations to lead the process of reform of the international monetary and financial system. Before and since then, others such as the Commonwealth have actively urged such a reform process, what many are beginning to call a new Bretton Woods moment. It took 15 years after the last global financial crisis, and a world war, before the United Nations Conference on Monetary and Financial Affairs at Bretton Woods, New Hampshire, took place in July 1944. While it is too late to prevent the current crisis, the international community is coming together to contain the damage and reverse the inevitable downturn. While doing so, we must not lose sight of our collective responsibility to do our best to try to prevent the recurrence of such devastating crises and to ensure an international monetary and financial system to support sustained and equitable development.

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Principles for a New Financial Architecture

Joseph E. Stiglitz

I. General Principles Concerning Financial Markets and the Role of Government

1. Financial markets are not an end in themselves, but a means: they are supposed to perform certain vital functions which enable the *real economy* to be more productive:
   a. Mobilizing savings
   b. Allocating capital;
   c. Managing Risk, transferring it from those less able to bear it to those more able

   It is hard to have a well-performing modern economy without a good financial system.

   In America, and some other countries, financial markets have not performed these functions well:
   a. The encouraged spendthrift patterns, which led to near-zero savings
   b. They misallocated capital
   c. The created risk, they did not manage it well, and they left huge risks with ordinary Americans, who are now bearing huge costs because of these failures

   These problems have occurred repeatedly and are pervasive, evidence that the problems are systemic and systematic. And failures in financial markets have effects that spread out to the entire economy.

2. While markets are at the center of every successful economy, markets only work well when private rewards are aligned with social returns. Incentives matter, but when incentives are distorted, we get distorted behavior.

   In spite of their failure to perform their key social functions, financial markets have garnered for themselves in the US and some other of the advanced industrial countries 30% or more of corporate profits—not to mention the huge compensation received by their executives.

3. Well functioning markets require a balance between government and markets. Markets often fail, and financial markets have, on their own, failed in ways that have large systemic consequences. The deregulatory philosophy that has prevailed in many Western countries during the past quarter century has no grounding in economic theory or historical experience; quite the contrary, modern economic theory explains why the government must take an active role, especially in regulating financial markets.

   Good regulation can increase confidence of investors in markets, and thus serve to attract capital to financial markets.

   Government regulation is especially important because inevitably, when the problems are serious enough, there will be bail-outs; thus, government is, implicitly or explicitly, providing insurance. And all insurance companies need to make sure that either the premia they charge for the risks are commensurate with the risks, or that the insured do not take actions which increase the likelihood of the insured against event occurring.

   Key regulations, like the Glass Steagall Act, were repealed in the United States. In other cases, the regulatory structure did not keep up with changes in the financial structure. The international banking regulatory structures (Basle II) were based on the notion of self-regulation, *an oxymoron.*

   Bail-outs have been a pervasive aspect of modern financial capitalism. Financial markets have repeatedly mismanaged risk, at great cost to taxpayers and society.

   When, a hundred years ago, Upton Sinclair depicted graphically America's stockyards, and there was a revulsion against consuming meat, the industry turned to government for regulation, to assure consumers that meat was safe for consumption. Regulatory reform would help restore confidence in our financial markets.

4. But passing regulations is not enough. They have to be enforced.

   The Fed had regulatory powers which it did not use. Those appointed to enforce the regulation succumbed to the same deregulatory philosophy that had led to the stripping away of regulation.

5. Innovation is important, but not all innovations make a positive social contribution. Those that do should be encouraged, and government may need to take a catalytic role.

   Much of the innovation in recent years has been regulatory, accounting, and tax arbitrage, while financial markets failed to make innovations which would help individuals and our society manage risk better; in some instances, they have

actually opposed such innovation. Historically, the government has played an important role in promoting key innovations.

6. The success of a market economy is based on competition. But firms strive to reduce competition. There is a need for strong competition laws with rigorous enforcement.

   When a firm is bailed out because it is too big too fail, it is evidence that competition laws have not been effectively enforced. Now financial institutions have become so big that they are almost too big to save. And in the process of addressing the current crisis, we are creating ever larger financial institutions, sowing the seeds for problems down the line. The high fees and other abusive practices of credit card companies is a result of anti-competitive behavior.

7. The success of a market economy requires good information—transparency. But there are often incentives, especially in managerial capitalism (where there is a separation of ownership and control), for a lack of transparency.

   Problems of lack of transparency are pervasive in financial markets, and they have resisted improvements, such as more transparent disclosure of the costs of stock options. Stock options in return have provided incentives for accounting that increases reported *profits—incentives for distorted and less transparent accounting. Financial institutions created products that were so complex and non-transparent that not even the firms that created them fully understood all of their implications. They put liabilities off-balance sheet, making it difficult to assess accurately their net worth.*

8. Problems of information asymmetries are pervasive in financial markets.

   Securitization and many of the other "innovations" have increased these asymmetries of information. The recognition of the importance of the limitations of information has played an important role in the current crisis.

9. Financial markets have often exploited the uninformed and the poorly educated.

   This is part of the reason for the need for strong consumer and investor protection. It is not a surprise that the problems first occurred among the least educated and lower income individuals. There was extensive predatory lending, and financial markets resisted laws restricted these abusive practices.

10. Ordinary individuals cannot be expected to monitor the financial position of banks. Such monitoring is a public good—a public responsibility. And the government should provide protection for the public against its failure to perform its function adequately. There needs to be comprehensive deposit insurance, fully funded by a tax on depositors.

Without such deposit insurance there can be runs on the banking system. The argument that providing such deposit insurance gives rise to moral hazard is absurd. But if the government provides insurance, it must make sure that the insured against event does not occur—just as a fire insurance company typically requires commercial buildings that it insures to have sprinklers.

11. Financial behavior is affected by many other parts of our tax and legal structures. Financial market reform cannot be fully separated from reform in these other laws.

    Tax laws encouraged leveraging. New bankruptcy laws that made it more difficult for poor to discharge their debts may have encouraged predatory lending practices.

12. Those who impose costs on others (externalities) must be forced to pay those costs. This is not just a matter of equity; it is a matter of economic efficiency. More generally, costs of regulation and bailing out of financial systems are part of the costs of financial intermediation. There is a presumption that efficiency requires that these costs be borne within the sector.

    In environmental economics, there is a basic principle, called the polluter pay principle. Wall Street has polluted our economy with toxic mortgages. It should now pay for the cleanup.

13. The role of the Fed is not just to maintain price stability, but to promote growth and high employment. A single minded focus on price stability may actually lead to greater economic instability. Economic stability requires a sound financial system.

    The Fed and central bankers around the world were focusing on second order inefficiencies associated with low inflation, as problems of financial market instability grew—with the resulting real loss of output and economic inefficiency that were so much larger.

14. There are large distributional consequences of financial policies (both macro-economic and regulatory). They cannot be delegated to technocrats, but are an essential part of the political process.

    While the economy needs a well-functioning financial system, what is in the interests of financial markets may not be in the interests of workers or small businesses. There are trade-offs. The Fed's responsibility is not to maximize the well-being of financial markets; their mandate is broader. It is important that those broader interests be better reflected in institutional design.

II. The principles of a regulatory agenda

A. **Objectives**

Regulations are required to

(a) ensure the safety and soundness of individual financial institutions and the financial system as a whole
(b) protect consumers
(c) maintain competition
(d) ensure access to finance for all
(e) maintain overall economic stability

B. **Design**

1. There are always going to be asymmetries between regulators and regulated—the regulated are likely to be better paid and there are important asymmetries of information. But that does not mean that there cannot be effective regulation. The pay and skills of those innovating new drugs may be different from those that test their safety and efficacy; yet no one would suggest that such testing is either infeasible or undesirable.

   But well designed regulatory structures take into account those asymmetries—some regulations are easier to implement and more difficult to circumvent.

2. There is always going to be some circumvention of regulations. But that doesn't mean that one should abandon regulations.

   A leaky umbrella may still provide some protection on a rainy day. No one would suggest that because tax laws are often circumvented, we should abandon them. Yet, one of the arguments for the repeal of Glass-Steagall was that it was, in effect, being circumvented. The response should have been to focus on the reasons that the law was passed in the first place, and to see whether those objectives, if still valid, could be achieved in a more effective way.

3. But it does mean that one has to be very sensitive in the design of regulations. Simple regulations may be more effective, and more enforceable, than more complicated regulations. Regulations that affect incentives may be more effective, and more enforceable, than regulations directed at the behaviors themselves.

4. And it also means that regulations have to constantly change, both to keep up with changes in the external environment, and to keep up with innovations in regulatory arbitrage.

5. There are important distinctions between financial institutions that are central to the functioning of the economy system, whose failure would jeopardize the functioning of the economy, and who are entrusted with the care of ordinary citizens' money, and those that provide investment services to the very wealthy. The former includes commercial banks and pension funds. These institutions must be heavily regulated, to protect our economic system and the individuals whose money they are supposed to be taking care of. Consenting adults should be allowed to do what they like, so long as they do not hurt others. *There needs to be a strong ring-fencing of these core financial institutions—they cannot lend money to or purchase products from this "risk" sector, unless such products have been individual approved by a Financial Products Safety Commission. (*In the subsequent discussion, we will refer to these financial institutions as highly regulated financial entities.)

   The fact that two investment banks have converted themselves into bank holding companies should be a source of worry. They argued that this would provide them a more stable source of finance. But they should not be able to use insured deposits to finance their risky activities. Evidently, they thought they could. It means that either prudential regulation of commercial banks has been so weakened that there is little difference between the two; or that they believe that they can use depositor funds in their riskier activities. Neither interpretation is comforting.

6. There should be a presumption that financial markets work fairly well, and as a result there are no free lunches to be had. Financial innovations that are defended as reducing transactions costs, but lead to increased fees for financial institutions, should be suspect.

   Many new financial products (derivatives) were sold as lowering transactions costs and providing new risk arbitrage opportunities, but pricing was based on information provided by existing assets, and they succeeded in generating huge fees.

7. Models used to provide risk assessment are only as good as the assumptions that are used in their implementation. In the past, there have been repeated failures in underestimating risks and correlations (e.g. among assets, between credit and interest rate risks) and of small probability events (once in a century events occur every ten years). Risk models used by highly regulated entities and those that regulate them must be alert to these problems, and to systemic risks.

8. Modern financial markets are complex, with complex interrelations among different institutions of different kinds, evidenced in the current crisis. *There is a need for a regulatory authority, a Financial Markets Stability Authority, to assess over risks.* While the Financial Products Safety Commission looks at individual products, and judges their appropriateness for particular classes

of purchasers, the Financial Markets Stability Commission looks at the functioning of the entire financial system, and how it would respond to various kinds of shocks. Such a Commission should have identified, for instance, the risk posed by the breaking of the housing bubble. All of the regulatory authorities (those regulating securities, insurance, and banking) should report to the FMSC. We have seen how all financial institutions are interconnected, and how an insurance firm became a systemic player. Similar functions can be performed by different kinds of institutions. There needs to be oversight over the entire system to avoid regulatory arbitrage.

9. Part of the problem in the current crisis is inadequate enforcement of existing regulations. It is not surprising: if government appoints as regulators those who do not believe in regulation, one is not likely to get strong enforcement. This means that we have to design *robust* regulatory systems, where gaps in enforcement are transparent. Relatively simple regulatory systems (see point 3 above and specific examples below) may be easier to implement and more robust. There needs to be sensitivity to the risk of regulatory capture. It may also be optimal to have duplicative regulatory systems: the costs of a mistake overwhelm the extra costs of regulation. And one must guard against regulatory competition—allowing a choice of regulators, which can lead to a race to the bottom.

10. While guarding against the mistakes of the past in no insurance for avoiding problems in the future, what is remarkable about Western financial systems is that they seem so immune from learning. Similar problems arise repeatedly: the underestimation of small probability risks, the underestimation of correlations, the lack of attention to problems of liquidity and systemic risk, problems posed by failures of counterparty risk. Any regulatory system has to pay special attention to these seemingly persistent failures in markets' risk judgments. It also must be sensitive to other aspects of market failures, especially if effective remediation is not undertaken, such as the underestimation of certain risks by rating agencies.

11. Regulatory capture is not just a matter of "buying" regulators, or even of "revolving doors," but also of the capture of ideas and mindsets. If those who are supposed to regulate the financial markets approach the problem from financial markets' perspectives, they will not provide an adequate check and balance. But much of the inadequacy of current regulations and regulatory structures is the result of financial markets' political influence, in many countries through campaign contributions. These deeper political reforms are an essential part of any successful regulatory reform.

III. **A New Regulatory Framework**

1. **Improved transparency and disclosure, in a form that is understandable to most investors.**

   But while transparency and disclosure has been at the center of those calling for better regulation, it does not suffice, and is more complicated than often seems the case.

   a. America prided itself on having transparent financial markets, criticizing others (such as those in East Asia) for their failures. It has turned out that that is not the case.
   b. Even disclosing the terms of the financial products may not have helped; some are so complicated that not even their originators fully understood the risks entailed.
   c. ***Greater reliance on standardized products rather than tailor made products may increase transparency and the efficiency of the economy***. It reduces the information burden on market participants, and it enhances competition (differentiating products is one of the ways that firms work to reduce the force of competition). There is a cost (presumably tailor made products can be designed to better fit the needs of the purchasers) but the costs are less than the benefits—especially since there is evidence that in many cases there was less tailoring than there should have been.
   d. Some years ago, there was resistance by those in the financial industry to the introduction of more transparent and better auctions as a way of selling Treasury bills.
   e. More recently, there was resistance to requirements for more transparent disclosure of the costs of stock options. Companies often do not report other aspects of executive compensation in a transparent way, and typically do not disclose the extent to which executive compensation is correlated with performance. (Too often, when stock performance is poor, stock options are replaced with other forms of compensation, so that there is in effect little real incentive pay.) Stock options provide incentives for corporate executives to provide distorted information. This may have played an important role in the current financial crisis. At the very least, ***there should be a requirement for more transparent disclosure of stock options***.
   f. Mark to market accounting was supposed to provide better information to investors about banks economic position. But now, there is a concern that this information may contribute to exacerbating the downturn. While financial markets used to boast about the importance of the "price discovery function" performed by markets, they now claim that market prices sometimes do not provide good information, and using transactional prices may provide a distorted picture of a

bank's economic position. The problem is only partially with mark to market accounting; it also has to do with the regulatory system, which requires the provision of more capital when the value of assets are written down. (See the discussion below) . Not using mark to market not only provides opportunities for gaming (selling assets that have increased in value, retaining those that have decreased, so that they are value at purchase price), it also provides incentives for excessive risk taking. Realizing that there is no perfect information system, it may be desirable to have both sets of information provided.

g. There needs to be clear disclosure of conflicts of interest, and if possible, they should be restricted. (See below)
h. No off balance sheet transactions should be allowed for highly regulated financial entities.

2. **Regulating incentives is essential**. The current system encourages excessive risk taking, a focus on the short term, and bad accounting practices.

    a. ***A key reform is moving away from rewarding executives through stock options***. (See the discussion above.)
    b. Any incentive pay should long term—or least longer term than the current horizon. ***Bonuses should be based on performance over at least a five year period. If part of compensation is based on shorter term performance, there need to be strong clawback provisions***.
    c. Any incentive pay system should not induce excessive risk taking, so that ***there should be limited asymmetries in the treatment of gains and losses***.
    d. Any pay system that is claimed to be incentive based should be demonstrably so. Average compensation and compensation of individual managers should be shown to related to performance.
    e. Those originating mortgages or other financial products should bear some of the consequences for failed products. ***There should be a requirement that mortgage originators retain at least a 20% equity share.***
    f. It is clearly problematic for rating agencies to be paid by those that they rate, and to sell consulting services on how ratings can be improved. Yet it is not obvious how to design alternative arrangements, which is why in many sectors inspections are publicly provided (Food and Drug Administration.) Competition among rating agencies can have perverse incentives—a race to the bottom. *At the very least,* ***rating agencies need to be more highly regulated. A government rating agency should be established***.
    g. There is a clear conflict of interest when a mortgage originator also owns the company that appraises house values. *This should be forbidden.*

3. Competition is essential to the functioning of a market economy.
    a. Financial institutions have become too big to fail. They have grown so large that many are almost too big to save. In many communities, small businesses have but one or two lenders to whom they can turn. **There has been a failure of effective enforcement of competition policy**. *But in response to the current crisis, competition has been eroded even further, especially in investment banking, and banks have become even larger.* ***When the crisis is passed, these banks must be broken up.***
    b. Banks have earned fees that are well in excess of competitive levels on credit cards. There is clear evidence of anti-competitive behavior. ***Competition needs to be created in credit cards. There needs to be more disclosure and transparency in fees charged to both consumers and merchants. Anti-competitive practices have to be restricted. Retailers that wish to allow discounts to those that pay cash should be allowed to do so.***

4. **Exploitive and risky practices of the financial sector need to be curbed.**

    a. These include pay-day loans, predatory lending, and rent-a-furniture and similar scams.
    b. *There needs to be* ***a usury law*** *(and this also applies to credit cards) limiting the* ***effective*** *rate of interest paid by users of the financial facility.*
    c. In the mortgage sector, variable rate mortgages in which payments can vary significantly (as opposed to variations in maturity) should be forbidden, at least for all individuals whose income is below a certain threshold. Practices which result in excessive transaction costs (entailing frequent refinancing of loans or mortgages) should be proscribed.
    d. ***Speed limits should be imposed on the rate of expansion of assets.*** **As an alternative, increased capital requirements/increased provisioning requirements and/or increased premia on deposit insurance on banks that increase their lending (lending in any particular category) at an excessive rate can provide incentives to discourage such risky behavior.**
    e. ***Derivatives and similar financial products should neither be purchased or produced by highly regulated financial entities, unless they have been approved for specific uses by a financial products safety commission (fpsc), and unless their use conforms to the guidelines for usage established by the fpsc.***

5. Commercial banks and similar institutions have to have adequate capital and provisioning of risks

a. *Capital adequacy standards/provisions (reserves) have to be designed to be countercyclical*. Otherwise, there is a risk that they will contribute to cyclical fluctuations. As asset values decrease in a downturn, it can force cutbacks in lending, exacerbating the downturn; and in the boom, the asset price increases allow more lending. On both sides, cyclical fluctuations are amplified.

b. Capital adequacy standards alone do not suffice; indeed, increasing capital adequacy standards may lead to increased risk taking. Moreover, while government provision of capital may provide a buffer against bankruptcy, so long as management focuses on the returns to themselves and non-governmental shareholders, depending on the form of the provision of capital, risks of excessive risk taking may not be mitigated. ***Capital adequacy standards are not a substitute for close supervision of the lending and risk practices of banks. Banks will have an incentive to engage in regulatory and accounting arbitrage, and regulators must be alert to this possibility. They must have sufficient authority to proscribe such behavior. Bad lending practices may increase in cyclical downturns; this necessitates closer supervision at such times.*** Regulators have to be particularly sensitive to the risks of increasing leverage in booms.

c. Regulators need to be aware of the risks posed by various practices within the financial system which contribute to risk and cyclicity (cyclical movements in leverage, pricing, rating of rating agencies). These can be offset by countercyclical capital adequacy/provisioning requirements; cyclically adjusted limits on loan-to-value ratios and/or rules to adjust the values of collateral for cyclical price variations.

d. Better designed provision requirements may help stabilize the financial system. Banks should be required to make compulsory provisions for bond defaults, which would increase with asset prices. Banks should put up provisions (reserves) when loans are *disbursed* rather than when repayments (or, rather the lack of repayments) are *expected.*

6. The regulatory system has to be designed to facilitate effective enforcement and to resist capture.

    a. Financial regulation needs to be comprehensive; otherwise funds will flow through the least regulated part. Transparency requirements on part of the system may help ensure that safety and soundness of that part of the system, but provide little information about systemic risks. This has become particularly important as different institutions have begun to perform similar functions. That is why there is a need for a financial markets stability commission, having overall oversight of the financial system, and providing integrating regulation of each of the parts of the system. Such a commission would also look carefully at the interrelations among the parts of the system—how exchange rate exposure of firms to whom banks lend may expose banks to foreign exchange risk. Especially in developing countries, bank regulations

may restrict uncovered foreign exchange positions. Both this and the 1997-1998 crisis exposed the importance of counterparty risk, and regulators will need to take this into account more than they have in the past. A Financial Markets Stability Commission should be particularly attentive to the systemic risk which arises when many banks use similar models, inducing similar actions at the same time.

b. Those who are affected by the failure of regulation—workers who lose their jobs, retirees who see their pensions diminished, taxpayers who have to bear the costs of bail-outs—should have a large voice in any regulatory structure.

AN ECONOMIST'S DEFENSE OF RESPONSIBLE OFF-SHORE FINANCIAL CENTRES IN SMALL STATES

Avinash D. Persaud

Political leaders in the US, Germany, France, the UK and elsewhere have once more threatened to close down off-shore financial centres. These centres have been presented as the drug dealers of modern finance and pushers of instability. Yet the origins of this crisis are a failure of regulatory philosophy in the US, Europe and elsewhere. It would have occurred were there no off-shore financial centres. The attack on off-shore centres is a politically seductive distraction from the thorny task of making regulation better in large developed countries and will end up being a discriminatory attack on small developing countries with little voice.

One of the first institutions to fail in this crisis was Northern Rock, a very British bank where supervisors appeared to overlook the niggling detail that funding long-term mortgages of over 100% of the value of homes in a mature boom, with short-term deposits and money market funds, is highly risky. A German savings institution, IKB, was next. Regulators did nothing about the exponential growth of mortgage-related financial derivatives, not because they were hidden in off-shore financial centres – they had the discretionary powers to raise bank capital charges for any additional risks they perceived - but because they thought that this was an example of safe financial innovation that was banking the under-banked and diversifying risk.

Admitting that the crisis was a failure of domestic regulation implies that those in power were out to lunch as the largest financial crash was brewing. It is easier to blame tax-dodging foreigners. But let us be real. The largest centres of boastfully light regulation and light taxes for non-residents were London, Luxembourg, Dublin, the Channel Islands, Gibraltar, Monaco and many other locations in the European backyard. Yet some G7 leaders would rather play to the gallery by stepping on small developing countries. You can see why international co-operation is struggling to secure legitimacy when the same countries that mucked up their own regulation, plunging the world into crisis, appoint themselves judge and jury of what is good, bad and ugly elsewhere.

There are at least three ways in which the current attack on off-shore financial centres is illegitimate. First, it flies against the notion of tax sovereignty. Europeans prize this internally, but do not want others to have it. Why should developing countries that have difficulties in administering direct taxes, and so rely more on land and consumption taxes, not have low income taxes? And remove tax competition and you remove one discipline on countries otherwise tempted to engage in expensive wars or over-generous government bail-outs.

Second, the idea of off-shore financial centres is that they offer low tax because taxes are paid before money reaches them and after it leaves them. Imagine a company that builds and sells cars in Britain, Turkey and Japan. If the holding company is based in an off-

shore financial centre, corporation taxes on earnings will be paid in the British, Turkish and Japanese subsidiaries before they arrive in the holding company. Taxes on dividends are then paid by the shareholders when they repatriate their dividends home – wherever that maybe. The off-shore centre acts as a "way station" that facilitates complex international trade and investment flows. There are no taxes or low taxes in the "way station" because the money is in transit. Taxes are paid at the beginning and at the end of the journey, just not along the way.

The potential for abuse is whether the way station becomes a hiding spot, either to reduce taxes at the end of the journey, or to launder criminal money. The problem is not the tax rate but Swiss-style bank secrecy. The solution is what Bermuda, Barbados and other responsible off-shore financial centres do, which is to have information agreements that allow tax authorities to share information. The presence of standardized tax information agreements applicable to all countries would be an objective measure of responsibility.

Of the 192 members of the UN, 56 countries and are a further 100 dependent territories have populations of less than 1.5 million. Smallness brings its own challenges and vulnerabilites. International finance is one of their few comparative advantages: it can be scaled up without more land and labour. Many have developed genuine world-class expertise in international financial services such as Bermuda, Luxembourg and Guernsey. The current financial crisis suggests that large states have a comparative disadvantage in global finance. They do not need global finance to prosper, but global finance distorts their economy and politics. There are more than a few small states that need to improve the quality of their regulation, but so too for large states. European and US governments should refocus regulation on all financial activities that take place in their jurisdiction, making them less vulnerable to the quality of regulation in Iceland or elsewhere, should agree broad principles internationally and should sign common information agreements across all the jurisdictions their banks deal with.

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Congressional Oversight Panel

January 2009

SPECIAL REPORT ON REGULATORY REFORM

Modernizing the American Financial Regulatory System: Recommendations for Improving Over-sight, Protecting Consumers, and Ensuring Stability*

*Submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343

Congressional Oversight Panel

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Report Submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343

I. Executive Summary

1. Lessons from the Past

Financial crises are not new. As early as 1792, during the presidency of George Washington, the nation suffered a severe panic that froze credit and nearly brought the young economy to its knees. Over the next 140 years, financial crises struck on a regular basis—in 1797, 1819, 1837, 1857, 1873, 1893–96, 1907, and 1929–33—roughly every fifteen to twenty years.

But as the United States emerged from the Great Depression, something remarkable happened: the crises stopped. New financial regulation—including federal deposit insurance, securities regulation, and banking supervision—effectively protected the system from devastating outbreaks. Economic growth returned, but recurrent financial crises did not. In time, a financial crisis was seen as a ghost of the past.

After fifty years without a financial crisis—the longest such stretch in the nation's history—financial firms and policy makers began to see regulation as a barrier to efficient functioning of the capital markets rather than a necessary precondition for success.

This change in attitude had unfortunate consequences. As financial markets grew and globalized, often with breathtaking speed, the U.S. regulatory system could have benefited from smart changes. But deregulation and the growth of unregulated, parallel shadow markets were accompanied by the nearly unrestricted marketing of increasingly complex consumer financial products that multiplied risk at every stratum of the economy, from the family level to the global level. The result proved disastrous. The first warning followed deregulation of the thrifts, when the country suffered the savings and loan crisis in the 1980s. A second warning came in 1998 when a crisis was only narrowly averted following the failure of a large unregulated hedge fund. The near financial panic of 2002, brought on by corporate accounting and governance failures, sounded a third warning.

The United States now faces its worst financial crisis since the Great Depression. It is critical that the lessons of that crisis be studied to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants, and the public.

2. Shortcomings of the Present

The current crisis should come as no surprise. The present regulatory system has failed to effectively manage risk, require sufficient transparency, and ensure fair dealings.

Financial markets are inherently volatile and prone to extremes. The government has a critical role to play in helping to manage both public and private risk. Without clear and effective rules in place, productive financial activity can degenerate into unproductive gambling, while sophisticated financial transactions, as well as more ordinary consumer credit transactions, can give way to swindles and fraud.

A well-regulated financial system serves a key public purpose: if it has the power and if its leaders

have the will to use that power, it channels savings and investment into productive economic activity and helps prevent financial contagion. Like the management of any complex hazard, financial regulation should not rely on a single magic bullet, but instead should employ an array of related measures for managing various elements of risk. The advent of the automobile brought enormous benefits but also considerable risks to drivers, passengers, and pedestrians. The solution was not to prohibit driving, but rather to manage the risks through reasonable speed limits, better road construction, safer sidewalks, required safety devices (seatbelts, airbags, children's car seats, antilock breaks), mandatory automobile insurance, and so on. The same holds true in the financial sector.

In recent years, however, the regulatory system not only failed to manage risk, it also failed to require disclosure of risk through sufficient transparency. American financial markets are profoundly dependent upon transparency. After all, the fundamental risk/reward corollary depends on the ability of market participants to have confidence in their ability to accurately judge risk.

Markets have become opaque in multiple ways. Some markets, such as hedge funds and credit default swaps, provide virtually no information. Even so, disclosure alone does not always provide genuine transparency. Market participants must have useful, relevant information delivered in an appropriate, timely manner. Recent market occurrences involving off-balance-sheet entities and complex financial instruments reveal the lack of transparency resulting from the wrong information disclosed at the wrong time and in the wrong manner. Mortgage documentation suffers from a similar problem, with reams of paper thrust at borrowers at closing, far too late for any borrower to make a well-informed decision. Just as markets and financial products evolve, so too must efforts to provide understanding through genuine transparency.

To compound the problem associated with uncontained and opaque risks, the current regulatory framework has failed to ensure fair dealings. Unfair dealing can be blatant, such as outright deception or fraud, but unfairness can also be much more subtle, as when parties are unfairly matched. Individuals have limited time and expertise to master complex financial dealings. If one party to a transaction has significantly more resources, time, sophistication or experience, other parties are at a fundamental disadvantage. The regulatory system should take appropriate steps to level the playing field.

Unfair dealings affect not only the specific transaction participants, but extend across entire markets, neighborhoods, socioeconomic groups, and whole industries. Even when only a limited number of families in one neighborhood have been the direct victims of a predatory lender, the entire neighborhood and even the larger community will suffer very real consequences from the resulting foreclosures. As those consequences spread, the entire financial system can be affected as well. More importantly, unfairness, or even the perception of unfairness, causes a loss of confidence in the marketplace. It becomes all the more critical for regulators to ensure fairness through meaningful disclosure, consumer protection measures, stronger enforcement, and other measures. Fair dealings provide credibility to businesses and satisfaction to consumers.

In tailoring regulatory responses to these and other problems, the goal should always be to strike a reasonable balance between the costs of regulation and its benefits. Just as speed limits are more stringent on busy city streets than on open highways, financial regulation should be strictest where the threats—especially the threats to other citizens—are greatest, and it should be more moderate

elsewhere.

3. Recommendations for the Future

Modern financial regulation can provide consumers and investors with adequate information for making sound financial decisions and can protect them from being misled or defrauded, especially in complex financial transactions. Better regulation can reduce conflicts of interest and help manage moral hazard, particularly by limiting incentives for excessive risk taking stemming from often implicit government guaranties. By limiting risk taking in key parts of the financial sector, regulation can reduce systemic threats to the broader financial system and the economy as a whole. Ultimately, financial regulation embodies good risk management, transparency, and fairness.

Had regulators given adequate attention to even one of the three key areas of risk management, transparency and fairness, we might have averted the worst aspects of the current crisis.

1. Risk management should have been addressed through better oversight of systemic risks. If companies that are now deemed "too big to fail" had been better regulated, either to diminish their systemic impact or to curtail the risks they took, then these companies could have been allowed to fail or to reorganize without taxpayer bailouts. The creation of any new implicit government guarantee of high-risk business activities could have been avoided.
2. Transparency should have been addressed though better, more accurate credit ratings. If companies issuing high-risk credit instruments had not been able to obtain AAA ratings from the private credit rating agencies, then pension funds, financial institutions, state and local municipalities, and others that relied on those ratings would not have been misled into making dangerous investments.
3. Fairness should have been addressed though better regulation of consumer financial products. If the excesses in mortgage lending had been curbed by even the most minimal consumer protection laws, the loans that were fed into the mortgage backed securities would have been choked off at the source, and there would have been no "toxic assets" to threaten the global economy.

While the current crisis had many causes, it was not unforeseeable. Correcting the mistakes that fueled this crisis is within reach. The challenge now is to develop a new set of rules for a new financial system.

The Panel has identified eight specific areas most urgently in need of reform:

1. Identify and regulate financial institutions that pose systemic risk.
2. Limit excessive leverage in American financial institutions.
3. Increase supervision of the shadow financial system.
4. Create a new system for federal and state regulation of mortgages and other consumer credit products.
5. Create executive pay structures that discourage excessive risk taking.
6. Reform the credit rating system.
7. Make establishing a global financial regulatory floor a U.S. diplomatic priority.
8. Plan for the next crisis.

While these are the most pressing reform recommendations, many other issues merit further study, the results of which the Panel will present in future reports. Despite the magnitude of the task, the central message is clear: through modernized regulation, we can dramatically reduce the risk of crises and swindles while preserving the key benefits of a vibrant financial system

Americans have paid dearly for this latest crisis. Lost jobs, failed businesses, foreclosed homes, and sharply cut retirement savings have touched people all across the county. Now every citizen—even the most prudent—is called on to assume trillions of dollars in liabilities spent to try to repair a broken system. The costs of regulatory failure and the urgency of regulatory reform could not be clearer.

II. Introduction

The financial crisis that began to take hold in 2007 has exposed significant weaknesses in the nation's financial architecture and in the regulatory system designed to ensure its safety, stability, and performance. In fact, there can be no avoiding the conclusion that our regulatory system has failed.

The bursting of the housing bubble produced the first true stress test of modern capital markets, their instruments, and their participants. The first cracks were evident in the subprime mortgage market and in the secondary market for mortgage-related securities. From there, the crisis spread to nearly every corner of the financial sector, both at home and abroad, taking down some of the most venerable names in the investment banking and insurance businesses and crippling others, wreaking havoc in the credit markets, and brutalizing equity markets worldwide.

As asset prices deflated, so too did the theory that had increasingly guided American financial regulation over the previous three decades—namely, that private markets and private financial institutions could largely be trusted to regulate themselves. The crisis suggested otherwise, particularly since several of the least regulated parts of the system were among the first to run into trouble. As former Federal Reserve Chairman Alan Greenspan acknowledged in testimony before the House Committee on Oversight and Government Reform in October 2008, "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."[1]

The financial meltdown necessitates a thorough review of our regulatory infrastructure, the behavior of regulators and their agencies, and the regulatory philosophy that informed their decisions. At the same time, we must be careful to avoid the trap of looking solely backward—preparing to fight the last war. Although the crisis has exposed many deficiencies, there are likely others that have yet to be uncovered. What is more, the vast federal response to the crisis—including unprecedented rescues of crippled businesses and a proliferation of government guaranties—threatens to distort private incentives in the future, further eroding the caution of financial creditors and making the job of regulatory oversight all the more essential.

Realizing that far-reaching reform will be needed in the wake of the crisis, Congress directed the Congressional Oversight Panel (hereinafter, "the Panel") to submit a special report on regulatory reform,

> analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, the

[1] *See* Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, New York Times (Oct. 24, 2008). *See also* House Committee on Oversight and Government Reform, Testimony of Alan Greenspan, *The Financial Crisis and the Role of Federal Regulators*, 110th Cong., at 2 (Oct. 23, 2008) (online at oversight.house.gov/documents/20081023100438.pdf).

rationale underlying such recommendation, and whether there are any gaps in existing consumer protections.[2]

Toward this end, part III of this report presents a broad framework for analyzing the effectiveness of financial regulation, focusing on three critical failures of the current system: (1) inadequate private and public risk management, (2) insufficient transparency and information, and (3) a lack of protection against deception and unfair dealing. These key failures of the regulatory system have manifested themselves in a plethora of more specific problems, ranging from excessively leveraged financial institutions to opaque financial instruments falling outside the scope of the jurisdiction of any regulatory agency. While this report cannot tackle every one of these problems, part IV focuses on eight areas of the current financial regulatory system that are in need of improvement, offering the Panel's recommendations for each as follows:

1. Identify and regulate financial institutions that pose systemic risk.
2. Limit excessive leverage in American financial institutions.
3. Modernize supervision of the shadow financial system.
4. Create a new system for federal and state regulation of mortgages and other consumer credit products.
5. Create executive pay structures that discourage excessive risk taking.
6. Reform the credit rating system.
7. Make establishing a global financial regulatory floor a U.S. diplomatic priority.
8. Plan for the next crisis.

Finally, part V of this report points to some additional challenges in need of attention over the longer term, several of which will be addressed in future reports of the Panel. At the end of the report is an appendix comprising summaries of other recent reports regarding reform of the regulatory system.

This report is motivated by the knowledge that millions of Americans suffer when the financial regulatory system and the capital markets fail. The financial meltdown has many causes but one overwhelming result: a great increase in unexpected hardships and financial challenges for American citizens. The unemployment rate is rising sharply every month, a growing number of Americans are facing the prospect of losing their homes, retirees are worried about how to afford even basic necessities, and families are anxious about paying for college and securing a decent start in adult life. The goal of the regulatory reforms presented in this report is not to endorse a particular economic theory or merely to guide the country through the current crisis. The goal is instead to establish a sturdy regulatory system that will facilitate the growth of financial markets and will protect the lives of current and future generations of Americans.

[2] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, at § 125(b)(2).

III. A Framework for Analyzing the Financial Regulatory System and its Effectiveness

1. The Promise and Perils of Financial Markets

Households, firms, and government agencies all rely on the financial system for saving and raising capital, settling payments, and managing risk. A dynamic financial system facilitates the mobilization of resources for large projects and the transfer of resources across time and space and provides critical information in the form of price signals that help to coordinate dispersed economic activity. A healthy financial system, one that allows for the efficient allocation of capital and risk, is indispensable to any successful economy.

Unfortunately, financial systems are also prone to instability and abuse. Until the dawn of modern financial regulation in the 1930s and early 1940s, financial panics were a regular—and often debilitating—feature of American life. The United States suffered significant financial crises in 1792, 1819, 1837–39, 1857, 1873, 1893–95, 1907, and 1929–33. After the Great Depression and the introduction of federal deposit insurance and federal banking and securities regulation, the next significant banking crisis did not strike for more than forty years. This period of relative stability—by far the longest in the nation's history—persisted until the mid-1980s, with the onset of the savings and loan crisis; dealing with that crisis cost American taxpayers directly some $132 billion.[3] The country also suffered a group of bank failures that produced the need to recapitalize the FDIC's initial Bank Insurance Fund in the early 1990s; suffered a stock market crash in 1987; witnessed a wave of foreign currency crises (and associated instability) in 1994–95 and 1997–98; saw the collapse of Long Term Capital Management (LCTM) hedge fund in 1998; and faced the collapse of the tech bubble in 2001. Financial crisis has now struck again, with the subprime-induced financial turmoil of 2007–09.

Although every crisis is distinctive in its particulars, the commonalities across crises are often more striking than the differences. As the financial historian Robert Wright explains: "All major panics follow the same basic outline: asset bubble, massive leverage (borrowing to buy the rising asset), bursting bubble (asset price declines rapidly), defaults on loans, asymmetric information and uncertainty, reduced lending, declining economic activity, unemployment, more defaults."[4]

Nor are financial panics the only cause for concern. Financial markets have also long exhibited a vulnerability to manipulation, swindles, and fraud, including William Duer's notorious attempt to corner the market for United States government bonds in 1791–92, the "wildcat" life insurance companies of the early nineteenth century (which took premiums from customers but disappeared before paying any claims), the infamous pyramiding scheme of Charles Ponzi in 1920, and the highly suspect practices of New York's National City Bank and its chairman, Charles Mitchell, in

[3] On the period of relative financial stability ("the great pause"), *see* David Moss, *An Ounce of Prevention: The Power of Sound Risk Management in Stabilizing the American Financial System* (2009). *See also* Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future, Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s*, at 187 (online at www.fdic.gov/bank/historical/history/167_188.pdf).

[4] *See* Andrea Young, *What Economic Historians Think About the Meltdown*, History News Network (Oct. 20, 2008) (online at hnn.us/articles/55851.html).

the run-up to the Great Crash of 1929. The apparent massive Ponzi scheme of Bernard Madoff that has recently unraveled in 2008 is only the latest in a long series of such financial scandals.

Even apart from the most spectacular financial crises and crimes, the failure of any individual financial institution—all by itself—can have devastating consequences for the investors and clients who rely on it.[5] The collapse of a bank, insurance company, or pension fund can prove particularly damaging, disrupting longstanding financial relationships and potentially destroying the safety nets that many Americans have spent years carefully building.

The good news is that many of these financial risks can be significantly attenuated through sound regulation. Well-designed regulation has the potential to enhance both financial safety and economic performance, and it has done so in the past. To be sure, the risks of capital market crises cannot be eliminated altogether, just as the risk of automobile accidents will never entirely disappear, despite rigorous safety standards.

2. The Current State of the Regulatory System

The purpose of financial regulation is to make financial markets work better and to ensure that they serve the interests of all Americans. There are many important (and sometimes competing) goals of financial regulation, ranging from safety and stability to innovation and growth. In order to achieve these goals, an effective regulatory system must manage risk, facilitate transparency, and promote fair dealings among market actors. The current system has failed on all three counts.

Failure to Effectively Manage Risk

As the current financial meltdown makes clear, private financial markets do not always manage risk effectively on their own. In fact, to a large extent, the current crisis can be understood as the product of a profound failure in private risk management, combined with an equally profound failure in public risk management, particularly at the federal level.

Failure of private risk management. The risk-management lapses in the private sector are by now obvious. In the subprime market, brokers and originators often devoted relatively little attention to risk assessment, exhibiting a willingness to issue extraordinarily risky mortgages (for high fees) so long as the mortgages could be sold quickly on the secondary market.[6] Securitizers on Wall Street and elsewhere proved hungry for these high-interest-rate loans, because they could earn large fees for bundling them, dividing the payments into tranches, and selling the resulting securities to

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[5] In fact, because of the salutory effects of existing regulations, not all failures of financial institutions create the same level of damage. For instance, the government has insured consumer deposits in financial institutions since the New Deal in recognition of the dangers of a loss of depositor confidence. Consequently, it is no longer the risk of shareholder losses that cause fear of systemic crisis, but rather the risk of financial institutions defaulting on fixed obligations.

[6] These mortgages included so-called 2-28s (which were scheduled to reset to a sharply higher interest rate after two years) and option-arms (which allowed customers essentially to set their own payments in an initial period, followed by ballooning payments after that). Whether or not borrowers could reasonably be expected to repay—based on their earning capacity—was no longer always a decisive criterion for lending, particularly against the backdrop of rising home prices. Said one broker of an elderly client who had lost his home as a result of an unaffordable loan, "It's clear he was living beyond his means, and he might not be able to afford this loan. But legally, we don't have a responsibility to tell him this probably isn't going to work out. It's not our obligation to tell them how they should live their lives." *See* Charles Duhigg, *When Shielding Money Clashes with Elders' Free Will*, New York Times (Dec 24, 2007).

investors. These securities proved attractive, even to relatively risk-averse investors, because the credit rating agencies (who were paid by the issuers) awarded their triple-A seal of approval to the vast majority of the securities in any given issue. The credit rating agencies concluded—wrongly, it turns out—that virtually all of the risk of a subprime mortgage-backed securitization was concentrated in its lowest tranches (e.g., the bottom 15 to 25 percent) and that the remainder was exceedingly safe. Nor did the process end there, since lower-tranche securities (e.g., those with a BBB rating or below) could be aggregated into so-called collateralized debt obligations (CDOs) and re-tranched, creating whole new sets of AAA and AA securities. Only when the housing market turned down and delinquencies and foreclosures started to rise, beginning in 2006–07, did the issuers, investors, and rating agencies finally recognize how severely they had underestimated the key risks involved.[7]

Had these excesses been limited to the subprime market, it is unlikely that the initial turmoil could have sparked a full-blown financial crisis. Unfortunately, the broader financial system was in no position to absorb the losses because a great many of the leading financial firms were themselves heavily leveraged (especially by incurring a large proportion of short-term debt) and contingent liabilities (including many tied back to the housing market). Such leverage had greatly magnified returns in good times, but proved devastating once key assets began to drop in value. Higher-leverage necessarily meant higher risk. As it became clear that not only AAA-rated mortgage-backed securities but also AAA-rated financial institutions were at risk, trust all but disappeared in the marketplace, leaving even potentially solvent financial institutions vulnerable to runs by their creditors, who were rattled and increasingly operating on a hair trigger.[8]

In a sense, no one should have been surprised by the turmoil. Unregulated and weakly regulated financial markets have historically shown a tendency toward excessive risk taking and instability. The reasons for this are worth reviewing.

To begin with, financial actors do not always bear the full consequences of their decisions and therefore are liable to take (or impose) more risk than would otherwise seem reasonable. For example, financial institutions generally invest other people's money and often enjoy asymmetric compensation incentives, which reward them for gains without penalizing them for losses. Even more troubling, the failure of a large financial firm can have systemic consequences, potentially triggering a cascade of losses, which means that risk taking by the firm can impose costs far beyond its own shareholders, creditors, and counterparties. The freezing up of the credit markets in 2008–09, because even healthy banks are afraid to lend, is an especially serious example of this phenomenon.

A closely related problem is that of contagion or panic, in which fear drives a sudden surge in demand for safety and liquidity. A traditional bank run by depositors is one expression of contagion, but other types of creditors can also create a "run" on a financial institution and potentially weaken or destroy it; for example, short-term lenders can refuse to roll over existing loans to the institution, and market actors may refuse to continue to deal with it. In fact, whole markets can succumb to

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[7] Credit card and automobile loans are also securitized and sold in various formats. It remains to be seen whether an increased rate of default on those loans (which can be expected as the economic slowdown deepens) will generate a second wave of severe capital market disruptions.

[8] *See* section III.2.

panic selling under certain circumstances. In all of these cases, the fearful depositors, creditors, and investors who suddenly decide to liquidate their positions may be imposing costs on others, since the first to run will generally get their money out whereas the last to do so typically will not. More broadly, poorly managed financial institutions impose costs on well-managed ones, because of the threat of contagion.

Yet another problem endemic to financial markets is that individual borrowers and investors may not always be ideally positioned to evaluate complex risks. How can any of us be sure that a particular financial agreement or product is safe? Ideally, we carefully read the contract or prospectus. But given limits on time and expertise (including the expense of expert advice), even a relatively careful consumer or investor is liable to make mistakes—and potentially large ones—from time to time. Virtually all of us, moreover, rely on various kinds of shortcuts in assessing risks in daily life—intuition, seeking nonexpert outside advice, a trusting attitude toward authority, and so on. Although such an approach may normally work well, it sometimes fails and is particularly subject to manipulation—for example, by aggressive (or even predatory) lenders. Such problems were an important contributor to the excesses and eventual implosion of subprime mortgage lending. In addition, particularly in recent years, it appears that even many of the most sophisticated investors—and perhaps even the credit rating agencies themselves—had trouble assessing the risks associated with a wide array of new and complex financial instruments. Complexity itself may therefore have contributed to the binge of risk taking that overtook the United States financial system in recent years.

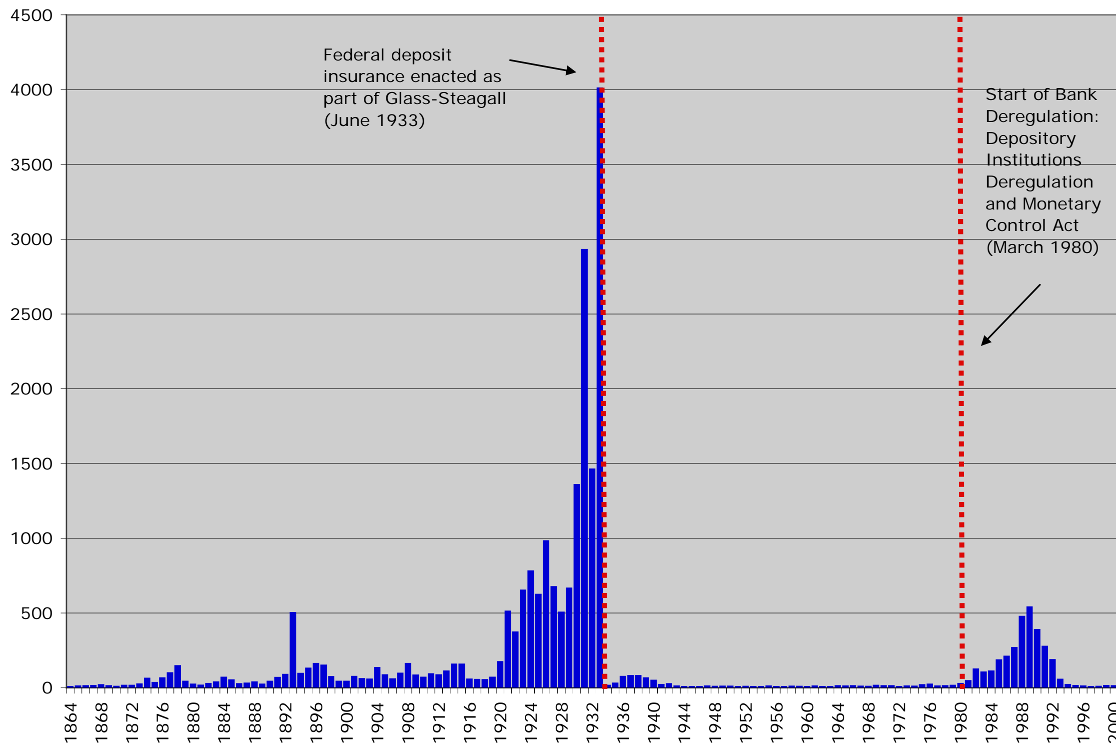
Failure of public risk management. Ideally, state and federal regulators should have intervened to control the worst financial excesses and abuses long before the crisis took hold. Almost everyone now recognizes that the government serves as the nation's ultimate risk manager—as the lender, insurer, and spender of last resort—in times of crisis. But effective public risk management is critical in normal times as well, both to protect consumers and investors and to help prevent crises from developing in the first place.[9]

A good example involves bank regulation. Americans have faced recurrent banking crises as well as frequent bank suspensions and failures for much of the nation's history. The problem appeared to ease after the creation of the Federal Reserve in 1914 but then returned with a vengeance in 1930–33, when a spiraling panic nearly consumed the entire American banking system. All of this changed after the introduction of federal deposit insurance in June of 1933. Bank runs virtually disappeared, and bank failures fell sharply. Critics worried that the existence of federal insurance would encourage excessive risk taking (moral hazard), because depositors would no longer have to worry about the soundness of their banks and instead would be attracted by the higher interest rates that riskier banks offered. The authors of the 1933 legislation prepared for this threat, authorizing not only public deposit insurance but also intelligent bank regulation designed to ensure the safety and soundness of insured banks. The end result was an effective system of new consumer protections, a remarkable reduction in systemic risk, and a notable increase in public confidence in the financial system. By all indications, well-designed government risk management helped

[9] On the government's role as a risk manager, *see* David Moss, *When All Else Fails: Government as the Ultimate Risk Manager* (2002).

strengthen the market and prevent subsequent crises.[10] (See figure below: Bank Failures, 1864–2000).

A Unique Period of Calm Amid the Storm: Bank Failures (Suspensions), 1864–2000



Source: David Moss, "An Ounce of Prevention: The Power of Sound Risk Management in Stabilizing the American Financial System," 2009.

In our own time, appropriate regulatory measures might have proved similarly salutary. Reasonable controls on overly risky consumer and corporate lending and effective limits on the leverage of major (systemic) financial institutions might have been enough, by themselves, to prevent the worst aspects of the collapse. Greater regulatory attention in numerous other areas, from money market funds and credit rating agencies to credit default swaps, might also have made a positive difference. However, key policymakers, particularly at the federal level, often chose not to expand this critical risk-management role—to cover new and emerging risks—when they had the chance.

Looking forward, the need for meaningful regulatory reform has now become particularly urgent—not only to correct past mistakes, but also to limit the likelihood and the impact of future crises and to control the moral hazard that is likely to flow from the recent profusion of federal bailouts and guaranties. If creditors, employees, and even shareholders of major financial institutions conclude that the federal government is likely to step in again in case of trouble (because of the systemic significance of their institutions), they may become even more lax about monitoring risk, leading to even greater excesses in the future. For this reason, the recent federal actions in support of the

[10] In fact, significant bank failures did not reappear until after the start of bank deregulation in the early 1980s. Bank deregulation is often said to have started with the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, and the Depository Institutions Act of 1982, Pub. L. No. 97-320.

nation's largest financial institutions, involving more than $10 trillion in new federal guaranties, make effective regulation after the crisis even more vital. The example set in 1933—of pairing explicit public insurance with an effective regulatory mechanism for monitoring and controlling moral hazard—must not be forgotten. In fact, the need to control the moral hazard created by the current financial rescue may be the most important reason of all for strengthening financial regulation in the months and years ahead.

Failure to Require Sufficient Transparency

While allowing financial institutions to take on too much risk, federal and state regulators at the same time have permitted these actors to provide too little information to protect investors and enable markets to function honestly and efficiently. Because financial information often represents a public good, it may not be adequately provided in the marketplace without government encouragement or mandate. Investors without access to basic financial reporting face serious information asymmetries, potentially raising the cost of capital and compromising the efficient allocation of financial resources.[11] Truthful disclosures are also essential to protect investors. Essential disclosure and reporting requirements may therefore enhance efficiency by reducing these informational asymmetries. The broad availability of financial information also promises to boost public confidence in financial markets. As former Securities and Exchange Commssion (SEC) Chairman Arthur Levitt has observed, "the success of capital is directly dependent on the quality of accounting and disclosure systems. Disclosure systems that are founded on high-quality standards give investors confidence in the credibility of financial reporting—and without investor confidence, markets cannot thrive."[12]

From the time they were introduced at the federal level in the early 1930s, disclosure and reporting requirements have constituted a defining feature of American securities regulation (and of American financial regulation more generally). President Franklin Roosevelt himself explained in April 1933 that although the federal government should never be seen as endorsing or promoting a private security, there was "an obligation upon us to insist that every issue of new securities to be sold in interstate commerce be accompanied by full publicity and information and that no essentially important element attending the issue shall be concealed from the buying public."[13]

Historically, embedding a flexible approach to jurisdiction has made for strong, effective regulatory agencies. When the SEC was founded, during the Depression, Congress armed the commission with statutory authority based upon an extremely broad view of what constituted a security and gave it wide latitude in determining what disclosures were necessary from those who sought to sell securities to the public. There was a similar breadth of coverage and

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[11] Modern economic research has shown that markets can only function efficiently—that Adam Smith's "invisible hand" only works—to the extent that the information processed by the markets is accurate and complete. *See* Joseph E. Stiglitz, *Globalization and Its Discontents* (2002) at ch. 3, n. 2 and accompanying text. On information asymmetry and the cost of capital, *see* Douglas Diamond and Robert Verrecchia, *Disclosure, Liquidity, and the Cost of Capital*, Journal of Finance, at 1325–1359 (Sept. 1991). *See also* S. P. Kothari, *The Role of Financial Reporting in Reducing Financial Risks in the Market*, *in Building and Infrastructure for Financial Stability,* at 89–102 (Eric. S. Rosengren and John S. Jordon eds., June 2000).

[12] *See id.* at 91.

[13] *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, George Washington Law Review, at 30 (1959).

flexibility in substantive approach in the Investment Advisors Act and the Investment Company Act, which together governed money managers. These broad grants of jurisdiction led to the SEC's having regulatory authority over most capital-market transactions outside the banking and insurance systems until the end of the 1970s.

However, the financial markets have outpaced even the broadest grants of regulatory authority. Starting in the 1980s, skilled market operators began to exploit what had previously seemed to be merely insignificant loopholes in this system—exceptions that had always existed in the regulation of investment management. The increasing importance of institutional intermediaries in the capital markets exacerbated this tendency. By the 1990s, the growth of over-the-counter derivative markets had created unregulated parallel capital-market products. This trend has continued in recent years, with the SEC allowing the founding of publicly traded hedge-fund and private-equity management firms that do not have to register as investment companies.

Over subsequent years, the reach of the SEC and its reporting requirements were gradually expanded. Securities traded over the counter, for example, were brought into the fold beginning in 1964. The SEC targeted "selective disclosure" in 2000 with Regulation Fair Disclosure (Reg FD), a new weapon in the ongoing fight against insider activities. Two years later, Congress passed the Sarbanes-Oxley Act, which aimed to bolster the independence of the accounting industry and required top corporate executives to personally certify key financial statements.[14]

By the time the crisis struck in 2007–08, however, one of the most common words used to describe the American financial system was "opaque." Hedge funds, which squeeze into an exemption in the Investment Company Act of 1940, face almost no registration or reporting requirements; moreover, a modest attempt by the SEC to change this situation was struck down in federal court in 2006. Similarly, over-the-counter markets for credit default swaps and other derivative instruments remain largely unregulated and, say critics, constitute virtually the polar opposite of open and transparent exchange. (According to news reports, an attempt by Brooksley Born, the former chairperson of the Commodity Futures Trading Commission, to regulate OTC-traded derivatives in 1997–98, was blocked by Fed Chairman Alan Greenspan, Treasury Secretary Robert Rubin, and others, allegedly on the grounds that such regulation could precipitate a financial crisis. In any event, Congress in 2000 prohibited regulation of most derivatives.)[15] In addition, the proliferation of off-balance-sheet entities (conduits, structured investment vehicles [SIVs], etc.) and the rapid growth of highly complex financial instruments (such as CDOs) further undermined clarity and understanding in the marketplace. The financial consultant Henry Kaufman maintains that leading financial institutions actively "pushed legal structures that made many aspects of the financial markets opaque."[16] Moreover, starting in 1994, with the Central Bank of Denver decision,[17] the courts have severely

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[14] *See* Chris Yenkey, *Transparency, Democracy, and the SEC: 70 Years of Securities Market Regulation*, *in Transparency in a New Global Order: Unvailing Organizational Visions* (Christina Garsten and Monica Lindh de Montoya eds., 2007).

[15] Peter S. Goodman, *The Reckoning: Taking Hard New Look at a Greenspan Legacy*, New York Times (Oct. 8, 2008).

[16] Henry Kaufman, *How the Credit Crisis Will Change the Way America Does Business: Huge Financial Companies Will Grow at the Expense of Borrowers and Investors*, Wall Street Journal (Dec. 6, 2008).

[17] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994).

limited the ability of investors to police transparency failures involving financial institutions working with public companies. This failure was extended in the Supreme Court's Stoneridge decision,[18] closing off liability to investors even in cases in which financial institutions were participants in a fraudulent scheme.

There are of course legitimate questions about how far policymakers should go in requiring disclosure—where the line should be drawn between public and proprietary information. But particularly given the breakdown that has now occurred, it is difficult to escape the conclusion that America's financial markets have veered far from the goal of transparency, fundamentally compromising the health and vitality of the financial sector and, ultimately, the whole economy.

Why our regulatory system failed to expand the zone of transparency in the face of far-reaching financial innovation is a question that merits careful attention. At least part of the answer, once again, appears to be that key regulators preferred not to expand the regulatory system to address these challenges, or simply believed that such expansion was unnecessary. In 2002, for example, Federal Reserve Chairman Alan Greenspan explained his view on "the issue of regulation and disclosure in the over-the-counter derivatives market" this way:

> By design, this market, presumed to involve dealings among sophisticated professionals, has been largely exempt from government regulation. In part, this exemption reflects the view that professionals do not require the investor protections commonly afforded to markets in which retail investors participate. But regulation is not only unnecessary in these markets, it is potentially damaging, because regulation presupposes disclosure and forced disclosure of proprietary information can undercut innovations in financial markets just as it would in real estate markets.[19]

Subsequent developments—including the effective failure (and rescue) of American International Group, Inc. (AIG), as a result of massive exposure in the credit default swaps market—raise serious questions about this hands-off view. The abuses in the mortgage markets, and especially in the subprime mortgage market, are a good example, but so are abuses throughout the range of consumer credit products. The challenge now is to develop a plan not only to bring much-needed sunlight into the most opaque corners of the financial system but to ensure appropriate regulatory adaptation to new financial innovation in the future.

Failure to Ensure Fair Dealings

The current regulatory system has not only allowed for excessive risk and an insufficient degree of transparency, but it has also failed to prevent the emergence of unfair dealings between actors. Overt lies are dishonest, of course, and lying may trigger legal liability. But fair dealing involves more than refraining from outright lying. Deception and misdirection are the antithesis of fair dealing. When the legal system permits deception and misdirection it undermines consensual

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[18] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008). *See also* Congressional Oversight Panel, Testimony of Joel Seligman, *Reforming America's Financial Regulatory Structure*, at 5 (Jan. 14, 2009) (online at cop.senate.gov/documents/testimony-011409-seligman.pdf).

[19] The Federal Reserve Board, *Remarks by Chairman Alan Greenspan before the Society of Business Economists, London, U.K.* (Sept. 25, 2002) (online at www.federalreserve.gov/BoardDocs/Speeches/2002/200209252/default.htm).

agreements between parties, the very foundation of a market economy designed to serve all individuals.

Deceptive or misleading dealings can occur in any setting, but they are most likely to occur when the players are mismatched. When one player is sophisticated, has ample resources, and works regularly in the field while the other is a nonspecialist with limited resources and little experience, the potential for deception is at its highest. A credit card contract, for example, may be a relatively simple, straightforward agreement from which both issuer and customer may benefit. Or it may be a thirty-plus page document that is virtually incomprehensible to the customer. In the latter case, the issuer who can hire a team of lawyers to draft the most favorable language may carefully measure every nuance of the transaction, while the customer who has little time or sufficient expertise to read—much less negotiate—such a contract is far less likely to appreciate the risks associated with the deal.

Similarly, in the subprime mortgage market prospective borrowers were often led to believe that a scheduled interest-rate reset would never affect them because they had been told that they could "always" refinance the property at a lower rate before the reset took effect. Similarly, studies show that payday loan customers, while generally aware of finance charges, are often unaware of annual percentage rates.[20] In one survey, of those who took on tax refund anticipation loans, approximately half of all respondents were not aware of the substantial fees charged by the lender.[21] One authority on consumer credit has catalogued a long list of "tricks and traps," particularly in the credit card market, designed to "catch consumers who stumble or mistake those traps for treasure and find themselves caught in a snare from which they cannot escape."[22] While each of these contracts may meet the letter of the law, deals that are structured so that one side repeatedly does not understand the terms do not meet the definition of fair dealing.

The available evidence suggests that the costs of deceptive financial products are high, quickly climbing into the billions of dollars annually.[23] But the problem is not limited to monetary loss—many people are stripped not only of their wealth, but also of their confidence in the financial marketplace. They come to regard all financial products with suspicion, including those on fair terms and those that could be beneficial to them.

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[20] *See* NFI, Gregory Elliehausen, *Consumers' Use of High-Price Credit Products: Do They Know What They Are Doing?*, at 29 (2006) (Working Paper No. 2006-WP-02); Credit Research Center, Georgetown University, Gregory Elliehausen and Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand,* at 2 (2001) (online at www.cfsa.net/downloads/analysis_customer_demand.pdf).

[21] *See* Elliehausen, *supra* note 20, at 31.

[22] Senate Committee on Banking, Housing and Urban Affairs of the United States Senate, Testimony of Elizabeth Warren, *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers*, 110th Cong., at 1 (Jan. 25, 2007) (online at banking.senate.gov/public/_files/warren.pdf). The list of tricks and traps includes "universal default, default rates of interest, late fees, over-limit fees, fees for payment by telephone, repeated changes in the dates bills are due, changes in the locations to which bills should be mailed, making it hard to find the total amount due on the bill, moving bill-reception centers to lengthen the time it takes a bill to arrive by mail, misleading customers about grace periods, and double cycle billing." *Id.* at 3.

[23] Oren Bar-Gill and Elizabeth Warren, *Making Credit Safer*, University of Pennsylvania Law Review (Nov. 2008) (summarizing studies showing the high costs of consumer errors on checking accounts, credit cards, payday loans and refund anticipation loans).

As the recent crisis has shown, the effects of deceptive contracts can have wide ripple effects. For example, deceptive mortgages have led to lender foreclosures on residential housing—foreclosures that cost taxpayers money and threaten the economic stability of already imperiled neighborhoods.[24] A recent housing report observed: "Foreclosures are costly—not only to homeowners, but also to a wide variety of stakeholders, including mortgage servicers, local governments and neighboring homeowners . . . up to $80,000 for all stakeholders combined."[25] Lenders can lose as well, forfeiting as much as $50,000 per foreclosure, which translates to roughly $25 billion in total foreclosure-related losses in 2003.[26] A city can lose up to $19,227 per house abandoned in foreclosure in lost property taxes, unpaid utility bills, property upkeep, sewage, and maintenance.[27] Many foreclosure-related costs fall on taxpayers, who ultimately must shoulder the bill for services provided by their local governments.

The burdens of credit-market imperfections are not spread evenly across economic, educational, or racial groups. The wealthy tend to be insulated from many credit traps, while the vulnerability of the working class and middle-class increases. For those closer to the economic margins, a single economic mistake—a credit card with an interest rate that unexpectedly escalates to 29.99 percent or misplaced trust in a broker who recommends a high-priced mortgage—can trigger a downward economic spiral from which no recovery is possible. There is ample evidence that African Americans and Hispanics have been targets for certain deceptive products, much to their injury and to the injury of a country that prizes equality of opportunity for all its citizens.[28]

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[24] *See* Joint Economic Committee, *Sheltering Neighborhoods from the Subprime Foreclosure Storm*, at 15–16 (Apr. 2007) (online at jec.senate.gov/index.cfm?FuseAction=Files.View&FileStore_id=8c3884e5-2641-4228-af85-b61f8a677c28) (hereinafter "JEC Report"). *See also* Nelson D. Schwartz, *Can the Mortgage Crisis Swallow a Town*?, New York Times (Sept. 2, 2007) (online at www.nytimes.com/2007/09/02/business/yourmoney/02village.html); U.S. Department of the Treasury, *Remarks by Secretary Henry M. Paulson, Jr. on Current Housing and Mortgage Market Developments at Georgetown University Law Center* (Oct. 16, 2007) (online at www.treasury.gov/press/releases/hp612.htm) ("Foreclosures are costly and painful for homeowners. They are also costly for mortgage servicers and investors. They can have spillover effects into property values throughout a neighborhood, creating a downward cycle we must work to avoid.").

[25] JEC Report, *supra* note 24, at 17. *See also* Dan Immergluck and Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, Housing Policy Debate, at 69–72 (2006) (finding that a single-family home foreclosure causes a decrease in values of homes within an eighth of a mile—or one city block—by an average of 0.9 percent, or approximately $1,870 when the average home sale price is $164,599, and 1.44 percent in low- and moderate-income communities, or about $1,600 when the average home sale price is $111,002).

[26] *See, e.g.,* Desiree Hatcher, *Foreclosure Alternatives: A Case for Preserving Homeownership*, Profitwise News and Views, at 2 (Feb. 2006) (online at www.chicagofed.org/community_development/files/02_2006_foreclosure_alt.pdf).

[27] *See* JEC Report, *supra* note 24, at 15.

[28] *See, e.g.,* Consumer Federation of America, Allan J. Fishbein and Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*, at 24 (May 2006) (online at www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf); U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, *Curbing Predatory Home Mortgage Lending,* at 35 (2000) (online at www.huduser.org/publications/hsgfin/curbing.html); Center for Community Change, Bradford Calvin, *Risk or Race? Racial Disparities and the Subprime Refinance Market*, at 6–8 (May 2002) (online at butera-andrews.com/legislative-updates/directory/Background-Reports/Center%20for%20Community%20Change%20Report.pdf); Paul Calem, Kevin Gillen and Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, Journal of Real Estate Finance and Economics, at 401–404 (Dec. 2004). Another study, based on the Federal Reserve data, found that "African-

When businesses sell deceptive products, they not only injure their customers but also injure their competitors, who are forced to adopt similar practices or face losing their markets. The result is a downward spiral, a race to the bottom in which those who offer the most slyly deceptive products enjoy the greatest profits while entire industries and markets are corrupted and cease to provide efficient and mutually beneficial transactions. The same phenomenon operates on a more macroeconomic level: some investment banks that may have had initial doubts about packing subprime loans were drawn into a downward spiral, abandoning their standards of investment quality in a race for the same profits that other firms appeared to be making.

Assuring fair dealing is not the same as assuring that no one makes a mistake. Buyers and sellers of financial services can miscalculate. They can fail to save, take unwise gambles, or simply buy too much. Personal responsibility will always play a critical role in dealing with financial products, just as personal responsibility remains essential to the responsible use of any physical product. Fair dealing assures only that deception and misdirection will not bring a person to ruin, while it leaves room to maximize the opportunities for people to chart their own economic futures, free to succeed and free to fail.

The government can play a unique role in assuring that repeat dealings in circumstances of substantial imbalances of power and knowledge are nonetheless fair dealings. Regulation can assure a more level playing field, one in which the terms of an agreement, for example, are clear and easily understood. When terms are clear, individuals are more likely to compare options, which in turn drives far greater market efficiency. More importantly, when terms are clear, individuals are better able to assess investment risks and are thus empowered to make decisions that are more beneficial for themselves.

By limiting the opportunities for deception and allowing for the necessary trust to develop between interconnected parties, regulation can enhance the vitality of financial markets. Historically, new regulation has often served this role. For example, as the money manager Martin Whitman has observed, far from stifling the markets, the new regulations of the Investment Company Act of 1940 enabled the targeted industry to flourish:

> It ill behooves any successful money manager in the mutual fund industry to condemn the very strict regulation embodied in the Investment Company Act of 1940. Without strict regulation, I doubt that our industry could have grown as it has grown, and also be as prosperous as it is for money managers. Because of the existence of strict regulation, the outside investor knows that money managers can

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American and Latino borrowers are at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors." Center for Responsible Lending, Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, at 3 (May 31, 2006) (online at www.responsiblelending.org/pdfs/rr011exec-Unfair_Lending-0506.pdf). A third study by the Survey Research Center at the University of Michigan found that black homeowners are significantly more likely to have prepayment penalties or balloon payments attached to their mortgages than nonblack homeowners, even after controlling for age, income, gender, and creditworthiness. Michael S. Barr, Jane K. Dokko, and Benjamin J. Keys, *Who Gets Lost in the Subprime Mortgage Fallout? Homeowners in Low- and Moderate-Income Neighborhoods* (Apr. 2008) (online at ssrn.com/abstract=1121215). And a fourth study, by Susan Woodward, found that black borrowers pay an additional $415 in mortgage fees and Latino borrowers pay an additional $365 in mortgage fees. Urban Institute, Susan Woodward, *A Study of Closing Costs for FHA Mortgages*, at ix (2008).

> be trusted. Without that trust, the industry likely would not have grown the way it has grown.[29]

Markets built on fair dealing produce benefits for all Americans on both sides of the transactions.

3. The Central Importance of Regulatory Philosophy

The magnitude of the current financial crisis makes clear that America's system of financial regulation has failed. As a result, there is now growing interest in reforming the essential structure of financial regulation in the United States. (See the appendix for a summary of other recent reports on regulatory reform.) Critics highlight the inherent problems of vesting regulatory authority in a large number of separate agencies at both the state and federal levels, each responsible for isolated elements of a vast financial architecture. Although this complex regulatory system benefits from competition across governmental bodies, it also suffers from the problem of "regulatory arbitrage" (a situation in which regulated firms play regulators off against one another) as well as numerous gaps in coverage.

Structural and organizational problems are certainly important, and are taken up in section III, below. But at root, the regulatory failure that gave rise to the current crisis was one of philosophy more than structure. In too many cases, regulators had the tools but failed to use them. And where tools were missing, regulators too often failed to ask for the necessary authority to develop what was needed.

Markets are powerful and robust institutions, and a healthy respect for free market activity has served this nation well since its founding. At the same time, the best tradition in American policy has always been pragmatic. History has consistently shown that markets cannot be counted upon to regulate themselves or to function efficiently in the absence of regulation. While the price mechanism calibrates supply and demand, it cannot prevent bank runs, abusive lending or Ponzi schemes without regulation. The current financial meltdown proves these points in an especially severe way.

Excesses and abuse are all too common in a system without regulation. Government thus has a vital role to play. As President Lincoln once wrote: "The legitimate object of government, is to do for a community of people, whatever they need to have done, but can not do, *at all*, or can not, *so well do*, for themselves—in their separate, and individual capacities."[30]

Lincoln's vision of government goes beyond correcting abuses to improving the welfare of "a community of people." Regulators must never lose sight of the fact that the well-being of Americans is their goal, and that the welfare of the people has never been best served by extreme political ideologies. Franklin Roosevelt perhaps put it best: the question, he said, is "whether individual men and women will have to serve some system of government or economics, or whether a system of government and economics exists to serve individual men and women."[31] Not only is

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[29] Letter from Third Avenue Funds Chairman of the Board Martin J. Whitman to Shareholders, at 6 (Oct. 31, 2005) (online at www.thirdavenuefunds.com/ta/documents/sl/shareholderletters-05Q4.pdf).

[30] Abraham Lincoln, *Speeches and Writings, 1832–1858: Speeches, Letters, and Miscellaneous Writings,* at 301 (Don Edward Fehrenbacher ed., 1989).

[31] Franklin Roosevelt, *Remarks to the Commonwealth Club* (Sept. 23, 1932) (online at

this pragmatic approach democratic, asking regulation and the market to serve the American people, but it also places the American people at the foundation of the economy. If Americans are secure and flourishing, the financial system will be secure and flourishing as well. If Americans are in crisis or face considerable risks, so too will the financial system. Success is defined by the quality of life Americans have, not by the impersonal metrics of any theory of government or economics.

Well-conceived financial regulation has the potential not only to safeguard markets against excesses and abuse but also to strengthen markets as foundations of innovation and growth. Creativity and innovation are too often channeled into circumventing regulation and exploiting loopholes. Smart financial regulations can redirect creative energy from these unproductive endeavors to innovations that increase efficiency and address the tangible risks people face.[32] As discussed above, the decades following the New Deal regulatory reforms were the longest period without a serious finanial crisis in the nation's history; they were also a period of unusually high average real economic growth.

In April 2008, former Federal Reserve Chairman Paul Volcker commented on these developments in a speech to the Economic Club of New York:

> [T]oday's financial crisis is the culmination, as I count them, of at least five serious breakdowns of systemic significance in the past twenty-five years—on the average one every five years. Warning enough that something rather basic is amiss.
>
> Over that time, we have moved from a commercial bank–centered, highly regulated financial system, to an enormously more complicated and highly engineered system. Today, much of the financial intermediation takes place in markets beyond effective official oversight and supervision, all enveloped in unknown trillions of derivative instruments. It has been a highly profitable business, with finance accounting recently for 35 to 40 percent of all corporate profits.
>
> It is hard to argue that the new system has brought exceptional benefits to the economy generally. Economic growth and productivity in the last twenty-five years has been comparable to that of the 1950s and '60s, but in the earlier years the prosperity was more widely shared.
>
> The sheer complexity, opaqueness, and systemic risks embedded in the new markets—complexities and risks little understood even by most of those with management responsibilities—has enormously complicated both official and private responses to this current mother of all crises….
>
> Simply stated, the bright new financial system—for all its talented participants, for all its rich rewards—has failed the test of the market place.…
>
> In sum, it all adds up to a clarion call for an effective response.[33]

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www.americanrhetoric.com/speeches/fdrcommonwealth.htm).

[32] Congressional Oversight Panel, Testimony of Joseph E. Stiglitz, *Reforming America's Financial Regulatory Structure*, at 3 (Jan. 14, 2009) (online at cop.senate.gov/documents/testimony-011409-stiglitz.pdf).

[33] Paul A. Volcker, *Address to the Economic Club of New York,* at 1-2 (Apr. 8, 2008) (online at econclubny.org/files/Transcript_Volcker_April_2008.pdf). In his address, Volcker recalled the financial troubles of New York City in 1975—that having been the last time he addressed the Economic Club of New York (then as President of

As Volcker himself went on to observe, there is no going back to the "heavily regulated, bank dominated, nationally insulated markets" of the past.[34] At the same time, given the enormity of the current crisis and the evident failure of financial markets to regulate themselves, it is imperative that Congress take up the challenge of fashioning appropriate regulation for the twenty-first century—to stabilize and strengthen the nation's financial markets in the face of extraordinary innovation and globalization. For this to work, we must first remind ourselves that government has a vital role to play, not in replacing financial markets or overwhelming them with rules, but in bolstering financial markets through judicious regulation. Rooted in the principles of sound risk management, transparency, and fairness, new financial regulation can succeed, and must succeed.

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the Federal Reserve Bank of New York). Volcker noted in his 2008 address, "Until the New York crisis, the country had been free from any sense of financial crisis for more than forty years." *Id.* at 1.

[34] *Id.* at 3.

IV. Critical Problems and Recommendations for Improvement

The sweeping nature of the current financial crisis points to the need for a thorough review of financial regulation and, ultimately, for significant regulatory reform. As discussed in part III, financial regulation is particularly necessary to manage risk, facilitate transparency, and ensure fair dealings. The current system has failed on all counts, and as a result, numerous discrete problems have emerged. This report focuses on the following most critical of these problems:

1. Systemic risk is often not identified or regulated until crisis is imminent.
2. Many financial institutions carry dangerous amounts of leverage.
3. The unregulated "shadow financial system" is a source of significant systemic risk.
4. Ineffective regulation of mortgages and other consumer credit products produces unfair, and often abusive, treatment of consumers, but also creates risks for lending institutions and the financial system.
5. Executive pay packages incentivize excessive risk.
6. The credit rating system is ineffective and plagued with conflicts of interest.
7. The globalization of financial markets encourages countries to compete to attract foreign capital by offering increasingly permissive regulatory laws that increase market risk.
8. Participants, observers, and regulators neither predicted nor developed contingency plans to address the current crisis.

This section addresses each problem in turn, and provides recommendations for improvement.

1. Identify and Regulate Financial Institutions that Pose Systemic Risk

***Problem with current system*: Systemic risk is often not identified or regulated until crisis is imminent.**

Today, there is no regulator with the authority to determine which financial institutions or products pose a systemic risk to the broader economy. In 2008, Bear Stearns, Fannie Mae, Freddie Mac, AIG, and Citigroup all appear to have been deemed too big—or, more precisely, too deeply embedded in the financial system—to fail. The decisions to rescue these institutions were often made in an ad hoc fashion by regulators with no clear mandate to act nor the proper range of financial tools with which to act.

This is the wrong approach. Systemic risk needs to be managed before moments of crisis, by regulators who have clear authority and the proper tools. Once a crisis has arisen, financial regulation has already failed. The underlying problem can no longer be prevented, it can only be managed, often at the cost of extraordinary expenditures of taxpayer dollars.

***Action item*: Mandate that a new or existing agency or an interagency task force regulate systemic risk within the financial system on an ongoing basis.**

A much better approach would be to identify the degree of systemic risk posed by financial institutions, products, and markets in advance—that is, in normal times—and to regulate them accordingly. Providing proper oversight of such institutions would help to prevent a crisis from striking in the first place, and it would put public officials in a much better position to deal with the

consequences should a crisis occur.[35]

To make this possible, Congress and the President should designate a body charged with identifying the degree of systemic risk posed by financial institutions, products, and markets. This body could be an existing agency, such as the Board of Governors of the Federal Reserve System, a new agency, or a coordinating body of existing regulators.[36]

The need for a body to identify and regulate institutions with systemic significance is a necessary response to two clear lessons of the current financial crisis: (1) systemic risk is caused by institutions that are not currently covered or adequately covered by the financial services regulatory system; and (2) in a crisis the federal government may feel compelled to stabilize systemically significant institutions. However, no regulatory body currently has the power to identify and regulate systemically significant nonbank institutions. Consequently, Congress should authorize legitimate, coherent governmental powers and processes for doing so.

The systemic regulator should have the authority to require reporting of relevant information from all institutions that may be systemically significant or engaged in systemically significant activities. It should have a process for working with the regulatory bodies charged with the day-to-day oversight of the financial system. Finally, it should have clear authority and the proper tools for addressing a systemic crisis.

The regulator should operate according to the philosophy that systemic risk is a product of the interaction of institutions and products with market conditions. Thus, the regulator would oversee structures described in the next two action items that address a continuum of systemic risk by increasing capital and insurance requirements as financial institutions grow. This approach seeks to maximize the incentives for private parties to manage risk while recognizing and acting upon the fact that as financial institutions grow they become more "systemically significant."

Finally, creating a systemic risk regulator is not a substitute for ongoing regulation of our capital markets, focused on safety and soundness, transparency, and accountability. The agencies charged with those missions must be strengthened while we at the same time address the problem of systemic risk.

***Action item*: Impose heightened regulatory requirements for systemically significant institutions to reduce the risk of financial crisis.**

Precisely because of the potential threat they pose to the broader financial system, systemically significant institutions should face enhanced prudential regulation to limit excessive risk taking and help ensure their safety. Such regulation might include relatively stringent capital and liquidity requirements, most likely on a countercyclical basis; an overall maximum leverage ratio (on the whole institution and potentially also on individual subsidiaries); well-defined limits on contingent liabilities and off-balance-sheet activity; and perhaps also caps on the proportion of short-term debt on the institution's balance sheet. The systemic regulator should consider the desirability of capping

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[35] *See* Moss, *supra* note 3.

[36] Vesting that authority in an existing agency, such as the Board of Governors of the Federal Reserve, would require attention to the issues of transparency and accountability that the Panel will consider further when it looks at regulator structure.

any taxpayer guarantee and whether to require systemically significant firms to purchase federal capital insurance under which the bank, in return for a premium payment, would receive a certain amount of capital in specified situations.[37]

Whether such enhanced oversight for systemically significant institutions should be provided by a new systemic regulator or by existing regulatory agencies is a question that requires further study and deliberation.

***Action item*: Establish a receivership and liquidation process for systemically significant nonbank institutions that is similar to the system for banks.**

The current bankruptcy regime under the Bankruptcy Code does not work well for systemically significant nonbanks institutions. Recent experience with the failure of Bear Stearns & Co. and Lehman Brothers Inc. has indicated that there are gaps in the system for handling the receivership or liquidation of systemically significant financial institutions that are not banks or broker-dealers and are therefore subject to the Bankruptcy Code. Two problems are evident: (1) Because the federal bankruptcy system was not designed for a large, systemically significant financial institution, financial regulators may feel the need to prop up the ailing institution in order to avoid a messy and potentially destructive bankruptcy process, and (2) the Bankruptcy Code's provisions for distribution of the assets of a bankrupt financial institution do not take into account the systemic considerations that regulators are obligated to consider.

The Panel recommends that systemically significant nonbank financial institutions be made subject to a banklike receivership and liquidation scheme. We note that the bankruptcy regime under the Federal Deposit Insurance Act has generally worked well.

2. Limit Excessive Leverage in American Financial Institutions

***Problem with current system*: Excessive leverage carries substantial risks for financial institutions.**

Leverage within prudent limits is a valuable financial tool. But excessive leverage in the financial sector is dangerous and can pose a significant risk to the financial system. In fact, it is now widely believed that overleveraging (i.e., relying on an increasingly steep ratio of borrowing to capital) at key financial institutions helped to convert the initial subprime turmoil in 2007 into a full-blown financial crisis in 2008.

Recent estimates suggest that just prior to the crisis, investment banks and securities firms, hedge funds, depository institutions, and the government-sponsored mortgage enterprises (primarily Fannie Mae and Freddie Mac) held assets worth nearly $23 trillion on a base of $1.9 trillion in capital, yielding an overall average leverage ratio of approximately 12:1. We must, however, consider this figure carefully, because average leverage varied widely for different types of financial institutions. The most heavily leveraged, as a class, were broker-dealers and hedge funds, with an average leverage ratio of 27:1; government sponsored enterprises were next, with an average ratio of 23.5:1.35. Commercial banks were toward the low end, with an average ratio of 9.8:1, and savings banks have the lowest average ratio at 8.7:1.

[37] *See* Moss, *supra* note 3.

Financial institutions pursue leverage for numerous reasons. All bank lending, for example, is leveraged, because a certain amount of capital is permitted to support a much larger volume of loans. And the leverage of financial institutions is generally procyclical, meaning that it tends to increase when asset prices are rising (when leverage seems safer) and tends to decline when they are falling (when leverage seems more dangerous).[38]

For an institution with high debt and a relatively small base of capital, returns on equity are greatly magnified. Unfortunately, high leverage can also prove destabilizing because it effectively magnifies losses as well as gains. If a firm with $10 billion in assets is leveraged 10:1, then a loss of just 3 percent ($300 million) on total assets translates into a 30 percent decline in capital (from $1 billion to $700 million), raising the bank's leverage ratio to nearly 14:1. The challenge is obviously far more extreme for a firm with leverage of 30:1, as was typical for leading investment banks prior to the crisis. Here, a 3 percent ($300 million) loss on total assets translates into a 90-percent decline in capital (from $333 million to $33 million) and a new leverage ratio of nearly 300:1. To get back to leverage of 30:1, that firm would either have to raise $300 million in new equity (to bring capital back to its original level) or collapse its balance sheet, selling more than 95 percent ($9.37 billion) of its assets and paying off an equivalent amount of debt.[39]

Although raising $300 million in new equity would seem vastly preferable to selling $9.37 billion in assets, the problem is that financial institutions with depleted capital often find it difficult to raise new equity, particularly in times of general financial distress. If sufficient new capital is not available and the weakened firms are ultimately forced to dispose of assets under firesale conditions, this can depress asset prices further, generating additional losses across the financial system (particularly in the context of mark-to-market accounting). In the extreme, these sales can set off a vicious downward spiral of forced selling, falling prices, rising losses and, in turn, more forced selling.

***Action item*: Adopt one or more regulatory options to strengthen risk-based capital and curtail leverage.**

The goal of enhanced capital requirements is to limit excessive risk taking during boom times and reducing the need for dangerous "fire sales" during downturns. Several common criteria must be met by proposals for enhanced capital requirements. Above all, any such proposals must operate in a way that does not restrict prudent leverage or produce other unintended consequences. Moreover, they must recognize that proper risk adjustment can prove particularly vexing: the appropriateness of a leverage ratio depends on the safety of the assets the leverage supports, both directly and in the

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[38] Tobias Adrian and Hyun Song Shin, *Liquidity, Monetary Policy, and Financial Cycles*, Current Issues in Economics and Finance, at 1–7 (Jan./Feb. 2008). Some have argued that high leverage—especially short-term debt—may have a positive governance impact by imposing tough discipline on the management of financial institutions. K. Kashyap, Raghuram G. Rajan, and Jeremy Stein, *Rethinking Capital Regulation* (Aug. 2008) (online at www.kc.frb.org/publicat/sympos/2008/KashyapRajanStein.08.08.08.pdf) (paper prepared for Federal Reserve Bank of Kansas City symposium on "Maintaining Stability in a Changing Financial System" in Jackson Hole, Wyoming). Given the experiences of the last year, however, this theory requires a good deal more research.

[39] This illustration was inspired by: Brandeis University Rosenberg Institute of Global Finance and University of Chicago Initiative on Global Markets, David Greenlaw, et al., *Leveraged Losses: Lessons from the Mortgage Market Meltdown* (2008) (U.S. Monetary Forum Report No. 2) (online at research.chicagogsb.edu/igm/docs/USMPF_FINAL_Print.pdf); David Scharfstein, *Why Is the Crisis a Crisis* (Dec. 2, 2008) (slide presentation prepared for Colloquium on the Global Economic Crisis, Harvard Business School).

context of the business as a whole. Determining that safety level is anything but easy, as the current crisis shows. Finally, any proposal must recognize that no one solution will fit the entire financial sector (or perhaps even all institutions of one type within the financial sector).

A number of valuable ideas have been proposed as ways to strengthen capital and curtail excessive leverage, including the following:

Objectives-based capital requirements. Under this approach, capital requirements should be applied not simply according to the type of institution (commercial bank, broker-dealer, hedge fund, etc.) but on the basis of regulatory objectives (for example, guard against systemic risk, etc.). For example, required capital ratios could be made to increase progressively with the size of the firm's balance sheet, so that larger financial institutions face a lower limit on leverage than smaller ones (on the assumption that larger firms have greater systemic implications and ultimately become "too big to fail"). Required capital ratios could also be made to vary with other variables that regulators determine to be salient, such as the proportion of short-term debt on an institution's balance sheet or the identity of the holders of its liabilities.

Leverage requirements. Beyond risk-based capital requirements, there is also a strong argument for unweighted capital requirements, to control overall leverage. Stephen Morris and Hyun Song Shin suggest that these "leverage requirements" are necessary to limit systemic risk, by reducing the need for dangerous asset fire sales in a downturn.[40] FDIC Chairperson Sheila Bair has been particularly insistent on this point, declaring in 2006, for example, that "the leverage ratio—a simple tangible capital to assets measure—is a critically important component of our regulatory capital regime."[41] It should be noted that the current crisis may be exacerbated because leverage ratios are not a common feature of banking regulation in Europe; any approach to curtailing leverage in a globalized financial system must implement such standards on a global basis.

Countercyclical capital requirements. To help financial institutions prepare for the proverbial rainy day and manage effectively in a downturn, it has been proposed that capital (and provisioning) requirements be made countercyclical—that is, more stringent when asset prices are rising and less stringent when they are falling. Since the procyclicality of financial institution leverage likely intensifies the ups and downs in asset markets, countercyclical capital requirements could serve as a valuable automatic stabilizer, effectively leaning against the wind. One approach could involve a framework that raises capital adequacy requirements by a ratio linked to the growth of the value of bank's assets in order to tighten lending and build up reserves when times are good. Spain's apparently favorable experience with "dynamic provisioning" in its banking regulation serves as a

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[40] Brookings Institute, Stephen Morris & Hyun Song Shin, *Financial Regulation in a System Context*, at 21–26 (2008) (online at www.brookings.edu/economics/bpea/~/media/Files/Programs/ES/BPEA/2008_fall_bpea_papers/2008_fall_bpea_morris_shin.pdf). *See also id.* at 23 ("Instead of risks on the asset side of the balance sheet, the focus is on the liabilities side of balance sheets, and the potential spillover effects that result when financial institutions withdraw funding from each other. Thus, it is raw assets, rather than risk-weighted assets that matter.").

[41] Federal Deposit Insurance Corporation, *Remarks by Sheila C. Bair, Chairman before the Conference on International Financial Instability: Cross-Border Banking and National Regulation, Federal Reserve Bank of Chicago and the International Association of Deposit Insurers* (Oct. 5, 2006) (online at www.fdic.gov/news/news/speeches/archives/2006/chairman/spoct0606.html).

model for many related proposals.[42] Joseph Stiglitz takes the idea one step further, suggesting that a "simple regulation would have prevented a large fraction of the crises around the world—speed limits restricting the rate at which banks can expand, say, their portfolio of loans. Very rapid rates of expansion are typically a sign of inadequate screening."[43] Similarly, because rapid increases in leverage appear to precede periods of financial turmoil, capital requirements could be tailored to discourage particularly quick buildups of leverage.

Liquidity requirements. To further address the problem of financial firms being forced to sell illiquid assets into a falling market, some commentators have proposed that regulators could impose liquidity requirements in addition to capital requirements, so that financial firms would have to hold a certain proportion of liquid assets as well as a liquidity buffer that could be used in a crisis. Armed with sufficient supply of liquid assets (such as treasury bills), firms could safely sell these assets in a downturn without placing downward pressure on the prices of less liquid assets, which would contribute to systemic risk.[44]

These and other proposals will need to be thoughtfully reviewed, bearing in mind that leverage is not a consistent phenomenon, but rather varies across financial institutions, regulatory structures, and different types of leveraged situations. The current crisis provides two lessons to inform this review. First, options to curtail excessive leverage must proceed as a top priority and an integral part of the restructuring of the regulation of American financial institutions. Second, reforms in this area must reflect the primary lesson of the crisis: that no asset types, however labeled, and no transaction patterns, however familiar, are inherently stable.

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[42] *See, e.g., Spanish Steps: A Simple Way of Curbing Banks' Greed*, Economist (May 15, 2008) (online at www.economist.com/specialreports/displaystory.cfm?story_id=11325484).

[43] House Financial Services Committee, Testimony of Joseph Stiglitz, *The Future of Financial Services Regulation*, 110th Cong. (Oct, 21, 2008) (online at financialservices.house.gov/hearing110/stiglitz102108.pdf). Stiglitz also notes that there are "several alternatives to speed limits imposed on the rate of expansion of assets: increased capital requirements, increased provisioning requirements, and/or increased premia on deposit insurance for banks that increase their lending (lending in any particular category) at an excessive rate can provide incentives to discourage such risky behavior." *Id.*

> [44] Liquidity requirements can mitigate contagion, and can play a similar role to capital buffers in curtailing systemic failure. In some cases, liquidity may be more effective than capital buffers in forestalling systemic effects. When asset prices are extremely volatile, for example during periods of major financial distress, even a large capital buffer may be insufficient to prevent contagion, since the price impact of selling into a falling market would be very high. Liquidity requirements can mitigate the spillover to other market participants generated by the price impact of selling into a falling market. Moreover, because financial institutions do not recognise the indirect benefits of adequate liquidity holdings on other network members (and more generally on system resilience), their liquidity choices will be suboptimal. As a result, liquidity and capital requirements need to be imposed externally, in relation to a bank's contribution to systemic risk.

Bank of England, Rodrigo Cifuentes, Gianluigi Ferrucci, and Hyun Song Shin, *Liquidity Risk and Contagion* (2005) (Working Paper No. 264) (online at www.bankofengland.co.uk/publications/workingpapers/wp264.pdf).

U.S. bank regulators monitor a bank's liquidity as part of their Uniform Financial Institutions Ratings (CAMELS) System. *See, e.g.,* Board of Governors of the Federal Reserve System, *Commercial Bank Examination Manual*, Sec. 2020.1.

3. Modernize Supervision of Shadow Financial System

***Problem with current system*: The unregulated "shadow financial system" is a source of significant systemic risk.**

Since 1990, certain large markets and market intermediary institutions have developed outside the jurisdiction of financial market regulators. Collectively, these markets and market actors have become known as the shadow financial system.[45] The key components of the shadow financial system are unregulated financial instruments such as over-the-counter (OTC) derivatives, off-balance-sheet entities such as conduits and SIVs,[46] and nonbank institutions such as hedge funds and private equity funds. While the shadow financial system must be brought within any plan for systemic risk management, that alone would be insufficient. Routine disclosure-based capital-market regulation and routine safety-and-soundness regulation of financial institutions will not function effectively unless regulators have jurisdiction over the shadow financial system and are able to enforce common standards of transparency, accountability, and adequate capital reserves.

As a result of the growth of the shadow financial system, it is nearly impossible for regulators or the public to understand the real dynamics of either bank credit markets or public capital markets. This became painfully clear during the collapse of Bear Stearns and the subsequent bankruptcy of Lehman Brothers, and the collapse of AIG. In the case of Bear Stearns, key regulators expressed the view that as a result of that firm's extensive dealing with hedge funds and in the derivatives markets, the systemic threat posed by a disorderly bankruptcy could prove quite severe, though difficult to predict with any certainty.[47] Six months later, Lehman Brothers was allowed to file for protection under Chapter 11, the only major financial firm to be allowed to do in the United States

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[45] *See, e.g.*, Bill Gross, *Beware Our Shadow Banking System*, Fortune (Nov. 28, 2007) (online at money.cnn.com/2007/11/27/news/newsmakers/gross_banking.fortune); Nouriel Roubini, *The Shadow Banking System is Unraveling*, Financial Times (Sept. 21, 2008) (online at www.ft.com/cms/s/0/622acc9e-87f1-11dd-b114-0000779fd18c.html).

[46] Off-balance sheet entities are a significant part of the shadow financial system, and are addressed in part in our earlier recommendations on leverage, and in part should be the subject of a more extended technical inquiry into reforming Financial Accounting Standard 140.

[47] In a speech on August 22, 2008, Federal Reserve Chairman Ben Bernanke spoke frankly about the potential for a Bear Stearns failure to echo throughout the financial system:

> Although not an extraordinarily large company by many metrics, Bear Stearns was deeply involved in a number of critical markets, including (as I have noted) markets for short-term secured funding as well as those for over-the-counter (OTC) derivatives. One of our concerns was that the infrastructures of those markets and the risk- and liquidity-management practices of market participants would not be adequate to deal in an orderly way with the collapse of a major counterparty. With financial conditions already quite fragile, the sudden, unanticipated failure of Bear Stearns would have led to a sharp unwinding of positions in those markets that could have severely shaken the confidence of market participants. The company's failure could also have cast doubt on the financial conditions of some of Bear Stearns's many counterparties or of companies with similar businesses and funding practices, impairing the ability of those firms to meet their funding needs or to carry out normal transactions. As more firms lost access to funding, the vicious circle of forced selling, increased volatility, and higher haircuts and margin calls that was already well advanced at the time would likely have intensified. The broader economy could hardly have remained immune from such severe financial disruptions.

Board of Governors of the Federal Reserve System, *Chairman Ben S. Bernanke Remarks on Reducing Systemic Risk before the Federal Reserve Bank of Kansas City's Annual Economic Symposium* (Aug. 22, 2008) (online at www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm).

during the financial crisis. Lehman's bankruptcy resulted in substantial systemwide disruption, particularly as a result of credit default swap obligations triggered by Lehman's default on its debt obligations. The unregulated nature of several financial markets involved in this crisis contributed to the inability of regulators to understand the unfolding problems and act responsively.

***Action item*: Ensure consistency of regulation for instruments currently operating in the shadow financial system.**

Extending the reach of financial regulation to cover the shadow financial system is necessary in order to accurately measure and manage risk across the markets. A consistent regulatory regime will also reduce the ability of market players to escape regulation by using complex financial instruments and to secure higher yields by masking risk through information asymmetries.

The Panel urges Congress to consider shifting the focus of existing regulation toward a functional approach. While the details would need to be worked out by empowered regulators, the principle is simple: hedge funds and private equity funds are money managers and should be regulated according to the same principles that govern the regulation of money managers generally. At a minimum, Congress must grant the SEC the clear authority to require hedge fund advisors to register as investment advisors under the Investment Advisors Act. If they venture into writing insurance contracts or providing credit to others, hedge funds' activities in these areas need to be regulated according to the principles governing insurance or lending. An over-the-counter derivative can be almost any kind of contract synthesizing almost any kind of economic act—such instruments need to be regulated according to what they do, not what they are called.

While further study is needed, proposals for regulating more consistently instruments currently in the shadow financial system include: applying capital requirements to firms engaged in making credit or insurance commitments through derivatives; requiring transparency around derivatives contracts tied to publicly traded securities; and holding hedge funds and private equity funds to a single, well-understood federal standard of fiduciary duty as other money managers are. However, regulating the shadow markets does not necessarily mean treating a hedge fund in the same manner as a mutual fund, or a credit default swap between institutions in the same manner as an insurance policy sold to retail consumers. Functional regulation can mean applying the same principles and not necessarily producing identical regulatory outcomes.

***Action item*: Increase transparency in OTC derivatives markets.**

The Panel also recommends implementing new measures to improve transparency in the shadow financial system. Lack of transparency in the shadow financial system contributed to failures of risk management and difficulty in pricing assets and assessing the health of financial institutions. Transparency can be enhanced in several ways; several options are presented below:

***Regulated clearinghouses*.** A clearinghouse is an entity that provides clearance and settlement services with respect to financial products. It acts as a central counterparty with respect to trades that it clears. When the original parties to the trade introduce it to the clearinghouse for clearing, the original trade is replaced by two new trades in which the clearinghouse becomes the buyer to the original seller and the seller to the original buyer.

Proposals for clearinghouses generally involve the clearinghouse itself taking on credit risk. Such credit risk raises the issue of how to provide adequate capital in case of a default. One method for doing so involves taking the "margin" to secure performance of each trade. Another method involves daily marks-to-market to reduce risk arising from price fluctuations in the value of the contract. Others have proposed guaranty funds, in which each of the clearing members of the clearinghouse puts up a deposit to cover its future liabilities. Most central counterparty proposals also involve "mutualization of risk," in which the guaranty fund deposits of all clearing members may be used to cover a default by one member if the defaulting member's margin payments and guaranty fund contribution are insufficient to cover the loss. Finally, a clearinghouse may have the right to call for further contributions from members to cover any losses.

In addition to regulators risk management principles, a clearinghouse structure may also involve inspection by federal for the purposes of detecting and punishing fraudulent activity and public reporting of prices, volumes and open interest.[48]

Exchange-traded derivatives. As an alternative to clearinghouses, regulators can require that all standardized—and standardizable—OTC derivatives contracts be traded on regulated derviatives markets. These markets would be governed by the same standards that guide designated contract markets under the Commodity Exchange Act (CEA). CEA-governed exchanges must fully disclose the terms of the contracts traded and rules governing trading, and must also publicly report prices, volumes and open interest. The exchange would maintain detailed records to be inspected by federal regulators and would be empowered with the ability to deter, detect, and punish fraudulent activity. Intermediaries participating in the exchange would face registration, reporting, and capital adequacy requirements as well. Finally, the exchanges could still make use of clearinghouses to minimize counterparty risk.

Public reporting requirements. SEC Chairman Christopher Cox has proposed requiring CDS market participants to adhere to a public disclosure regime that would allow regulators to monitor market risk and potential market abuse. Cox's proposals include: (1) public reports of OTC transactions to improve transparency and pricing, and (2) reporting to the SEC derivatives positions that affect public securities.[49]

4. Create a New System for Federal and State Regulation of Mortgages and other Consumer Credit Products

***Problem with current system*: Ineffective regulation of mortgages and other consumer credit products has produced unfair, and often abusive, treatment of consumers, which destabilizes both families and the financial institutions that trade in those products.**

For decades, default rates on traditional home mortgages were low; profits to mortgage lenders were steady. Millions of Americans used mortgages to enable them to buy homes and retain homes. Over

[48] *See* President's Working Group on Financial Markets, *Policy Objectives for the OTC Derivatives Market* (Nov. 14, 2008) (online at www.treas.gov/press/releases/reports/policyobjectives.pdf).

[49] Christopher Cox, *Swapping Secrecy for Transparency*, New York Times (Oct. 18, 2008) (online at www.nytimes.com/2008/10/19/opinion/19cox.html).

time, however, a number of mortgage lenders and brokers began offering higher-priced, higher-profit—and higher risk—mortgages to millions of families.[50] Unlike the low-risk "prime" mortgages of the 1940s through the 1990s, the new "subprime" offered much bigger payouts for lenders and, ultimately, for the investors to whom the lenders sold these mortgages, but they also created higher costs and greater risks for consumers. For example, a family buying a $175,000 home with a subprime loan with an effective interest rate of 15.6 percent would pay an extra $420,000 during the 30-year life of the mortgage—that is, over and above the payments due on a prime 6.5 percent mortgage. While investors were attracted to the bigger returns associated with these subprime mortgages, many overlooked the much bigger risks of default that have now become glaringly apparent.

The new subprime mortgages were marked by exotic, and often predatory, new features, such as two year teaser rates that permitted marketing of mortgages to individuals who could not have qualified for credit at the enormous required rate increase in year three, or so-called "liars" or "no-doc" loans based on false paperwork about a borrower's financial situation. Terms such as these virtually guaranteed that the mortgages would default, and families would lose their homes, unless the real estate price inflation continued. These mortgages were especially cruel for new, especially lower-income, home buyers. The data show, however, that a substantial number of middle-income families (and even some upper-income families) with low default risk signed up for subprime loans that were far more expensive than the prime mortgages for which they qualified.

The complexity of subprime mortgage products made understanding the costs associated with an offered mortgage, let alone comparing several mortgage products, almost impossible. The high proportion of people with good credit scores who ended up with high-cost mortgages raises the specter that some portion of these consumers were not fully cognizant of the fact that they could have borrowed for much less. [51] This conclusion is further corroborated by studies showing that

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[50] *See* Federal Reserve Board, Christopher J. Mayer, Karen M. Pence, and Shane M. Sherlund, *The Rise in Mortgage Defaults*, at 2 (2008) (Finance and Economics Discussion Series No. 2008-59) (online at www.federalreserve.gov/Pubs/feds/2008/200859/200859pap.pdf) ("According to data from the Mortgage Bankers Association, the share of mortgage loans that were 'seriously delinquent' (90 days or more past due or in the process of foreclosure) averaged 1.7 percent from 1979 to 2006… But by the second quarter of 2008, the share of seriously delinquent mortgages had surged to 4.5 percent."). For detailed historical data on prime and subprime mortgages, *see* Mortgage Bankers Association, *National Delinquency Survey* (online at www.mbaa.org/ResearchandForecasts/productsandsurveys/nationaldelinquencysurvey.htm).

[51] In 2002, for example, researchers at Citibank concluded that at least 40 percent of those who were sold high interest rate, subprime mortgages would have qualified for prime-rate loans. Lew Sichelman, *Community Group Claims CitiFinancial Still Predatory*, Origination News, at 25 (Jan. 2002) (reporting on new claims of CitiFinancial's predatory practices after settlements with state and federal regulators). Freddie Mac and Fannie Mae estimate that between 35 percent and 50 percent of borrowers in the subprime market could qualify for prime market loans. *See* James H. Carr & Lopa Kolluri, *Predatory Lending: An Overview*, in Fannie Mae Foundation, *Financial Services in Distressed Communities: Issues and Answers,* at 31, 37 (2001). *See also* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, Maryland Law Review, at 730 (2006). A study by the Department of Housing and Urban Development of all mortgage lenders revealed that 23.6 percent of middle-income families (and 16.4 percent of upper-income families) who refinanced a home mortgage ended up with a high-fee, high-interest subprime mortgage. U.S. Department of Housing and Urban Development, Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending*, at 28 (2002) (Working Paper No. HF-014) (online at www.huduser.org/Publications/pdf/workpapr14.pdf). A study conducted for the Wall Street Journal showed that from 2000 to 2006, 55 percent of subprime mortgages went to borrowers with credit scores that would have qualified them for lower-cost prime mortgages. Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even the Very Credit Worthy; As*

subprime mortgage prices cannot be fully explained by borrower-specific and loan-specific risk factors.[52] These difficulties were further exacerbated by sharp selling practices and delayed disclosure of relevant documents. Buyers were steered to overpriced mortgages by brokers or other agents who represented themselves as acting in the borrower's best interests, but who were taking commissions from subprime lenders to steer them to riskier mortgages.[53] In other cases, lenders would not make relevant documents available until the closing date. In all of these respects, the mortgage market simply failed consumers.

Although mortgage documents include a raft of legally-required disclosures, those disclosures are a long way from a meaningful understanding of the loan transaction—and a much longer distance from supporting competitive markets. Many of the same points can be made for credit cards and other consumer financial products. In all of these cases consumers have little access to the key information they need to make responsible decisions. The result is a market in which people fail to assess risks properly, over-pay, and get into financial trouble. As the current crisis shows, these effects are not confined to those who buy the credit products. The high risk that consumers could not pay back their loans was multiplied by the bundling and re-bundling of millions of the loans into asset-backed securities;. That rebundling, in turn, spread the risk further, to the investment portfolios of other financial institutions, pension funds, state and local governments, and other investors for whom such risk was not appropriate. Ultimately, the widespread marketing of high-cost, high-risk consumer products has contributed to the destabilizing of the entire economy.

If, for example, a home buyer had been required to demonstrate an ability to pay the long-term mortgage rate rather than the teaser rate, home owners—and the country—would have been spared the specter of millions of foreclosures when payment resets made the monthly payment unaffordable. Moreover it would have been impossible to offer flawed investment products based on such mortgages.

State regulators have a long history as the first-line of protection for consumers. For example, states first sounded the alarm against predatory lending and brought landmark enforcement actions against some of the biggest subprime lenders, including Household, Beneficial Finance, AmeriQuest, and

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Housing Boomed, Industry Push Loans to a Broader Market, Wall Street Journal (Dec. 3, 2007) (study by First American Loan Performance for the Journal). By 2006, that proportion had increased to 61 percent. *Id.* None of these studies is definitive on the question of overpricing because they focus exclusively on FICO scores, which are critical to loan pricing but are not the only factor to be considered in credit risk assessment. However, they suggest significant market problems.

[52] Joint Center for Housing Studies, Harvard University, Ren S. Essene and William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans*, at 2 (2007) (online at www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf) (quoting Fishbein and Woodall, *supra* note 28, at 24); Howard Lax, et al., *Subprime Lending: An Investigation of Economic Efficiency*, Housing Policy Debate, at 533 (2004).

[53] *See, e.g.*, Howell E. Jackson and Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums* (Jan. 2002) (online at www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf). In some neighborhoods these brokers went door-to-door, acting as "bird dogs" for lenders, looking for unsuspecting homeowners who might be tempted by the promise of extra cash. Other families were broadsided by extra fees and hidden costs that didn't show up until it was too late to go to another lender. One industry expert described the phenomenon: "Mrs. Jones negotiates an 8% loan and the paperwork comes in at 10%. And the loan officer or the broker says, 'Don't worry, I'll take care of that, just sign here.'" Dennis Hevesi, *A Wider Loan Pool Draws More Sharks*, New York Times (Mar. 24, 2002).

Delta Funding. But states are sometimes pressured to offer no more consumer protection than is offered on the federal level so that financial firms do not leave their state regulator for a more favorable regulatory environment (taking the fee revenues they provide with them). [54] Moreover, the same competition for business that exists at the state level also exists at the federal level. Federal regulators face the possibility of losing business both to state regulators or to other federal regulatory agencies. At the federal level, this problem is exacerbated by direct financial considerations. The budgets of the OCC and OTS, for example, are derived from the number and size of the financial institutions they regulate, which means that a bank's threat to leave a regulator has meaningful consequences.[55] As Professor Arthur Wilmarth has testified, "Virtually the entire [Office of the Comptroller of the Currency] budget is funded by national bank fees, and the biggest national banks pay the highest assessment rates…. The OCC's unimpressive enforcement record is, unfortunately, consistent with its strong budgetary incentive in maintaining the loyalty of leading national banks."[56]

This has caused much of the regulatory scheme to come unraveled. State usury laws have eroded; according to recent research, at least 35 states have amended their usury laws to make it legal to charge annual interest rates exceeding 300 percent in connection with consumer credit products.[57] Many states were apparently also unwilling to deal with subprime mortgages. In 2006, fully half—52 percent—of subprime mortgages originated with companies that were subject only to state regulation.[58] And now, as the mortgage crisis deepens, the National Association of Attorneys General has a highly visible working group on foreclosures, but only about half of the states participate.

In addition, the authority of the states to deal with consumer protection for credit products has been sharply limited by interpretations in federal law. First, the Supreme Court has ruled that the usury laws of a national bank's state of incorporation controlled its activities nationwide. The decision naturally produced the pressures for repeal of state usury protections noted above. Second, the Office of the Comptroller of the Currency and federal courts have interpreted the National Banking Act to pre-empt action by state regulators to apply state consumer protection laws to national banks or to operating subsidiaries of national banks; virtually all of the nation's large banks—and most of those receiving federal assistance under the TARP—are national banks. The OCC's action was prompted by the attempt of Georgia to apply its Fair Lending Act to all banks within its jurisdiction. Yet, despite promises to Congress and the states, federal regulators have made the problem worse

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[54] In any of these situations, of course, the state from which the financial institution switches its charter is deprived of substantial revenue, and the new chartering jurisdiction gains substantial revenue.

[55] Michael Schroeder, *Bank Regulator Cleans House*, Wall Street Journal (Aug. 19, 2005) ("Bank consolidation has created competition among regulators. The OCC has been a winner in wooing banks to choose it as their regulator, helping to keep its coffers flush. Bank fees finance its $519 million annual budget, not taxpayer money.").

[56] *See, e.g.*, Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Arthur E. Wilmarth, Jr., *Review of the National Bank Preemption Rules,* 108th Cong. (Apr. 7, 2004) (online at banking.senate.gov/public/_files/wilmarth.pdf); Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, Temple Law Review, at 70–74, 77–84 (2005).

[57] Christopher L. Peterson, *Usury Laws, Payday Loans and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, Minnesota Law Review, at 1139 (2008).

[58] Greg Ip and Damian Palleta, *Regulators Scrutinized in Mortgage Meltdown*, Wall Street Journal (Mar. 27, 2007).

by failing to provide any significant supervision or regulation of their own.[59]

***Action item*: Eliminate federal pre-emption of application of state consumer protection laws to national banks.**

Preemption affects states' consumer protection initiatives in three main respects:

1. *Standards*: The ability of states to set consumer protection laws and the scope of coverage for those laws.

2. *Visitation*: The ability of states to examine financial institutions for compliance with consumer protection laws.

3. *Enforcement*: The ability of states to impose penalties for violations of consumer protection laws.

Visitation and enforcement are closely connected but distinct.

Given the critical role of state consumer protection, Congress should amend the National Banking Act to provide clearly that state consumer protection laws can apply to national banks and to reverse the holding that the usury laws of a national bank's state of incorporation govern that bank's operation through the nation.

***Action item*: Create a single federal regulator for consumer credit products.**

The need for a uniform federal law to create a meaningful baseline of protections is clear. It is essential that one regulatory agency have the responsibility and accountability for drafting, implementing, and overseeing effective consumer credit product protection rules. Without a uniform set of minimum standards, regulatory arbitrage among state—and federal—regulators will continue. and no regulator or agency will have the authority and responsibility to protect consumers.

The new federal regulator must be responsible for establishing minimum standards for disclosure and transparency, reviewing consumer credit products (in a manner set by statute) in light of those standards to eliminate unfair practices, and promoting practices that encourage the responsible use of credit. This regulator should assure that consumers are not misled by the terms of the sales pitches for credit products and that they have the information needed to make informed and thoughtful purchasing decisions. The statement of purposes of the legislation creating the new agency, and the standards governing its actions, would include the need to balance consumer protection with the legitimate need of financial institutions to create fair products and maintain the flow of credit to the national economy.

Creation of a single federal regulator would produce a single, national floor for consumer financial products. Some state regulators might conclude that their citizens require better protection, and they might put other constraints on the institutions that want to do business in their states. This proposal

[59] *See, e.g., Watters v. Wachovia Bank*, 550 U.S. 1 (2007). *See also* Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, Minnesota Law Review (2004); Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, South Carolina Law Review (2000).

leaves them free to do so. The regulatory agency simply assures that all Americans, regardless of where they live, can count on basic protection. Regulations that apply to all products of a certain kind—e.g., mortgages, credit cards, payday loans—without any exceptions are far more comprehensive than those based on the kind of institution that issued them—federally chartered, state charted, thrift, bank, etc. Because such baselines are inescapable, the impact of regulatory arbitrage is sharply undercut. A financial institution cannot escape the restrictions on mortgage disclosures, for example, by reincorporating from a federal bank to a state bank. Any issuer of home mortgages must meet the minimum federal standards.

One option is to make the new federal regulator an independent agency within the financial regulatory community. This approach would have several advantages. A single regulator would have the opportunity to develop significant expertise in consumer products. Consumer protection would be a priority rather than one issue among many competing with a myriad of other regulatory priorities that have consistently commanded more attention in financial institution regulatory agencies. An agency devoted to consumer protection can make it a first priority to understand the functioning of financial products in the consumer marketplace. Expertise can also be concentrated from around the country. A single group of regulators can develop greater expertise to ensure that products are comprehensible to customers and that they are protected from unfair business practices. Such expertise can also be transferred from one product to another. As financial products become more functionally intertwined—for example, home equity lines of credit that operate like credit cards—an agency can develop the needed cross-expertise and more nuanced rules.

Another option is to place the new regulator within the Federal Reserve Board. The Board is the umbrella supervisor of bank holding companies, and it directly supervises state-chartered banks that choose to become members of the Federal Reserve System. It was given specific authority to deal with deceptive mortgages more than forty years ago.[60] Congress voted repeatedly to expand the Board's power to provide stronger consumer protection.[61]

Placing the new regulator within the Board would keep safety and soundness and consumer protection responsibilities together, on the ground that each responsibility, if properly implemented, could complement and re-enforce the other. Choosing that option, however, would require changes to the Federal Reserve Act to make consumer protection one of the Fed's primary responsibilities, on a par with bank supervision. It would also depend on a new understanding and attitude by the Board toward its execution of its consumer protection mission.

Federal Reserve Chairman Ben Bernanke has acknowledged that although the powers of the Fed to deal with mortgage abuses were "broad,"[62] the Board has for years been slow to act,[63] and the

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[60] Truth in Lending Act (TILA), Pub. L. No. 90-321 (1968), at § 105(a) (codified as amended at 15 U.S.C. § 1601 et seq.) ("The Board shall prescribe regulations to carry out the purposes of this title."). The Federal Reserve Board implements TILA through its Regulation Z. 12 C.F.R. pt. 226. *See also* Home Ownership and Equity Protection Act of 1994 (HOEPA), Pub. L. No. 103-325 (codified at 15 U.S.C. § 1639) (amending TILA).

[61] Congress has amended TILA to improve consumer credit protection. *See, e.g.,* Fair Credit and Charge Card Disclosure Act of 1988, Pub. L. No. 100-583 (codified at 15 U.S.C. § 1637). In 1994, Congress amended TILA again to address predatory lending in the mortgage market. HOEPA, *supra* note 60.

[62] In 2007, Chairman Bernanke said the Board would "consider whether other lending practices meet the legal definition of unfair and deceptive and thus should be prohibited under HOEPA." Board of Governors of the Federal Reserve System, *Chairman Ben S. Bernanke Remarks on The Subprime Mortgage Market before the Federal Reserve*

actions it took were inadequate.[64] Its power under TILA and HOEPA to issue regulations binding upon all mortgage lenders gave it the capacity to halt the lending practices that inflated the housing bubble and that lead millions of home owners toward eventual foreclosure, but the Fed failed to do so.

Similarly, in areas such as credit card regulation, only when Congress threatened to take away powers, did the Fed finally act.[65] Barney Frank, Chairman of the House Financial Services Committee, explained that the failure of the Fed to act was longstanding: "When Chairman Bernanke testified before us a few weeks ago . . . he said something I hadn't heard in my 28 years in this body, a Chairman of the Federal Reserve Board uttering the words, 'consumer protection.' It had not happened since 1981."[66]

Currently, the staffing, the budgets, the expertise and the primary responsibilities of the Fed necessarily reflect the critical functions it performs: setting monetary policy and controlling the money supply, consolidated supervision of bank holding companies and the financial institutions those holding companies own to assure the safety and soundness of those groups, supervision of state-chartered member-banks in coordination with state regulators, and oversight of the federal reserve banks. Under this option the Fed would be required to accept consumer protection as a responsibility that is the equal of its other responsibilities, staff and budget for that function and, makes its operations in the area transparent. These responsibilities should be subject to specific oversight by a designated Board member.

Wherever it is placed, the success of the new regulator would depend in part on a statutory outline of the manner in which it would be related to the various financial institution regulatory agencies, and how those agencies would relate to one another, in dealing with consumer credit products. The agencies that are responsible for assuring the safety and soundness of the financial institutions would be able to pursue those goals without interference. The point of the single regulatory authority would be only to assure that both financial institutions and non-financial institutions that issue consumer credit products must play on a level field, all meeting the minimum standards

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Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007) (online at www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm). In 2008, recognizing that its authority under HOEPA is "broad," the Board strengthened Regulation Z. 73 Fed. Reg. 44,522 (July 30, 2008).

[63] It was not until the end of 2001, after the volume of subprime loans had increased nearly 400 percent, that the Board restricted more abusive practices and broadened the scope of mortgages covered by HOEPA. *See* 66 Fed. Reg. 65,604, 65,605 (Dec. 20, 2001).

[64] The Fed updated Regulation Z in response to HOEPA in March 1995. 60 Fed. Reg. 15,463. It also amended Regulation C, "Home Mortgage Disclosure," in 2002. 67 Fed. Reg. 7222. Nonetheless, neither regulation was strong enough to head off the mortgage abuses that continued to accelerate through 2008.

[65] *See, e.g.*, Jane Birnbaum, *Credit Card Overhauls Seem Likely*, New York Times (July 5, 2008) ("Representative Barney Frank, Democrat of Massachusetts and chairman of the House Financial Services Committee, said the Federal Reserve acted last fall after the House approved legislation that would have transferred some of the Fed's regulatory power to other agencies. 'At that point, I said use it or lose it,' Mr. Frank recalled. 'And subsequent to that, the Fed began using its authority, and is now proposing rules similar to those in our credit card bill.'")

[66] House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, Statement of Chairman Barney Frank, *The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers,* 110th Cong. 5–6 (2008).

established by the federal agency. No one issuer could gain advantage by moving to a different regulator.

5. Create Executive Pay Structures that Discourage Excessive Risk Taking

***Problem with current system:* Executive pay packages incentivize excessive risk.**

Executive pay is a key issue in modernizing the financial regulatory system. However, the common focus on the themes of inequality and "pay for performance" misses the unnecessary risk that many compensation schemes introduce into the financial sector. Altering the incentives that encourage this risk through the tax code, regulation, and corporate governance reform will help mitigate systemic risk in future crises.

Executive compensation has been one of the most controversial issues in American business since the late 1980s. In response to criticism that executives' and shareholders' interests did not sufficiently align,[67] executive compensation packages began to contain more and more stock options, to the point where options now represent the lion's share of a high-ranking executive's pay.[68]

Much criticism of executive pay has had its origins in the increase in the ratio of the pay of public company executives to average worker pay, from 42:1 in 1982 to over 400:1 in the early years of this decade.[69] Recent executive pay scandals, such as those associated with the backdating of stock options, have centered on efforts by executives to disconnect pay from performance without informing investors.[70] Numerous accounts of executive pay in the context of the financial crisis of 2007–08 have focused on large severance packages, often described as once again disconnecting pay from performance.[71]

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[67] Steven Balsam, *An Introduction to Executive Compensation*, at 161 (2002).

> [68] According to academic literature, between 1992 and 2002, the inflation-adjusted value of employee options granted by firms in the S&P 500 increased from an average of $22 million per company to $141 million per company, rising as high as $238 million per company in 2000. One academic study we referenced showed that, whereas in 1992 share options accounted for only 24 percent of the average pay package for these CEOs, by 2002 options comprised approximately half of the typical CEO's total compensation. The practice of granting option awards has not been limited to the top echelon of company executives. The percentage of option grants to all employees has grown steadily as well, if not at the same pace as the very top-most strata of corporate executives.

Senate Subcommittee on Investigations, Testimony of John W. White, *Concerning Tax and Accounting Issues Related to Employee Stock Option Compensation*, 110th Cong. (June 5, 2007) (online at idea.sec.gov/news/testimony/2007/ts060507jww.htm) (internal citations omitted).

[69] Jeanne Sahadi, *CEO Pay: Sky High Gets Even Higher*, CNNMoney.com (Aug. 30, 2005) (online at money.cnn.com/2005/08/26/news/economy/ceo_pay).

[70] *See, e.g.,* U.S. Securities Exchange Commission, *SEC Charges Former Apple General Counsel for Illegal Stock Option Backdating* (Apr. 24, 2007) (online at www.sec.gov/news/press/2007/2007-70.htm).

[71] The most prominent example is that of Angelo Mozilo, the former Chief Executive Officer of Countrywide Financial Corporation. Countrywide was rescued from bankruptcy by being acquired by Bank of America, which is now itself seeking additional financial assistance from the TARP. Mozilo realized more than $400 million in compensation from 2001 to 2007, most of it in the form of stock related compensation that he received and cashed out during the period. *Executive Incentives*, Wall Street Journal (Nov. 20, 2008) (online at

However, even before the current crises, many criticized such incentive plans for encouraging excessive focus on the short term at the expense of consideration of the risks involved.[72] This short-term focus led to unsustainable stock buyback programs, accounting manipulations, risky trading and investment strategies, or other unsustainable business practices that merely yield short-term positive financial reports.

Executive pay should be designed, regulated, and taxed to incentivize financial executives to prioritize long-term objectives, and to avoid both undertaking excessive, unnecessary risk and socializing losses with the help of the federal taxpayer.

***Action item*: Create tax incentives to encourage long-term–oriented pay packages.**

Financial firm packages typically have a number of features that introduce short-term biases in business decision making. Most equity-linked compensation is either in the form of performance bonuses, typically awarded on an annual basis, and options on restricted stock, typically awarded in the form of grants with three-year vesting periods, and no restrictions on sale after vesting. These structures, together with the typical five-years-or-less tenure of public company CEOs, often lead to a focus on investment horizons of less than three years.[73]

Altering the tax treatment of executive compensation packages in the interests of encouraging stability, lessening risks, and orienting finance executives toward long-term goals represents a relatively simple step toward solving the incentive problem. Such a change could result from revising applicable tax rates, changing the treatment of compensation as income versus capital gains, or other relatively simple measures.

***Action item*: Encourage financial regulators to guard against asymmetric pay packages in financial institutions, such as options combined with large severance packages.**

Asymmetric links between compensation and risk create incentives for executives to pursue potentially systemically threatening high-risk–high-reward strategies without sufficient regard for the downside potential. Encouraging regulators to spot and discourage compensation packages that excessively insulate executives from losses will help resolve this asymmetry and promote stability.

Stock options create incentives that are tied to stock price, but the overall compensation package's asymmetric link to stock price actually helps encourage more dramatic risk taking. As the price of the underlying stock declines, the option holder become less sensitive to further declines in value of the underlying stock, and more interested in the possibility of achieving dramatic gains, regardless

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online.wsj.com/public/resources/documents/st_ceos_20081111.html). Similarly, three of Merrill Lynch's top executives realized a combined $200 million in bonuses shortly before Bank of America absorbed that firm. Andrew Clark, *Banking Crisis: Merrill Lynch Top Brass Set to Share $200m*, The Guardian (Sept. 17, 2008) (online at www.guardian.co.uk/business/2008/sep/17/merrilllynch.executivesalaries).

[72] CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics, *Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value*, at 9-10 (2006) (online at www.darden.virginia.edu/corporate-ethics/pdf/Short-termism_Report.pdf).

[73] *Id.*

of the risk of further losses.[74]

A number of common features of executive pay practice that further protect executives against downside risk exacerbate this asymmetry problem. Among these features are the prevalence of option repricing when the underlying company stock falls below the option strike price for sustained periods of time and large severance packages paid to failed executives.

While asymmetries in executive compensation are potentially harmful in the context of any company, they create particular difficulties in the context of regulated financial institutions. Most regulated financial institutions are the beneficiaries of explicit or implicit guarantees. The FDIC insurance system is an explicit guarantee to some depositors, which in the current crisis has been extended to all bank debt. The current Treasury and Federal Reserve rescues of Fannie Mae, Freddie Mac, and AIG, and the recent TARP actions in relation to Citigroup and Bank of America—and perhaps all nine major TARP recipient banks—all raise issues of implicit guarantees. These guarantees provide regulators with an opportunity to ensure that problematically asymmetrical compensation plans do not reappear in these institutions.

***Action item*: Regulators should consider requiring executive pay contracts to provide for clawbacks of bonus compensation for executives of failing institutions.**

Financial system regulators should consider revoking bonus compensation for executives of failing institutions that require federal intervention. Whether the federal government promises to support the institution before a crisis develops, as with Fannie Mae and Freddie Mac, or after, as with TARP recipients, the prospect of losing bonus compensation could deter risky practices that make the federal rescue more probable.

The cases of the Fannie Mae and Freddie Mac seem particularly relevant. In both companies, executive pay in the course of the 1990s moved from a model focused on corporate stability to a model focused on stock price maximization through asymmetric, short-term incentives.[75] It appears that this change fed pressures to increase margins in ways that were only possible by engaging in riskier investment practices.[76] This approach to executive pay is inconsistent with federal guarantees of solvency; inevitably, if it is not abandoned, taxpayers will end up paying for imprudent risk taking by improperly incentivized executives.

As the financial crisis has developed, there has been a fair amount of discussion of clawbacks of executive pay. The Sarbanes-Oxley Act of 2002 required clawbacks of executive pay awarded as a result of fraudulent financial statements.[77] Similar clawback provisions could help restore symmetry and a longer-term perspective to executive compensation systems. As such, regulators should consider adding them to the tools at their disposal.

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[74] Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 139 (2004).

[75] Federal Reserve Bank of St. Louis, William R. Emmons and Gregory E. Sierra, *Executive Compensation at Fannie Mae and Freddie Mac* (Oct. 26, 2004) (Working Paper No. 2004-06) (online at papers.ssrn.com/sol3/papers.cfm?abstract_id=678404).

[76] *Id.*

[77] Sarbanes-Oxley Act of 2002, Pub.L. No. 107-204, at § 304.

***Action item*: Encourage corporate governance structures with stronger board and long-term investor oversight of pay packages.**

The Associated Press recently reported that "even where banks cut back on pay, some executives were left with seven- or eight-figure compensation that most people can only dream about. Richard D. Fairbank, the chairman of Capital One Financial Corp., took a $1 million hit in compensation after his company had a disappointing year, but still got $17 million in stock options. The McLean, Va.-based company received $3.56 billion in bailout money on Nov. 14."[78]

Corporate governance regulations should strengthen the role of boards and long-term shareholders in the executive pay process with the goal of encouraging executive pay practices that align executives' interests with the long-term performance of the businesses they manage

The twin problems of asymmetric and short-term-focused executive pay have been the subject of a number of reform efforts by business groups. Such reform recommendations have come from the Conference Board, in its report on the origins of the financial crisis,[79] and from the Aspen Institute's Principles for Long Term Value Creation,[80] endorsed by the U.S. Chamber of Commerce and the Business Roundtable, as well as by the Council of Institutional Investors and the AFL-CIO.

Financial regulators should encourage these efforts wherever possible and provide assistance wherever practicable.

6. Reform the Credit Rating System

***Problem with current system*: The credit rating system is ineffective and plagued with conflicts of interest.**

The major credit rating agencies played an important—and perhaps decisive—role in enabling (and validating) much of the behavior and decision making that now appears to have put the broader financial system at risk. In the subprime-related market specifically, high ratings for structured financial products—especially mortgage-backed securities (MBS), collateralized debt obligations (CDO), and CDOs that invested in other CDOs (frequently referred to as CDO-squared, or CDO^2)—were essential for ensuring broad demand for these products. High ratings not only instilled confidence in potentially risk-averse investors, but also helped satisfy investors' regulatory requirements, which were often explicitly linked to ratings from the major credit rating agencies. By 2006, Moody's business in rating structured financial products accounted for 44 percent of its revenues, as compared to 32 percent from its traditional corporate-bond rating business.[81] It has also been reported that "roughly 60 percent of all global structured products were AAA-rated, in contrast

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[78] Frank Bass and Rita Beamish, *Study: $1.6B of Bailout Funds Given to Bank Execs*, Associated Press (Dec. 21, 2008).

[79] Conference Board, Linda Barrington, Ellen S. Hexter, and Charles Mitchell, *CEO Challenge 2008: Top 10 Challenges—Financial Crisis Edition* (Nov. 2008) (online at www.conference-board.org/publications/describe.cfm?id=1569).

[80] Aspen Institute, *Long-Term Value Creation: Guiding Principles for Corporations and Investors* (2008).

[81] Harvard Business School, Joshua D. Coval, Jakib Jurek, and Erik Stafford, *The Economics of Structured Finance*, at 4 (2008) (Working Paper No. 09-060) (online at papers.ssrn.com/sol3/papers.cfm?abstract_id=1287363).

to less than 1 percent of corporate issues."[82] Financial firms, from Fannie Mae to AIG, also benefited greatly from having high credit ratings of their own—especially AAA—allowing them not only to borrow at low rates on the short-term markets to finance longer-term (and higher yielding) investments but also to sell guaranties of various sorts, effectively "renting out" their credit rating.

Numerous explanations have been offered for credit rating agencies' apparent mistakes, including conflicts of interest, misuse of complex models, and their quasi-public status as nationally recognized statistical rating organizations (NRSROs).

Regarding conflicts of interests, worrisome is the rating agencies' practice of charging issuers for their ratings, a practice that began at Fitch and Moody's in 1970 and at Standard & Poor's a few years later.[83] Although the practice of collecting payments from issuers has long provoked criticism, market observers often downplayed these concerns, suggesting that "the agencies have an overriding incentive to maintain a reputation for high-quality, accurate ratings."[84] Others, however, claim that the "issuer pays" model biases ratings upward and also encourages "ratings shopping" by issuers, which in turn provokes a race to the bottom on the part of the rating agencies, each willing to lower quality standards to drum up more business.[85]

Beyond the ratings themselves, credit rating agencies also charge issuers for advice, including pre-rating assessments (in which issuers learn what ratings will likely be under various hypothetical scenarios) and risk-management consulting. In some cases, credit rating agency analysts subsequently go to work for the companies they had been rating.[86] This revolving-door practice creates not only the potential for conflicts of interest but also for gaming of the system, since former employees of the rating agencies presumably know how best to exploit weaknesses in the agencies' risk assessment models.

Many critics charge that it was the models themselves—and overreliance on them—that got the credit rating agencies into trouble in recent years, particularly in assigning ratings to structured financial products. "Instead of focusing on actual diligence of the risks involved, demanding additional issuer disclosures, or scrutinizing collateral appraisers' assessments," writes one skeptic, "rating agencies primarily relied on mathematical models that estimated the loss distribution and simulated the cash flows of RMBS [residential mortgage backed securities] and CDOs using historical data."[87]

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[82] *Id.*

[83] Richard Cantor and Frank Packer, *The Credit Rating Industry*, FRBNY Quarterly Review, at 4 (Summer–Fall 1994). *See also* Claire Hill, *Regulating the Rating Agencies*, Washington University Law Quarterly, at 50 (2004).

[84] Cantor and Packer, *supra* note 81, at 4.

[85] House Committee on Oversight and Government Reform, Testimony of Jerome S. Fons, *Credit Rating Agencies and the Financial Crisis*, 110th Cong., at 3 (Oct. 22, 2008) (online at oversight.house.gov/documents/20081022102726.pdf).

[86] John P. Hunt, *Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, Columbia Business Law Review, at 32-33 (2009) (papers.ssrn.com/sol3/papers.cfm?abstract_id=1267625).

[87] Jeffrey David Manns, *Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating*

Many of the models involved excessively rosy assumptions about the quality of the underlying mortgages, ignoring the fact that these mortgages (especially subprime mortgages) were far riskier than ever before and were in fact becoming steadily riskier year by year.[88] Credit rating agency modeling of mortgage-related securities may also have involved mistaken assumptions about the independence of the underlying mortgages—including the assumption that defaults would not be highly correlated across a broad bundle of mortgages or mortgage-related securities.[89] By extension, many of the rating agencies' models may also have involved overly optimistic assumptions about the direction of housing prices (that is, that they would not fall by much, if at all). When asked on a conference call in March 2007 about how a 1 to 2 percent decline in home prices over an extended period of time would affect Fitch's modeling of certain subprime-related securities, a Fitch representative conceded, "The models would break down completely."[90]

Yet another problem plaguing the rating agencies' models was the practice of embedded structuring by issuers, according to which CDOs would themselves become inputs into new CDOs (CDO^2). "With multiple rounds of structuring," three finance professors explain, "even minute errors at the level of the underlying securities, which would be insufficient to alter the security's rating, can dramatically alter the ratings of the structured finance securities."[91]

Of particular concern from a regulatory standpoint is the extent to which state and federal (and even global) financial regulations are linked to private credit ratings—and, in fact, to ratings issued by just a handful of specially designated credit rating agencies, the NRSROs). To the extent that leading credit rating agencies enjoy a protected status and virtually guaranteed demand as a result of their regulatory significance, they may face diminished incentives to maintain the quality of their ratings.

The SEC has recently undertaken a number of reforms aimed at the operations of the NRSROs pursuant to the passage of the Credit Rating Agency Reform Act of 2006 (the Rating Agency Act),[92]

Agency Accountability, North Carolina Law Review (forthcoming), at 32–33 (papers.ssrn.com/sol3/papers.cfm?abstract_id=1199622) (accessed Jan. 4, 2009).

[88] U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies,* at 33 (July 2008) (online at www.sec.gov/news/studies/2008/craexamination070808.pdf) (hereinafter "Summary Report") ("In addition to the recent growth in subprime origination, there has also been a growth in the risk factors associated with subprime mortgages. Studies indicate that the percentage of subprime loans with less-than-full documentation, high combined loan to total value (CLTVs), and second liens grew substantially between 1999 and 2006. Notably, while 2/28 adjustable rate mortgages comprised just 31 percent of subprime mortgages in 1999, they comprised almost 69 percent of subprime loans in 2006. Further, 40-year mortgages were virtually non-existent prior to 2005, but they made up almost 27 percent of the subprime loans in 2006. These data provide evidence that the majority of subprime origination occurred within the last five years, and the loans containing very high risk combinations are even more recent."). The SEC report also documented that, at one major credit rating agency, "the average percentage of subprime RMBS in the collateral pools of CDOs it rated grew from 43.3 percent in 2003 to 71.3 percent in 2006." *Id.* at 7. Given these dramatic changes in the mortgage market, basing models on historical mortgage data may have proved particularly problematic.

[89] Indeed, a significant degree of independence was essential, since "CDOs rely on the power of diversification to achieve credit enhancement." Coval, et al., *supra* note 81, at 10.

[90] *See id.* at 23.

[91] *Id.* at 10.

[92] Credit Rating Agency Reform Act of 2006, P. Law No. 109-291.

which granted the SEC authority to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. Before this grant of authority to the SEC, NRSROs were essentially unregulated. Pursuant to its new regulatory authority, the SEC has registered ten firms;[93] instituted examinations of NRSROs' practices;[94] and proposed rules designed to enhance accountability, transparency, and competition.[95] The Rating Agency Act and the SEC's recent regulatory activity are positive developments. However, since 2006 the financial crisis has revealed the extent of the harmful consequences of the deep-seated conflicts of interest and distorted incentives associated with the credit ratings firms. With the knowledge that the contours of reform of credit rating agency regulation must take into account the SEC's actions, we propose the following recommendations.

***Action item*: Adopt one or more regulatory options to address conflicts of interest and incentives.**

To address conflicts of interest, the SEC or a new regulatory body (see below) could impose limits on the proportion of revenues of rating agencies that are derived from issuers, though there is disagreement about whether alternative revenue sources would prove sufficient.[96] Alternatively, for each rating, issuers could be required to pay into a pool, from which a rating agency would be chosen at random.[97] Here, the challenge would be to maintain the quality of ratings after severing the link between pay and performance. One could also imagine the introduction of grace periods in which credit rating analysts could not take jobs with their clients. While this too would limit conflicts of interest, it might also interfere with the recruiting of high-quality credit analysts at the rating agencies.

To improve incentives, the SEC or some other regulatory body should further encourage additional competition by progressively expanding the ranks of the NRSROs.[98] Other options would include additional disclosure requirements or prohibitions on rating agencies' use of nonpublic information.[99] Since rating agencies currently face little if any legal liability for malfeasance in the production of ratings, a number of experts have proposed strategies for imposing liability on credit

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[93] U.S. Securities Exchange Commission, *Nationally Recognized Statistical Rating Organizations* (online at www.sec.gov/divisions/marketreg/ratingagency.htm) (accessed Jan. 26, 2008) (hereinafter "SEC NRSRO Web site"). These ten include the old line firms Moody's, Standard & Poor's, and Fitch. *Id.*

[94] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Christopher Cox, *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies,* 110th Cong. (Apr. 22, 2008) (online at www.sec.gov/news/testimony/2008/ts042208cc.htm).

[95] SEC NRSRO Web site, *supra* note 93.

[96] House Committee on Oversight and Government Reform, Testimony of Sean J. Egan, *Credit Rating Agencies and the Financial Crisis*, 110th Cong., at 9 (Oct. 22, 2008) (online at oversight.house.gov/documents/20081022102906.pdf).

[97] David G. Raboy, *Concept Paper on Credit Rating Agency Incentives* (Jan. 9, 2009) (unpublished working paper on file with the Panel).

[98] Hill, *supra* note 83, at 86–87.

[99] Egan, *supra* note 96, at 8.

rating agencies to ensure appropriate accountability.[100] Although such reforms might well prove helpful, they would be unlikely to solve the underlying problem by themselves.

***Action item*: Reform the quasi-public role of NRSRO's and consider creating a Credit Rating Review Board.**

Perhaps the most pressing issue of all from a regulatory standpoint is the NRSRO designation itself. Particularly given all of the concerns that have been raised about the credit rating agencies and their poor performance leading up to the current crisis, state and federal policymakers will need to reassess whether they can continue to rely on these private ratings as a pillar of public financial regulation.[101] In fact, it may be time to consider the possibility of eliminating, or at least dramatically scaling back, the NRSRO designation and replacing it with something else.[102]

One option would be to create a public entity—a Credit Rating Review Board—that would have to sign off on any rating before it took on regulatory significance. Even if an asset was rated as investment grade by a credit rating agency, it could still not be added to a bank or pension fund portfolio, for example, unless the rating was also approved by the review board. Ideally, the board would be given direction by lawmakers to favor simpler (plain vanilla) instruments with relatively long track records. New and untested instruments might not make the cut. Of course, such new instruments could still be actively bought and sold in the private marketplace. Only regulated transactions that currently require ratings would be effected. Two key advantages of this approach are that it would permit a dramatic opening of the market for private credit ratings and at the same time discontinue the unsuccessful outsourcing of vital regulatory monitoring.

Another, substantially different, option for the design of such a Credit Rating Review Board would be to model the board in part on the Public Company Accounting Oversight Board (PCAOB), a nont-for-profit corporation that was created by the Sarbanes-Oxley Act to oversee the auditors of public companies.[103] Under this model, the Credit Rating Review Board would not rate instruments ex ante, but instead audit ratings after the fact, perhaps on an annual basis, to ensure that rating agencies are sufficiently disclosing their rating methodologies, the ratings agencies' methodologies are sound, and the rating agencies are adhering to their methodologies. Depending on the course of the SEC's rulemaking, the Credit Rating Review Board could coordinate with or assume some of the SEC's authority to regulate conflicts of interest and inspect, investigate, and discipline NRSROs.

7. Make Establishing a Global Financial Regulatory Floor a U.S. Diplomatic Priority

***Problem with current system*: The globalization of financial markets encourages countries to compete to attract foreign capital by offering increasingly permissive regulatory laws that**

[100] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Frank Partnoy, *Assessing the Current Oversight and Operation of Credit Rating Agencies,*109th Cong., at 5 (Mar. 7, 2006) (online at banking.senate.gov/public/_files/partnoy.pdf).

[101] A recent SEC report acknowledged, "The rating agencies' performance in rating these structured finance products raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole." Summary Report, *supra* note 88, at 2).

[102] Frank Partnoy has suggested linking regulation instead to market-based measures of risk, such as credit spreads or the prices of credit default swaps. Partnoy, *supra* note 100, at 80–81.

[103] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, at §§ 101–109.

increase market risk.

The rapid globalization of financial markets in recent decades has created a new set of problems for national regulators and exposed market participants to an additional element of risk. Capital is able to flow freely across international borders, while regulatory controls are bound to domestic jurisdictions. Private actors, therefore, have the benefit of seeking out regulatory climates that best accommodate their financial objectives. Countries, in turn, bid for capital flows by adjusting their tax and regulatory schemes, as well as their legal infrastructure and employment laws. While New York and London tout their preeminence as financial capitals, Tokyo, Hong Kong, Singapore, Bahrain, and Doha, Qatar have all become financial hubs. At the same time, certain offshore tax havens, such as the Cayman Islands, the Bahamas, and the Channel Islands have developed local industries catering to the financial services needs of foreigners. Often, the sole comparative advantage offered by these locations is the opportunity to profit from "regulatory arbitrage." The consequence is a global race to the bottom whereby deregulation is pursued to the detriment of market stability.

Meanwhile, global markets have become increasingly interconnected. From 1990 to 2000, the total dollar amount of crossborder securities holdings where non-U.S. investors held U.S. securities, or vice versa, grew from approximately $1.5 trillion to approximately $6.9 trillion.[104] Today, U.S. issuers raise debt and equity funding in local markets all over the world. Conversely, foreign issuers who previously looked to the liquidity of the United States capital markets now find equally liquid pools of capital in Europe and Asia.

When financial turmoil strikes issuers or borrowers in one country, it is equally likely to have adverse consequences beyond national borders. The subprime mortgage crisis of 2008 caused widespread havoc outside the United States, beginning with a small thrift in England and sweeping over the world. At the same time the United States government initiated its $700 billion bailout plan, the United Kingdom established a facility to make additional capital available to eight of its largest banks and building societies, the governments of France, Belgium, Luxembourg and the Netherlands made large capital infusions to bail out major banks operating in those countries, and the government of Iceland was forced to take over the three largest banks there.[105] Stock markets worldwide plunged. Investors large and small suffered.

The abiding lesson is that booms and busts can no longer be restricted to their country of origin. Nations must embark on aggressive diplomatic efforts to address the collective risks posed by today's globalized financial markets.

***Action item*: Build alliances with foreign partners to create a global financial regulatory floor.**

Given the ease with which money moves across international borders, it is difficult for one country to adopt a system to provide adequate regulation of the capital markets, as well as adequate consumer protection, unless all major participants in the global economy have agreed to coordinated action beforehand. Otherwise, regulatory arbitrage and the resulting race to the bottom are

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[104] Securities Industry Association, *Securities Industry Fact Book*, at 80 (2002) (online at www.sifma.org/research/statistics/other/2002Fact_Book.pdf).

[105] Steven Erlanger and Katrin Bennhold, *Governments on Both Sides of the Atlantic Push to Get Banks to Lend*, New York Times (Nov. 6, 2008).

inevitable. To assure the stability of the markets, it is therefore imperative for U.S. financial market regulators, as well as the State Department, to work together to encourage greater harmonization of regulatory standards, as well as broad adoption of a floor of recognized "prudent regulatory measures."

Better coordination of regulation and surveillance, while difficult to achieve, will result in better-regulated entities that are less likely to cause damages to global markets and other market participants. It is also likely to result in more efficient and less costly regulation for regulated entities.

***Action item*: Actively participate in international organizations that are designed to strengthen communication and cooperation among national regulators.**

Financial services regulators have created a number of organizations to share ideas and information regarding financial services entities and markets. These include the Basel Committee on Bank Supervision (BCBS), the Senior Supervisors Group (SSG), and the International Organization of Securities Commissions (IOSCO). The SSG, for one, meets regularly to discuss supervisory matters and to issue recommendations for better supervision.[106]

The SSG also periodically sponsor "colleges of supervisors," in which supervisors from several countries that have jurisdiction over part of the operations of a globally active financial services firm will convene to discuss issues regarding regulation of the firm. Established linkages between regulators with different perspectives on a particular entity facilitate information-sharing that enables all supervisors to better understand the risks facing the entity. These relationships also ensure better coordination during times of stress. These efforts should be expanded to include consideration of systemically important financial institutions, in order to develop a better understanding of the risk profiles of such institutions and to improve their ability to intervene where the risk profile increases to potentially destabilizing levels.

8. Plan for the Next Crisis

***Problem with current system*: Participants, observers, and regulators neither predicted nor developed contingency plans to address the current crisis.**

Despite calls for caution from some quarters, very few observers predicted the severity of the current collapse in the housing, debt, and equity markets, or the massive decline in economic activity. Those commentators who most vocally raised doubts about the sustainability of housing prices, the pace of derivatives growth, or lax regulation were largely dismissed as fearmongers, or as simply "not getting it."[107]

Traditional measures of financial and economic exposure, such as bank capitalization, troubled loans, stock prices, and money supply growth, indicated only moderate exposure to a sharp asset

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[106] Senior Supervisors Group, *Observations on Risk Management Practices in the Recent Market Turbulence* (Mar. 6, 2008) (online at www.newyorkfed.org/newsevents/news/banking/2008/ssg_risk_mgt_doc_final.pdf).

[107] *See, e.g., Meet Dr. Doom*, IMF Survey, at 308 (Oct. 16, 2006) (online at www.imf.org/EXTERNAL/PUBS/FT/SURVEY/2006/101606.pdf).

price collapse and a severe recession.[108] Yet there was a compelling case for concern based on a closer examination of the multiple layers of leverage invested in housing assets and their derivatives.[109] More broadly, stagnant household productivity, the pace of financial product innovation and the increased leverage on Wall Street might all have set off alarm bells.[110]

Indeed, some analysts see systemic collapses as inherently more likely in complex, interdependent systems such as our modern financial environment.[111] While most destructive outcomes are deemed to be so unlikely, based on historical comparisons, that they are not worth considering, recent analysis indicates on the contrary that complex systems produce these "outlier" results on a counterintuitively regular basis.[112]

Current institutions are not likely to fare better in the future. Governments, industry, Wall Street, and academia typically employ economists with similar training and backgrounds to create their forecasts, leading to procyclical optimism and convergence of economic forecasts. In particular, economists have a truly dismal record in predicting the onset of recessions and asset crashes.[113] Given the risk of a similar collapse in the future and the lack of formal processes in business or government requiring that the truly dismal scenarios be assessed, the current system will likely face similar risks not long after the present crisis is resolved.

***Action item*: Create Financial Risk Council of outside experts to report to Congress and regulators on possible looming challenges.**

To promote better planning, financial experts should be aiming to identify the problems of the future, much as the military does. To this end, the Panel recommends establishing a Financial Risk Council featuring a truly diverse group of opinions, a formal mechanism whereby the concerns, both individual and collective, of this group will be regularly brought to the attention of Congress and financial regulators, with a focus on precisely those low-likelihood, huge-magnitude developments that consensus opinion will dismiss.

The council should consider all potential domestic and foreign threats to the stability of the U.S.

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[108] *See, e.g., id.*

[109] General Accountability Office, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System,* at 16–23 (2009). (online at www.gao.gov/new.items/d09216.pdf) (discussing overleveraging and financial interconnectedness as contributing to a risky financial environment immediately preceding the current crisis).

[110] *Id.*

[111] *Id.* at 18–19.

[112] *See, e.g.,* Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (2007); Daniel G. Goldstein and Nassim Nicholas Taleb, *We Don't Quite Know What We Are Talking About When We Talk About Volatility* (Mar. 28, 2007) (online at ssrn.com/abstract=970480).

[113] Even where outside advisory groups have been set up to counsel the Government regularly on economic issues, as the Conseil d'Analyse Economique (CAE) does in France, there is a marked similarity of backgrounds among their membership. Conseil d'Analyse Économique, *Membres du Conseil* (online at www.cae.premier-ministre.gouv.fr) (accessed Jan. 26, 2009). This may help explain why these bodies did not produce even minority viewpoints warning of the current financial crash; CAE did not produce a report on the subprime mortgage crisis until September, 2008. Conseil d'Analyse Économique, *Rapports du Conseil d'analyse économique* (online at www.cae.premier-ministre.gouv.fr) (accessed Jan. 26, 2009).

financial systems. These sources of threat should include, but not be limited to: (1) economic shocks and recessions; (2) asset booms and busts; (3) fiscal, trade, foreign exchange, and monetary imbalances; (4) infrastructure failures, natural disaster, and epidemics; (5) institutional mismanagement; (6) crime, fraud; and terrorism; (7) legislative and regulatory failure; and (8) failed product and process innovation.

Strong, independent thinking among the membership of the Council will be critical: every effort should be made to avoid an optimistic consensus that there are no major threats looming. To that end, Council members should represent a diverse array of stakeholders, with a record of speaking their minds.

The council would be required to publish regular reports to Congress and to select among various techniques for identifying threats. These approaches might include:

1. Wargaming: Teams represent various market, government, regulatory, and subversive constituents. A control team sets up the initial environment and introduces destabilizing changes. The teams respond in real time and the control group feeds the impacts of their decisions into the environment. Subsequent to the wargame, there is an examination of outcomes, the level of constituent preparedness, and the quality of the risk management processes.
2. Strategic scenario analysis: An analytic team works backward from worst-case financial crisis outcomes to identify the potential triggering factors and preventative or mitigating solutions. This approach prevents the "it couldn't happen" mindset.
3. Nonlinear modeling/"black swan" sensitivity analysis: An analytic team assumes previously unseen levels for key variables in order to destabilize financial models and observes break points and systemic failures.

A Financial Risk Council composed of strong, divergent voices should avoid overly optimistic consensus and conventional wisdom, keeping Congress appropriately concerned and energized about known and unknown risks in a complex, highly interactive environment.

V. Issues Requiring Further Study

There are several important questions regarding financial regulatory reform that are beyond the scope of this Report, and will require further attention.

First, the Panel has identified three highly technical issues relating to the financial regulatory system, and recommends that the relevant regulatory agencies take up specialized review of these questions. These are:

1. *Accounting rules*: Further study is required to identify needed reforms of the current accounting rules, particularly with connection to systemic risk. Among the issues that should be considered are mark-to-market accounting, mark-to-model accounting, fair-value accounting, issues of procyclicality, accounting for contingent liabilities, and off-balance-sheet items.
2. *Securitization*: Further study is required to consider the logic and limits of securitization, and reform options such as requiring issuers to retain a portion of offering, phased compensation based on loan or pool performance, and other requirements.
3. *Short-selling*: In light of recent imposed limits, regulation of short-selling should be further studied and long-term policies should be developed.

Second, the Panel plans to address regulatory architecture more thoroughly in a subsequent report, including the issues of co-regulation, universal banking, regulatory capture, the revolving door problem, bankruptcy and receivership issues involving financial institutions, and the division of regulatory responsibilities.

VI. Acknowledgments

The Panel owes a debt of gratitude to many people who helped produce this report. Our deepest thanks go to Professor David Moss of Harvard Business School, who played a key role in conceptualizing and drafting the report. He was ably assisted by Melanie Wachtell, who worked long hours both to direct the underlying research efforts and to help pull the final draft together. The Panel is also grateful to Christopher Caines for his meticulous and thoughtful editing of this report. We express our thanks to Professor Arthur Wilmarth, Professor Patricia McCoy, Professor Ronald Mann, Professor Julio Rotemberg, Professor David Scharfstein, and Dr. Robert Litan, all of whom read portions of the draft and made helpful comments. Ganesh Sitaraman and Jonathan Lackow offered important drafting assistance. Thanks are also due to Abbye Atkinson, Brett Arnold, Cole Bolton, Marc Farris, Arthur Kimball-Stanley, Gregory Lablanc, Eric Nguyen, Adam Pollet, Walter Rahmey, Chris Theodoridis, Patrick Tierney, and Chieh-Ting Yeh, who contributed careful and detailed research to this undertaking.

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The Panel is also grateful to the following individuals who generously provided their time and expertise to the preparation of this report: Tobias Adrian, Professor Edward Balleisen, Dean Baker, Brandon Becker, Pervenche Beres, Professor Bruce Carruthers, Professor Lord Eatwell, Douglas Engmann, former Senator Phil Gramm, Professor Michael Greenberger, Professor Joseph Grundfest, Michael Jamroz, Robert Kelly, Professor Naomi Lamoreaux, Professor Stan Liebowitz, Professor Andrew Lo, David Raboy, Professor Hal Scott, L.W. Seidman, Professor Jay Westbrook, Professor Luigi Zingales, Professor Todd Zywicki, and the Squam Lake Working Group on Financial Regulation (including Martin Baily, Andrew Bernard, John Campbell, John Cochrane, Doug Diamond, Darrell Duffie, Ken French, Anil Kashyap, Rick Mishkin, Raghu Rajan, David Scharfstein, Matt Slaughter, Bob Shiller, Hyun Song Shin, Jeremy Stein, and Rene Stulz). The Panel thanks the following institutions and organizations for their contributions: Business Roundtable (including John Castellani and Tom Lehner), the Chicago Board Options Exchange, the Financial Industry Regulatory Authority, the Council of Institutional Investors (including Anne Yerger, Amy Borrus, and Jeff Mahoney), the Consumer Federation of America (and Barbara Roper), the International Swaps and Derivatives Association (and Robert Pickel), and the National Consumer Law Center (including Lauren Saunders and Margot Saunders). The Panel also benefited from the guidance of David Einhorn, Sarah Kelsey, Arthur Levitt, Alex Pollock, Professor Robert Merton, and Lawrence Uhlick.

VII. About the Congressional Oversight Panel

In response to the escalating crisis, on October 3, 2008, Congress provided the U.S. Department of the Treasury with the authority to spend $700 billion to stabilize the U.S. economy, preserve home ownership, and promote economic growth. Congress created the Office of Financial Stabilization (OFS) within Treasury to implement a Troubled Asset Relief Program (TARP). At the same time, Congress created the Congressional Oversight Panel to "review the current state of financial markets and the regulatory system." The Panel is empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy. Through regular reports, the Panel must oversee Treasury's actions, assess the impact of spending to stabilize the economy, evaluate market transparency, ensure effective foreclosure mitigation efforts, and guarantee that Treasury's actions are in the best interests of the American people. In addition, Congress has instructed the Panel to produce a special report on regulatory reform that will analyze "the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers."

On November 14, 2008, Senate Majority Leader Harry Reid and the Speaker of the House Nancy Pelosi appointed Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School to the Panel. With the appointment on November 19 of Congressman Jeb Hensarling to the Panel by House Minority Leader John Boehner, the Panel had a quorum and met for the first time on November 26, 2008, electing Professor Warren as its chair. On December 16, 2008, Senate Minority Leader Mitch McConnell named Senator John E. Sununu to the Panel, completing the Panel's membership.

Congressman Hensarling and former Senator Sununu did not approve this report. Their alternative view is included in the following section.

VIII. Additional Views

Richard E. Neiman

I am pleased to support the Panel's special report on regulatory reform, which begins to address some of the most critical issues facing our nation, such as improving consumer protection, reducing systemic risk, eliminating regulatory gaps, and enhancing global co-ordination of supervision. These are precisely the issues we need to address in these unprecedented times, when Americans are losing their homes, and the financial system and our economy are at greater risk than at any time since the Depression.

Addressing any one of these issues individually would be a challenge; compiling a report that addresses them all within nine short weeks was a herculean task. Given the diversity of backgrounds and ideological views of the panel members, the fact that we have reached agreement on the critical issues and on many action items to address those issues is truly remarkable.

As the only regulator on the panel, I find it appropriate to highlight certain issues of particular importance and to which I bring a unique perspective.

- STATES MUST BE ALLOWED TO INCREASE THEIR ROLE IN PROTECTING CONSUMERS

States have long strived to protect their citizens from harmful financial products and should continue to carry out this vital role. States, like New York, sounded an early alarm on subprime lending by adopting anti-predatory lending legislation and reaching landmark settlements with the nation's top mortgage bankers, providing hundreds of millions of dollars in consumer restitution and improving industry practices.

Rather than join with the states, however, the OCC and the OTS thwarted state efforts, by claiming broad field preemption and then failing to adopt measures that protected consumers. This federal overreach caused gaps in consumer protection standards, as more protective state laws were set aside without being replaced by appropriate national standards or equivalent enforcement efforts.

I want to underscore the Panel's recommendation to eliminate federal preemption of state consumer laws and confirm the ability of states to examine and enforce compliance with federal and state consumer protection laws. The recommendations will restore the appropriate balance between federal and state regulators and provide the basis for a "New Federalism." It will draw on what is best about our current dual banking system, close gaps in consumer protection, and maximize the effectiveness of the joint resources of state and federal regulators.

- THE FEDERAL RESERVE BOARD SHOULD SET MINIMUM FEDERAL STANDARDS FOR CONSUMER PROTECTION

The Panel's report calls for the establishment of a single federal regulator that would have overarching consumer protection responsibilities, such as setting national minimum standards. We need to establish adequate baseline consumer protections for all Americans. Under this proposal, states could adopt more stringent requirements than the federal body, as local conditions warranted,

and could regulate consumer protection standards in the absence of federal action. This would allow states to serve as incubators to develop innovative regulatory solutions. Laws that are tried first at the state level and found successful often serve as the model for laws at the national level.

The national minimum standards should go beyond required disclosures and extend to substantive regulation of consumer financial products. Disclosure alone does not address the issues that gave rise to the current crisis. We need to address key issues, including affordability, suitability, and the duty of care owed by financial services providers to consumers.

While I wholeheartedly support a heightened emphasis on consumer issues, I believe the functions of consumer protection should not be separated from the role of safety and soundness. Loans that take unfair advantage of consumers adversely affect the safety and soundness of financial institutions. Regulators must consider an institution's activities holistically, to detect emerging problems and have adequate tools to respond. Too narrow a mission could lead to myopic, impractical regulations, increasing the likelihood of negative unintended consequences and threatening to undermine the safety and soundness of financial institutions. Assigning the consumer protection function to a new stand-alone agency with a limited mandate would create yet another federal bureaucracy, at a time when I believe we need to be streamlining and avoiding counter-productive regulatory turf wars.

I recognize that the Federal Reserve Board may have been slow to take up consumer protection responsibilities placed on it by Congress. However, I believe that the current crisis has demonstrated to the Fed the importance of consumer protection to the health of our financial institutions and the economy as a whole.

- THE FEDERAL RESERVE BOARD SHOULD BE THE SYSTEMIC REGULATOR

The Panel's report correctly identifies the need for a federal systemic risk regulator, and I concur with proposals, such as those by the Group of Thirty, that this role be performed by a country's central bank.

The current crisis has demonstrated that the Federal Reserve Board, our nation's central bank, is ideally suited to harness the tools available to it to address systemic risk. The Fed has played a pivotal role in designing and implementing solutions to the current financial crisis and has gained unparalleled insight into risks presented by non-banking as well as banking institutions. However, the Fed still has no explicit authority over many non-banking organizations that meet the definition for being "systemically significant." The Fed's function in setting monetary policy, as well as supervising banking organizations and providing discount window facilities, strategically places it at the heart of the nation's regulatory nerve center. Creating new agencies to perform these broader systemic tasks would needlessly duplicate existing functions, dilute current levels of expertise and fail to take advantage of the wealth of experience accumulated by the Fed. The Federal Reserve's mission could easily be updated to formally incorporate these tasks into a broader mandate. I am confident that result would be a healthier, more vibrant financial system.

- WE NEED TO RESTORE THE CONFIDENCE OF THE AMERICAN PUBLIC

As the Panel's report states, we need to restore a proper balance between free markets and the

regulatory framework, in order to ensure that those markets operate to protect the economy, honest market participants and the public. I look forward to working with Congress to address the issues the report identifies, so that we can restore the confidence of the American public in the financial services system.

Congressman Jeb Hensarling and former Senator John E. Sununu

Preface

As part of the Economic Emergency Stabilization Act of 2008 (P.L. 110-343), Congress required that the newly established Congressional Oversight Panel (the Panel) prepare a report "analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, the rationale underlying such recommendation, and whether there are any gaps in existing consumer protections." Even in an environment where dozens of organizations have already offered their own perspective on the economic crisis and regulatory reform, assembling such a document in the short time the Panel has been in operation would be a daunting task. Adding to the challenge, the Panel is a diverse group which possessed a dedicated, but minimal staff well into the middle of January. As a result, much of the work drafting the Panel Report was given to individuals outside its operation.

Building consensus over such a broad range of economic questions would be difficult in any event. The timing and process for preparing this document, unfortunately, made it more so. Given the differences that remain regarding our views of the systemic weaknesses that led to the crisis, and, more important, policy recommendations for reform, we have chosen not to support the Panel Report as presented. Instead, we provide here a more concise statement of the underlying causes of the current financial crisis and a series of recommendations for regulatory modernization. While there are several points in the Panel Report with which we agree, we also provide a summary of several areas where our disagreement led us to oppose the final product.

This statement is organized into several sections:

1. Introduction
2. Observations on Current State of Financial Regulation
3. Underlying Causes of the Credit Crisis
4. Recommendations for Financial Service Regulatory Modernization and Reform
5. Differences with Congressional Oversight Panel Recommendations

In preparing this summary, we drew heavily from several sources, which presented a range of views, but in which we also shared many common themes and recommendations. These include the Group of 30's *Financial Reform: A Framework for Financial Stability*, the Committee on Capital Markets Regulation's *Recommendations for Reorganizing the U.S. Financial Regulatory Structure*, the GAO's *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, and the Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure*. Others playing an influential role in helping frame the often

complicated policy questions engendered by this work include the scholars at the American Enterprise Institute (AEI), particularly Peter Wallison and Alex Pollock, as well as those at George Mason University's Mercatus Center, including Professor Todd Zywicki, Houman B. Shadab, and Satya Thallam.

If one theme emerged among others in these differing perspectives on the challenges ahead, it is that our pursuit should not be simply to identify new rules or areas in which to regulate, but to build a structure and system that is modern and appropriate to the institutions and technologies being used every day. A well-designed system should enhance market discipline, minimize risks to taxpayers, and avoid the pitfalls of unintended consequences. We hope our recommendations are true to these objectives.

Introduction

Since the collapse and rescue of Bear Stearns in March 2008, legislators, regulators, and financial market participants have found themselves enmeshed in a discussion of whether the financial system needs to be saved, and, if so, how best to save it. In October 2008, Congress passed the Emergency Economic Stabilization Act (EESA), which made available $700 billion for the purpose of purchasing mortgage-backed securities from financial institutions in hope of stabilizing the financial system. Shortly after Congress voted to make these funds available, the Treasury Department changed course and instead decided to purchase capital in the nation's financial institutions to free up credit markets.

Recent events—including additional losses by the nation's financial institutions, new Treasury programs to support two of the country's largest financial firms, and reports that the sums spent thus far on recapitalizing financial institutions have had only modest impact—demonstrate that while identifying problems in a marketplace might be easy, the task of isolating those problems, diagnosing their cause, and discerning how best to address them remains challenging. The conversation over how best to revive the financial system continues, and despite its urgency, it is essential that the participants in that conversation not rush to act in pursuit of a plan that fails to solve the problems we face, or makes them worse.

Beyond the pressing challenges to stabilize our economic system, however, is the broader question of how best to oversee our financial system. If reorganization is to be done responsibly, it will demand an extraordinary amount of study, research, thought, and discussion, beginning with a careful, unbiased consideration of what exactly led to the crisis that now threatens our financial system. The observations and recommendations contained in these views should therefore be viewed as a preliminary contribution to the debate, not the final word. If not for reasons of modesty, then for reasons of prudence and responsibility, readers should be cautioned that this represents the opening round of a longer conversation regarding the future of our financial system.

While the rapid escalation of the credit crisis last fall forced Congress to forgo a more deliberative process in considering policy options to respond, it is widely acknowledged now by both proponents and opponents of congressional action that properly addressing this crisis will involve a more carefully crafted response than the broadly defined powers given to Treasury under the $700 billion EESA. The stakes are no less important in regulating our financial system, for the consequences of mistakes made in rushing to fix a problem not fully understood will sow the seeds of even greater problems in the future.

As a precursor for constructive reform, policy makers must first avoid a reflexive urge to simply write new rules. In the wake of the largest financial crisis since the Great Depression, some have called immediately to "reregulate" the financial system to prevent calamities like this from occurring again. Those that believe that regulation is the only answer, however, ignore the significant ways in which government intervention magnified our existing problems. In fact, there are few, if any, segments of the economy in which government regulates, intervenes, and legislates as heavily as it does in the financial and housing sectors. Before embracing more government regulation as the only answer, such advocates should consider the many ways in which government regulation itself can be part of the problem. The history of financial regulation is replete with such examples as either regulators or regulation have simply failed or made matters worse.

In fact, the hallmark of past efforts to regulate the financial system has been that government regulation frequently fails. History has also repeatedly shown us that adding rigid new government regulations in the midst of a crisis to solve existing problems may be like the old military adage of armies being prepared to fight the last war. For example:

1. For decades, banking regulators tried to fix deposit prices nationally through "Regulation Q," which effectively denied savers significant amounts of interest and, in turn, imperiled thrifts and banks as deposits fled when interest rates were high. As with all government regulation, Reg Q was grounded in the belief that government mandates could manage market forces and keep banks safer.
2. Twenty years ago, in response to the failure of 1,600 commercial banks in the Savings and Loan crisis, the federal government enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 (P.L. 102-242), which significantly tightened bank and S&L regulation in an attempt to generate stability. However, the tougher restrictions of FDICIA did not fix the problem, and the S&L crisis ended up costing American taxpayers over $120 billion.[114]
3. More recently, state and federal legislation mandated the use of credit ratings from a few rating agencies, which effectively transformed these agencies into a government-sponsored cartel. What began as an impulse to bring safety and objectivity to the regulation of broker-dealers ended by creating a concentrated point of failure, jeopardizing the entire financial system.
4. Finally, there is the example of the Federal Reserve's effort to use monetary policy to avoid the recessionary effects of the tech bubble's bursting, only to find that in doing so, it had helped create the housing bubble.

In addition to its demonstrated failure in preventing financial collapse, regulation imposes significant costs on the financial system in several ways. For example, rather than increasing stability and enhancing safety, regulation can invite chaos and encourage otherwise irrational risk taking among market participants who falsely believe that government will act as a guardian angel to protect them. Market participants thus underprice risk because they conjecture government has managed the risks that market participants would otherwise have had to assess. However, in reality, any government—from our current one to the most heavy-handed of all totalitarian central planners—can never completely regulate a market given its resource constraints and the ingenuity

[114] Timothy Curry and Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC Banking Review (December 2000) (online at www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf).

of individual entrepreneurs with a proper profit motive.

Regulation can also reduce competition because its costs are more easily borne by large companies than by small ones. Large companies also have the ability to influence regulators to adopt regulations that favor their operations over those of smaller competitors. This is particularly true when regulations add costs that smaller companies cannot bear. Take, for example, the continuing decline in the number of community banks, the locally owned and operated institutions at the heart of many small towns and cities across the county. In 2004, the Federal Deposit Insurance Corporation (FDIC) released a report on the future of banking that found that although community banks still make up a majority of the banking industry, the number of community banks had been cut almost in half since 1985. The report also found that their deposit share has also declined significantly in that time frame as large banks extended their geographic reach.[115] Regulation also may keep low cost producers or international competitors out of regulated markets.

Regulation can also harm consumers in the form of higher costs, less innovation, and fewer choices. Regulatory costs are passed along to consumers through higher prices for services or products. For an example, one need only look at their monthly telephone bill to see firsthand how the cost of various government regulations imposed on phone services are directly passed onto consumers in the form of new fees. Since the application of regulations over a population is generally universal but the direct benefits are often only individually realized, many regulations end up imposing costs on all consumers for the benefit of a limited few. Additionally, the associated cost of some regulations end up exceeding their value by adding costs to the process of developing new products or new services. There are countless examples of this phenomenon in the insurance industry, where it can take years to achieve the regulatory approval needed to roll out a new product offering or, in some bewildering cases, to enact rate reductions for the benefit of consumers if the reduction is approved at all.[116]

Instead of creating new regulatory hurdles, a superior approach to better protect consumers and preserve wealth-creating opportunities is to enhance and reinforce wise regulation while bolstering private sector market discipline. This belief was well articulated in March 2000, when Gary Gensler, then Undersecretary for Domestic Finance in President Clinton's Treasury Department and currently President Obama's nominee to chair the Commodity Futures Trading Commission (CFTC), testified before the House Financial Services Committee regarding systemic risk in our capital markets. Over the course of his remarks, Gensler explained that instead of advocating for new or increased regulations, the approach supported by Treasury emphasized the formative role of the private sector in protecting market participants:

> The public sector has three roles.... Promoting market discipline means crafting government policy so that creditors do not rely on governmental intervention to safeguard them against loss.
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> Transparency is the necessary corollary to market discipline. The

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[115] Tim Critchfield with Tyler Davis, Lee Davison, Heather Gratton, George Hanc, and Katherine Samolyk, *Community Banks: Their Recent Past, Current Performance, and Future Prospects* (2004) (online at www.fdic.gov/bank/analytical/future/fob_03.pdf) (FDIC Future of Banking Study).

[116] John Kennedy, *Gov. Crist, State Regulators Reject State Farm's 7 Percent Rate Reduction*, Chicago Tribune (July 31, 2007) (online at www.chicagotribune.com/business/sfl-0731statefarm,0,3467689.story).

> government cannot impose market discipline, but it can enhance its effectiveness by promoting transparency. Transparency lessens uncertainty and thereby promotes market stability.
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> Promoting competition in financial markets lessens systemic risk. The task of public policy must be to ensure the stability and integrity of the market system. In any sector of the financial market, the dominance of one or two firms can lessen competition and the efficiency of the market pricing mechanism. In addition, the entry of a subsidized financial institution into a market may motivate other firms to take on greater risks and weaken their operating results.[117]

Undersecretary Gensler had the right idea then, and his words should help provide the framework for the structural changes to our regulatory regime that we are now considering.

Observations on Current State of Financial Regulation

The United States has the most robust, accessible, and sound financial structure of any country in the world. That structure has provided unparalleled opportunities for millions, from seasoned market participants to casual investors to hardworking teachers and nurses hoping to live out the American dream. The success of our structure has been based on market discipline coupled with an appropriate level of regulation that fosters competition, transparency, and accountability.

Yet recently, this approach has been attacked by a small but vocal chorus claiming that two decades of financial deregulation has initiated the crisis that our financial system is now facing. These advocates of expanded government power contend that for years, government has been hard at work repealing all aspects of regulation in our financial sector. However, while such rhetoric might elicit some populist appeal, such claims do not bear scrutiny because the facts simply do not exist to support them.

One frequent argument heard from many critics is that the Gramm-Leach-Bliley Act (P.L. 106-102), which repealed the Depression-era Glass-Steagall Act's separation of investment and commercial banking, was somehow responsible for the current credit crisis. To the contrary, a wide variety of experts across the political spectrum have dismissed that claim as "a handy scapegoat"[118] at best. When asked in October 2008 if Gramm-Leach-Bliley was a mistake, Alice M. Rivlin, the former director of both the Congressional Budget Office and the Office of Management and Budget, testified: "I don't think so, I don't think we can go back to a world in which we separate different kinds of financial services and say these lines cannot be crossed. That wasn't working very well.... We can't go back to those days, we have got to figure out how to go forward."[119] Even former President Bill Clinton remarked in a 2008 interview that "I don't see that signing that bill had anything to do with the current crisis."[120] If anything, Gramm-Leach-Bliley has played a significant

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[117] House Financial Services Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Gary Gensler, *Securities and Government Sponsored Enterprises* (Mar. 22, 2000) (online at financialservices.house.gov/banking/32200gen.htm).

[118] David Leonhardt, *Washington's Invisible Hand*, New York Times (Sept. 26, 2008).

[119] Financial Services Committee, Testimony of Alice Rivlin, oral remarks (Oct. 21, 2008) (online at financialservices.house.gov/hearing110/hr102108.shtml).

[120] Editorial, *Bill v. Barack on Banks*, Wall Street Journal (Oct. 1, 2008) (online at

role in attenuating the severity of this crisis by allowing commercial banks to merge with floundering investment banks—like JPMorgan Chase and Bear Stearns, Bank of America and Merrill Lynch, and Goldman Sachs and Morgan Stanley—actions that would have been explicitly prohibited had the Glass-Steagall Act still been in effect.

Although the advocates for expanded government power would have you believe otherwise, a careful examination of the historical record points toward the conclusion that regulation of the financial services sector has at least held constant if not substantially *increased* in recent years. One need only think about the sprawling regulatory mandate that the Sarbanes-Oxley Act (P.L. 107-204) imposed upon our financial system. Intended to toughen financial reporting requirements in the wake of the Enron scandal, Sarbanes-Oxley has created many needed reforms but its burden has also resulted in many companies taking their business—and their money—overseas. The result has been a flow of capital away from the U.S., capital which could have helped to shore-up American banks. In addition to Sarbanes-Oxley, over the last twenty years the federal government has implemented a wide array of new regulations on banks, mortgage lenders, and other financial services companies. These new regulations include:

1. The Federal Deposit Insurance Corporation Improvement Act of 1991 (P.L. 102-242), which was designed to improve bank supervision, examinations, and capital requirements.
2. The Home Ownership and Equity Protection Act (HOEPA) of 1994 (P.L. 103-325), which mandates enhanced disclosures by lenders who make certain high-cost refinancing loans to borrowers.
3. The 1989 and 2002 expansions of the mandated data furnished by lenders under the Home Mortgage Disclosure Act (HMDA).
4. Te 2001 Bank Secrecy Act amendments made by the USA PATRIOT Act (P.L. 107-56), which enhanced anti-terro
5. rist and money laundering record-keeping requirements for banks.
6. The Fair and Accurate Credit Transactions Act of 2003 (P.L. 108-159), which created new information sharing, indentify theft protection, and consumer disclosure mandates.
7. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8), which required lenders to provide new disclosures regarding credit offers and interest rates.
8. Various other Truth in Lending Act (TILA)/Regulation Z regulations and other federal banking agency guidance regarding lending, offers of credit, and consumer protections.

In fact, instead of wholesale deregulation, the case can be made that government has made concerted efforts to strengthen the very regulations that helped set the stage for the current financial crisis. To take one obvious example, there has been a strengthening of the Community Reinvestment Act, which has encouraged banks to make mortgage loans to borrowers who previously would have been rejected as non-creditworthy. Also, the Department of Housing and Urban Development's (HUD) affordable housing mandates for the government-sponsored enterprises (GSEs) were steadily increased from the 1990s through 2008, adding new targets and rules that compelled Fannie and Freddie to take certain loan purchasing actions to stay in compliance. Additionally, U.S. bank regulators are moving to quickly implement new capital

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online.wsj.com/article/SB122282635048992995.html).

requirements through the Basel II capital accord, which was less than two years old when plans for its adoption were announced on September 30, 2005. These untested rules will replace the Basel I rules that generally assigned lower capital charges for housing assets, which tended to increase the leveraging of housing-related assets, making our financial system less stable.[121]

Furthermore, proponents of the "regulation is the cure" argument must bear in mind that the most egregious financial failures have occurred not in the unregulated financial markets of hedge funds and over-the-counter derivatives, but in the highly regulated world of commercial and investment banking, where regulation has been the most burdensome. The former U.S. investment banks—which bought the so-called toxic assets that have been identified as one of the root causes of the financial crisis—were regulated by the Securities and Exchange Commission (SEC). Yet that supervision was insufficient to prevent the collapse of Bear Stearns or Lehman Brothers, two of this nation's largest investment banks, or the charter transformation of two other large investment banks, Goldman Sachs and Morgan Stanley, into bank holding companies. The credit rating agencies that blessed these products with AAA ratings were also regulated by the SEC, yet that supervision was not enough to prevent the inaccurate evaluations and gross errors in judgment of those agencies.

This nation's highly regulated commercial banks, subject to regulation by several agencies similarly snapped up large quantities of these assets, all while supposedly under the oversight and supervision of their regulators. Yet the results of this country's heavy regulation of commercial banks have also been abysmal. Wachovia, formerly the nation's fourth largest bank, was regulated by the Comptroller of the Currency (OCC). Countrywide Financial was a national bank under OCC supervision until mid-2007, and then it became a federal thrift regulated by the Office of Thrift Supervision (OTS). Washington Mutual, IndyMac and Downey Savings and Loan Association were all also federal thrifts regulated by the OTS. All five were well regulated. And the housing market collapse caused all five to fail.[122]

By contrast, many of the less stringently regulated actors in the financial system, such as hedge funds and other private pools of capital, and less stringently regulated products, such as derivatives and swaps traded over the counter, seem to have weathered the crisis better than their highly regulated counterparts. While investors in some of those products have lost money, and some of the companies engaged in those lines of business have closed their doors, these failures did not produce massive systemic risk concerns that required federal intervention placing taxpayer dollars at risk.

These observations lead to the clear point that heavy regulation, despite the outsized claims made for its effectiveness in avoiding crisis, will not solve our problems. As financial historian Bernard Shull stated in a 1993 paper on the matter:

> Comprehensive banking reform, traditionally including augmented and improved supervision, has typically evoked a transcendent, and in retrospect, unwarranted optimism. The Comptroller of the Currency announced in 1914 that, with the new

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[121] Department of the Treasury, *Risk-based Capital Standards: Advanced Capital Adequacy Framework*, 72 Fed. Reg. 69288 (Dec. 7, 2007) (online at www.setonresourcecenter.com/register/2007/Dec/07/69288A.pdf).

[122] Binyamin Appelbaum and Ellen Nakashima, *Banking Regulator Played Advocate Over Enforcer*, Washington Post (Nov. 23, 2008.) (online at www.washingtonpost.com/wp-dyn/content/article/2008/11/22/AR2008112202213_pf.html).

> Federal Reserve Act, "financial and commercial crises or panics … Seem to be mathematically impossible." Seventy-five years later, confronting the S&L disaster with yet another comprehensive reform … The Secretary of the Treasury proclaimed "two watchwords guided us as we undertook to solve this problem: Never Again."[123]

More than fifteen years after Shull's paper, many stand ready to march down the same well-worn path, clinging to the belief that heavy-handed regulation holds the answer. Those claims should be rejected. There is a better and more effective path to choose.

A Brief History of the Subprime Crisis

To some observers, the turmoil in the U.S. financial markets, caused by severe dislocations in the country's housing markets, has heralded the end of the free-market system. But with all due respect to the critics of capitalism, the economic crisis in which the country now finds itself reflects not the failure of the free-market system, but more so the result of decades of misguided government policies that interfered with the functioning of that system. While recent events demonstrate a need for regulatory reform, modernization, and improvement, the larger lesson is that a number of well-meaning but clearly misguided government policies distorted America's housing markets, which in turn produced grave consequences for the financial system and the underlying economy.

In a rush to be seen as doing "something" in response, the advocates of expanded government power have brought forward a range of old proposals to regulate, reregulate, and overregulate any and every aspect of our economy. We believe a more practical approach would be to identify and correct the government policies that inflated the housing bubble underlying this crisis and then decide what change is necessary. Thus, the essential debate is not between deregulation and re-regulation, but instead between *wise* regulation and *counterproductive* regulation. Wise regulation helps make markets more competitive and transparent, empowers consumers with effective disclosure to make rational decisions, effectively polices markets for force and fraud, and reduces systemic risk. Counterproductive regulation hampers competitive markets, creates moral hazard, stifles innovation, and diminishes the role of personal responsibility in our economy. It is also procyclical , passes on greater costs than benefits to consumers, and needlessly restricts personal freedom.

Those who simply advocate for reregulation because they claim that the free markets have failed ignore the various ways that government itself helped set the stage for the current financial crisis. The housing sector—where the difficulties confronting our markets started—is not a deregulated, free-market in any sense of the word. This country's housing market is overloaded with substantial government components, including the regulatory roles of large government agencies; implicit and explicit government guarantees supporting the underwriting, issuance, and securitization of mortgages; and a cluster of mandates aimed at achieving universal home ownership. Indeed, the crisis this country finds itself facing does not stem from deregulation (since little has taken place over the last couple of decades) or even the mistakes of participants in the free market (although many harmful mistakes were committed), but instead from the myriad ways in which government

[123] Bernard Shull, *The Limits of Prudential Supervision: Economic Problems, Institutional Failure and Competence* (1993) (online at www.levy.org/download.aspx?file=wp88.pdf&pubid=378).

initiatives interfered with the functioning of private markets.

Our observations have led us to conclude that there are at least five key factors that led to the current crisis:

1. A highly accommodative monetary policy that lowered interest rates dramatically, kept them low, and inflated the housing bubble.
2. Broad federal policies designed to expand home ownership in an "off-budget" fashion, which encouraged lending to those who could not afford home ownership.
3. The moral hazard inherent in Fannie Mae and Freddie Mac, the two failed GSEs, which exploited their congressionally granted duopoly status to benefit from privatized profits earned against socialized risks taken.
4. An anticompetitive government sanctioned credit rating oligopoly that misled investors and failed in its responsibility to provide accurate, transparent assessments of risk.
5. Failures throughout the mortgage securitization process that resulted in the abandonment of sound underwriting practices.

Monetary Policy. The Federal Reserve set the stage for a wave of mortgage borrowing by keeping credit conditions too loose for too long earlier this decade. In response to the bursting of the high-tech bubble in 2000, the Federal Reserve began lowering interest rates in early 2001 to cushion the economic fallout. These highly accommodative policies were maintained in response to the 2001 recession and the economic shock of the 9-11 terrorist attacks. The target for the federal funds rate—the benchmark interbank lending rate in the U.S.—was lowered to just 1 percent by mid-2003, and maintained at that level until mid-2004.[124] The real funds rate—which is the difference between the funds rate set by the Federal Reserve and expected inflation—demonstrates just how aggressively the Federal Reserve was in conducting monetary policy during this period. The real funds rate dropped from 4 percent in late 2000 to -1.5 percent by early 2003.[125]

The Federal Reserve's decision to cushion the economic blow from the dramatic collapse in equity prices unleashed a wave of cheap credit on a housing market that was already experiencing a boom cycle. By mid-2003, the interest rate on a conventional thirty-year mortgage dipped to an all-time low of just 5.25 percent, fueling demand in the housing market thanks to mortgage credit that had become cheap and plentiful in light of the Federal Reserve's rate cuts.[126] As a result of demand and cheap credit, new home construction rose to a twenty-five-year high in late 2003, and remained at historic levels for two years.[127]

It has been widely reported that over the last fifty years, there has not been a single year in which the national average home value had fallen despite some regional declines and various economic

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[124] Federal Reserve Board (online at www.federalreserve.gov/fomc/fundsrate.htm) (accessed Jan. 26, 2009).

[125] Mark Zandi, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis* (2009).

[126] Federal Reserve Bank of St. Louis (online at research.stlouisfed.org/fred2/series/MORTG/).

[127] *Remarks of John B. Taylor at the Symposium of Housing, Housing Finance, and Monetary Policy sponsored by the Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming* (Sept. 2007) (online at www.kc.frb.org/PUBLICAT/SYMPOS/2007/PDF/Taylor_0415.pdf).

troubles and recessions. The allure of this statistic was so appealing that even former Federal Reserve Chairman Alan Greenspan and current Chairman Ben Bernanke at various points attested to it in defense of our housing markets. In fact, a 2004 report by top economists from Fannie Mae, Freddie Mac, the National Association of Realtors, the National Association of Home Builders, and the Independent Community Bankers of America entitled *America's Home Forecast: The Next Decade for Housing and Mortgage Finance* even concluded that "there is little possibility of a widespread national decline since there is no national housing market."[128] This widely held belief augmented Federal Reserve monetary policy and further inflated the housing bubble.

Even with the brisk pace of home construction, demand still outstripped supply, pushing home prices even higher. Between 1995 and 2002, in the midst of the housing boom, home prices appreciated between 2 percent and 5 percent a year. By 2004 and 2005, at the height of the bubble, home prices were appreciating at nearly 15 percent per year. Between 1997 and 2006, real home prices for the U.S. as a whole increased 85 percent. Another measure of the unsustainable inflation that took place in housing prices is the relationship between house prices and rents. Over the past twenty-five years, the price-to-rent ratio was roughly 16.5. In 2003, at the start of the bubble, the price-to-rent ratio was 18.5. It then quickly grew to an all-time peak of 25 by the end of 2005.[129]

The bubble grew as cheap credit and sharply increasing home prices fueled the frenzy of first-time homeowners eager to buy into a market before prices got out of reach. It also encouraged current homeowners to purchase bigger homes or to buy additional properties for investment purposes. Federal Reserve economists have estimated that the share of investment real estate purchases jumped to roughly 17 percent in 2005 and 2006 at the height of the housing boom, up from just more than 6 percent a decade earlier.[130]

These double digit increases in housing prices not only stimulated demand among home buyers who wanted to get into the housing market before they were priced out or were eager to invest on rising home prices, they also created an environment in which lenders, securitizers, and investors believed that it was impossible to make a bad loan. The consequences should have been foreseeable. Borrowers bought bigger, more expensive homes, betting that perpetually rising housing prices would allow them to refinance their mortgages at a later date while benefiting from ongoing appreciation in housing values. Lenders assumed that even if buyers defaulted, rising house prices would allow them to sell the home for more than the amount owed by the borrower.

Economists have consistently identified the Federal Reserve's accommodative monetary policy as one cause of the current financial crisis. For example, John B. Taylor, a professor of economics at Stanford and the creator of the "Taylor rule" guideline for monetary policy, has said the Federal Reserve made a mistake by keeping interest rates so low. According to Taylor's formula, the

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[128] David Leonhardt and Vikas Bajaj, *Drop Foreseen in Median Price of U.S. Homes*, New York Times (Aug. 26, 2007) (online at www.nytimes.com/2007/08/26/business/26housing.html?ei=5090&en=9bd44f2f8b0ef4f4&ex=1345780800&partner=rssuserland&emc=rss&pagewanted=all).

[129] Zandi, *supra* note 125; Robert J. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do About It* (2008).

[130] Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *The 2006 HMDA Data*, Federal Reserve Bulletin (Dec. 2007).

Federal Reserve should have raised interest rates much sooner than it did given the economic conditions at the time. Taylor himself has said that "a higher funds path would have avoided much of the housing boom.… The reversal of the boom and thereby the resulting market turmoil would not have been as sharp."[131] Given the key role that the Federal Reserve's monetary policy has played in contributing to the credit crisis we now face, it must be acknowledged that those decisions had a major impact on market conditions and helped to influence how investors chose to allocate their capital in our economy.

Federal Policy to Expand Home Ownership.. For well over twenty years, federal policy has promoted lending and borrowing to expand homeownership, through incentives such as the home mortgage interest tax exclusion, the Federal Housing Administration (FHA), and discretionary spending programs such as HUD's HOME block grant program. But perhaps the most damaging initiative undertaken by the federal government was the effort to pressure private financial institutions to subsidize home ownership through the Community Reinvestment Act (CRA). Undertaken with the best of intentions—expanding home ownership among poor and underserved communities—the unintended consequences of the CRA clearly demonstrate that government's attempts to manipulate market behavior to achieve social goals often lead to harmful results.

Enacted in 1977, the CRA encouraged banks to extend credit to "underserved" populations by requiring that banks insured by the federal government "help meet the credit needs of its entire community." To ensure that banks are meeting this mandate, each federally insured bank is periodically examined by its federal regulator. As a result of its enactment, bank lending to low- and moderate-income families has increased by 80 percent.[132]

In 1997, Wall Street firms, the GSEs, and the CRA converged in a landmark event: the first securitization of CRA loans, a $384-million offering guaranteed by Freddie Mac.[133] Over the next 10 months, Bear Stearns issued $1.9 billion of CRA mortgages, backed by Fannie or Freddie, and between 2000 and 2002 this business accelerated in dramatic fashion as Fannie Mae issued $20 billion in securities backed by CRA mortgages.[134] By encouraging lenders and underwriters to relax their traditional underwriting practices, the CRA, investment firms and the GSEs saddled American taxpayers with the consequences of mortgages that borrowers cannot repay.

Equally problematic are reports that some of these CRA-inspired loans are mortgages that borrowers can repay, but choose not to, given that the property that secures these loans is now worth less than the amount outstanding. Whether borrowers cannot or will not repay, the irony is that these lower-income home buyers—those who were supposed to benefit from the government's actions—are now defaulting at a rate three times that of other borrowers. With these defaults, the damage to homeowners, neighborhoods, state and local governments as the tax base shrinks, and now to all American taxpayers, is enormous.

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[131] Taylor, *supra* note 127.

[132] U.S. Department of the Treasury, *The Community Reinvestment Act after Financial Modernization: A Baseline Report* (Apr. 2000).

[133] First Union Capital Markets Corp., *Bear, Stearns & Co. Price Securities Offering Backed By Affordable Mortgages Unique Transaction to Benefit Underserved Housing Market* (Oct. 20, 1997).

[134] *Fannie Mae Increase CRA Options*, ABA Banking Journal (Nov. 1, 2000).

In the course of this crisis, there has been some heated discussion over the role CRA loans have played in contributing to our current woes. Proponents of CRA-like mandates have maintained that only a small portion of subprime mortgage originations are related to the CRA, and those CRA loans that have been written are performing in a manner similar to other types of subprime loans. Such claims, however, miss the fundamental point that critics of the CRA have made: though they may be small in volume, CRA loan mandates remain large in precedent because they inherently required lending institutions to abandon their traditional underwriting standards in favor of more subjective models to meet their government mandated CRA obligations.

For example, in April of 1993, the Boston Federal Reserve Bank, under the leadership of future Freddie Mac Chairman Dick Syron, published an influential best practices guide called *Closing the Gap: A Guide To Equal Opportunity Lending*. The guide made several recommendations to lending institutions on various ways they could increase their low-income lending practices. Some of these recommendations, which encouraged institutions to abandon the traditional lending and underwriting policies used to ensure the quality of loans made, included:

1. "Special care should be taken to ensure that standards are appropriate to the economic culture of urban, lower-income, and nontraditional consumers."
2. "Policies regarding applicants with no credit history or problem credit history should be reviewed. Lack of credit history should not be seen as a negative factor.… In reviewing past credit problems, lenders should be willing to consider extenuating circumstances."
3. Institutions can "work with the public sector to develop products that assist lower-income borrowers by using public money to reduce interest rates, provide down payment assistance, or otherwise reduce the cost of the mortgage."
4. "A prompt and impartial second review of all rejected applications can help ensure fairness in the lending decision and prevent the loss of business opportunities.... This process may lead to changes in the institution's underwriting policies.… In addition, loan production staff may find that their experience with minority applicants indicates that the institution's stated loan policy should be modified to incorporate some of the allowable compensating factors."[135]

Taken in isolation, the good intentions of these recommendations is plain; taken together, however, it is also clear that lenders were being urged to abandon proven safety and soundness underwriting standards in favor of new outcome-based underwriting standards. Again, the salient point is not to debate the notion of could or should more be done to make affordable loans available to underserved communities. The question is what damage is done to the overall stability of an institution when it alters its lending guidelines to comply with a government mandate to advance a social policy.

Similarly, banks were urged by other private sector parties to ignore traditional lending guidelines, this time in the pursuit of greater and faster profit. In May of 1998, Bear Stearns published an article with guidance on why and how lenders should package CRA loans into mortgage backed

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[135] Boston Federal Reserve, *Closing the Gap: A Guide to Equal Opportunity Lending* (Apr. 1993) (online at www.bos.frb.org/commdev/commaff/closingt.pdf).

securities.[136] That document advised lenders that: "Traditionally rating agencies view LTV [loan-to-value ratios] as the single most important determinant of default. It is most important at the time of origination and less so after the third year." Bear Stearns also encouraged lower lending standards by arguing that when "explaining the credit quality of a portfolio to a rating agency or GSE, it is essential to go beyond credit scores," and that "the use of default models traditionally used for conforming loans have to be adjusted for CRA affordable loans." While such advice might have been important to maximizing profitability, Bear Stearns' guidance is yet one more example of how the conflict between a social policy mandate like the CRA and the fiscal requirements of basic safety and soundness operations led to a dangerous diminution in lenders' traditional underwriting standards.

The GSEs. Standing at the center of the American system of mortgage finance are the two now-failed government-chartered behemoths created to expand homeownership opportunities: the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Market participants have long understood that this government created duopoly was implicitly, though not explicitly, backed by the federal government. This "implied guarantee" flowed from several factors, including the very existence of a government charter that effectively sanctioned this duopoly, access to a Treasury line of credit, and exemption from payment of state and local taxes. Although Fannie and Freddie were nominally designed to be competitors, in practice this implied guarantee allowed the two largely to work in unison as a cartel to set and maintain prices in the market.

The dangers inherent in such an implied guarantee were twofold. First, their unique status allowed Fannie and Freddie to borrow funds in the marketplace at subsidized rates. Ostensibly, these funds would be used to purchase mortgages from lenders, fulfilling their mission to provide liquidity in the secondary mortgage markets. For over a decade, however, the GSEs continued to build enormous investment portfolios, earning profits by arbitraging the difference between their low, subsidized borrowing costs and the higher yields in their portfolio's ever riskier assets. Beginning in 1990, their investment portfolios grew tenfold, from $135 billion to $1.5 trillion,[137] allowing many of their shareholders and executives to become personally wealthy thanks to the GSEs' subsidized borrowing costs while the American taxpayer assumed most of the risk.

Second, their implied guarantee created a false sense of security and standards for the products they purchased and securitized. This perception played a major role in the proliferation of GSE-backed subprime and Alt-A securities, providing a *de facto* government seal of approval for even the riskiest loans as market participants believed these securities were appropriately priced and represented minimal risk. Their predominance in the mortgage market meant that Fannie and Freddie's business practices—credit rating, underwriting, risk modeling—were seen as the "gold standard" in the industry, despite flaws that later became apparent.

For its part, Congress substantially magnified these potential risks by charging the GSEs with a

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[136] Dale Westhoff, *Packaging CRA Loans into Securities*, Mortgage Banking (May 1, 1998) (online at www.allbusiness.com/personal-finance/real-estate-mortgage-loans/677967–1.html).

[137] U.S. Department of the Treasury, *Remarks of Assistant Secretary for Financial Institutions Emil W. Henry Jr., before the Housing Policy Council of the Financial Services Roundtable* (June 26, 2006) (online at www.ustreas.gov/press/releases/js4338.htm).

mission to promote homeownership and thus inflating the supply of credit available to fund residential mortgages. The GSEs' congressional mandate and their access to cheap funding allowed the government to pressure Fannie and Freddie to expand homeownership to historically credit-risky individuals without the burden of an explicit on-budget line item at taxpayer expense, a budget goal long sought by housing advocates. For instance, in 1996, the HUD required that 42 percent of Fannie's and Freddie's mortgage financing should go to borrowers with income levels below the median for a given area.[138] HUD revised those goals again in 2004, increasing them to 56 percent of their overall mortgage purchases by 2008.[139] In addition, HUD required that 12 percent of all mortgage *purchases* by Fannie and Freddie be "special affordable" loans made to borrowers with incomes less than 60 percent of an area's median income, and ultimately increased that target to 28 percent for 2008.[140]

These "affordable housing" goals and other federal policies succeeded at increasing the homeownership rate from 64 percent in 1994 to an all-time high of 69 percent in 2005.[141] However, they did so at a great cost. To meet these increasingly large government mandates, Fannie and Freddie began to buy riskier loans and encouraged those who might not be ready to buy homes to take out mortgages. This GSE-manufactured demand boosted home prices to an artificially high level and fostered enthusiasm for the wave of exotic mortgage products that began to flood the market.

For example, in 1999, under pressure from the Clinton Administration to expand home loans among low- and moderate-income groups, Fannie Mae introduced a pilot program in fifteen major markets encouraging banks to extend mortgage credit to persons who lacked the proper credit histories to qualify for conventional loans. The risks of such a program should have been apparent to all. *The New York Times*, in a prescient comment on the program at the time, remarked: "In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting an economic rescue."[142]

During this period, the government also began to push Fannie and Freddie into the subprime market. In 1995, HUD authorized Fannie and Freddie to purchase subprime securities that included loans to low-income borrowers and allowed the GSEs to receive credit for those loans toward their mandatory affordable housing goals. Subprime lending, it was thought, would benefit many borrowers who did not qualify for conventional loans. Fannie and Freddie readily complied, and as a result, subprime and near-prime loans jumped from 9 percent of securitized mortgages in 2001 to 40 percent in 2006.[143]

Fannie's and Freddie's heavy involvement in subprime and Alt-A mortgages increased following

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[138] Russell Roberts, *How Government Stoked the Mania*, Wall Street Journal (Oct. 3, 2008).

[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] Steven A. Holmes¸ *Fannie Mae Eases Credit to Aid Mortgage Lending*, New York Times (Sept. 30, 1999).

[143] Russell Roberts, *How Government Stoked the Mania*, Wall Street Journal (Oct. 3, 2008).

their accounting scandals in 2003 and 2004 in an attempt to curry favor with Congress and avoid stricter regulation. Data from these critical years before the housing crisis hit show Fannie and Freddie had a large direct and indirect role in the market for risky mortgage loans. In 2004 alone, Fannie and Freddie purchased $175 billion in subprime mortgage securities, which accounted for 44 percent of the market that year. Then, from 2005 through 2007, the two GSEs purchased approximately $1 trillion in subprime and Alt-A loans, and Fannie's acquisitions of mortgages with less than 10-percent down payments almost tripled.[144]

Without question, the purchase and securitization of such loans by Fannie and Freddie was a clear signal and incentive to all loan originators to write more subprime and Alt-A loans regardless of their quality. As a result, the market share of conventional mortgages dropped from 78.8 percent in 2003 to 50.1 percent by 2007 with a corresponding increase in subprime and Alt-A loans from 10.1 percent to 32.7 percent over the same period.[145] The message, as *The New York Times* noted, was clear: "[T]he ripple effect of Fannie's plunge into riskier lending was profound. Fannie's stamp of approval made shunned borrowers and complex loans more acceptable to other lenders, particularly small and less sophisticated banks."[146] Soon, Fannie and Freddie became the largest purchasers of the higher-rated (AAA) tranches of the subprime pools that were securitized by the market. This support was essential both to form these investment pools and market them around the world. Fannie and Freddie thus played a pivotal role in the growth and diffusion of the mortgage securities that are now crippling our financial system.

Fannie and Freddie also played a leading role in weakening the underwriting standards that had previously helped ensure that borrowers would repay their mortgages. For instance, in May 2008, Fannie and Freddie relaxed the down payment criteria on the mortgages they buy, accepting loans with down payments as low as 3 percent.[147] And in recent years both companies markedly stepped up their guarantees on Alt-A loans, which often did not require the verification of income, savings, or assets for potential borrowers. Between 2005 and the first half of 2008, Fannie guaranteed at least $230 billion worth of these risky loans, more than three times the amount it had guaranteed on all past years combined. However, these poorly underwritten loans are now increasingly turning sour amid the housing downturn, especially those concentrated in California, Florida, Nevada, and Arizona, where the housing bubble was particularly large and real estate speculation was rampant.[148]

To preserve their government-granted duopoly powers and maintain unfettered access to cheap funds, Fannie and Freddie spent enormous sums on lobbying and public relations. According to the *Associated Press*, they "tenaciously worked to nurture, and then protect, their financial empires by

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[144] American Enterprise Institute, Peter Wallison and Charles Calomiris, *The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac* (Sept. 30, 2008).

[145] Joint Center for Housing Studies, *The State of the Nation's Housing* (2008) (online at www.jchs.harvard.edu/publications/markets/son2008/index.htm).

[146] Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, New York Times (Oct. 5, 2008).

[147] *Fannie Mae Relaxes Loan Down Payment Requirements*, Reuters News Service (May 19, 2008).

[148] James R. Hagerty, *Fannie, Freddie Share Spotlight in Mortgage Mess*, Wall Street Journal (Oct. 16, 2008).

invoking the political sacred cow of homeownership and fielding an army of lobbyists, power brokers and political contributors."[149] Fannie and Freddie's lobbyists fought off legislation that might shrink their investment portfolios or erode their ties to the federal government, raising their borrowing costs. In fact, Franklin D. Raines, Fannie Mae's former chairman, once told an investor conference that "we manage our political risk with the same intensity that we manage our credit and interest rate risk."[150] Raines's statement was undoubtedly true: over the past ten years, Fannie and Freddie spent more than $174 million on lobbying.[151]

As long as times were good, the GSEs were able to point to their affordable housing goals to distract attention from the inherent risk their business model posed. But, for more than a decade, alarms have been sounded about the precarious position of the GSEs. For example, in Congress, as far back as 1998, GSE reform advocates like former Rep. Richard Baker were voicing their concerns over "the risks and potential liabilities that GSEs represent."[152] In 2000, Rep. Baker demonstrated he was far ahead of the curve when he observed that by "improving the existing regulatory structure of the housing GSEs in today's good economic climate, we can reduce future risk to the taxpayer and the economy."[153] That year, the House Financial Services Committee held no fewer than six hearings on the subject of GSE reform, with at least five more over the following two years.[154] Yet from 2000 to 2005, although at least eight major GSE reform bills were introduced in Congress, Fannie and Freddie exerted enough influence that only one, the Federal Housing Finance Reform Act of 2005, ever gained enough support to be passed by either body, but it ultimately did not become law.[155]

Others in government shared similar concerns. In 1997, the General Accountability Office cautioned in its testimony before the House Committee on Banking and Financial Services that "the outstanding volume of federally assisted GSE credit is large and rapidly increasing."[156] As referenced above, then-Treasury Undersecretary Gensler testified in March 2000 that "the willingness of a GSE to purchase a mortgage has become a far more significant factor in deciding whether to originate that mortgage." Gensler went on to state that as the GSEs continue to grow, "issues of potential systemic risk and market competition become more relevant," and concluded

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[149] Tom Raum and Jim Drinkard, *Fannie Mae, Freddie Mac Spent Millions on Lobbying,* Associated Press (July 17, 2008).

[150] Wallison and Calomiris, *supra* note 144.

[151] *Fannie Mae, Freddie Mac Spent Millions on Lobbying*, Associated Press (July 17, 2008).

[152] Statement of Rep. Richard Baker (July 16, 1997) (online at financialservices.house.gov/banking/71697bak.htm).

[153] Statement of Rep. Richard Baker (March 22, 2000) (online at financialservices.house.gov/banking/32200bak.htm).

[154] House Committee on Financial Services Archived Hearings (online at financialservices.house.gov/banking/test1062.htm and financialservices.house.gov/hearings107.shtml).

[155] H.R. 1461, 109th Cong. (2005)

[156] House Financial Services Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Jim Bothwell of the General Accountability Office (July 16, 1997) (online at financialservices.house.gov/banking/71697gao.htm).

that the current moment was "an ideal time to review the supervision and regulation of the GSEs."[157] In 2004, then-Federal Reserve Chairman Alan Greenspan warned in his testimony before the Senate Banking, Housing, and Urban Affairs Committee that "the current system depends on the risk managers at Fannie and Freddie to do everything just right.... But to fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later."[158]

Outside of Congress, more red flags were flown over the obvious weaknesses of the GSE model. At another House Financial Services Committee hearing on GSEs in 2000, low-income housing advocate John Taylor of the National Community Reinvestment Coalition warned that the lack of a strong regulatory agency for Fannie and Freddie "threatens the safety and soundness of the GSEs."[159] At the same hearing, community activist Bruce Marks of the Neighborhood Assistance Corporation of America expressed his fears that without enhanced regulatory control over Fannie and Freddie, the GSEs might participate "in potentially profitable but also potentially risky investments [*sic*] schemes [that] pose potential risks for the housing and banking industry and for the economy in general."[160]

Unfortunately, despite all the evidence of systemic risk and repeated efforts to consolidate, strengthen, and increase regulatory oversight of Fannie and Freddie, calls for reform mostly fell on deaf ears. One reason why reform efforts failed was that the GSEs and their ardent defenders in Congress have spent the better part of the last decade first ignoring, then rejecting, then attempting to contradict the mounting evidence that the whole system was in danger. In 2001, Fannie Mae itself attempted to dispel the need for any change, declaring before Congress that "we operate successfully under the most rigorous of safety and soundness regimes; we are subject to a high level of market discipline and provide the marketplace with world-class disclosures."[161] Freddie Mac, for its part, used the same hearing to proclaim that their "superior risk management capabilities, strong capital position and state-of-the-art information disclosure make Freddie Mac unquestionably a safe and sound financial institution."[162]

After their credibility eroded from their accounting scandals, Fannie and Freddie increasingly relied on elected officials to fight attempts at reform. In 2003, Rep. Barney Frank famously remarked at a hearing on a pending GSE reform bill: "I believe there has been more alarm raised about potential

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[157] Gensler, *supra* note 117.

[158] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Alan Greenspan (Feb. 24, 2004) (online at www.access.gpo.gov/congress/senate/pdf/108hrg/21980.pdf).

[159] House Financial Services Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of John Taylor (June 15, 2000) (online at financialservices.house.gov/banking/61500tay.htm).

[160] House Financial Services Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Bruce Marks (June 15, 2000) (online at financialservices.house.gov/banking/62100mar.htm).

[161] House Financial Services Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of J. Timothy Howard of Fannie Mae (July 11, 2001) (online at financialservices.house.gov/media/pdf/071101th.pdf).

[162] House Financial Services Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Mitchell Delk of Freddie Mac (July 11, 2001) (online at financialservices.house.gov/media/pdf/071101md.pdf).

[GSE] un-safety and unsoundness than, in fact, exists.... I do not want the same kind of focus on safety and soundness that we have in OCC and OTS. I want to roll the dice a little bit more in this situation towards subsidized housing."[163] In 2004, Senator Chris Dodd called Fannie and Freddie "one of the great success stories of all time,"[164] while in 2005 Senator Chuck Schumer confessed that perhaps "Fannie and Freddie need some changes, but I don't think they need dramatic restructuring in terms of their mission."[165] The scope of this head-in-the-sand mentality was perhaps most completely embodied by Rep. Maxine Waters who, in 2002, categorically rejected the need for any GSE reform bill, proclaiming at a House Financial Services Committee hearing on the matter "If it is not broken, why fix it?"[166]

Although it is fair to say that no one ought to be blamed for lacking the ability to predict the future, the fact remains that for more than a decade there were clear, discernable, and announced warnings that Fannie and Freddie were growing too big and that if left unchecked would eventually collapse beneath their own weight. Too many public policy makers failed to heed those warnings, or knowingly disregarded them, and as a result taxpayers have now been left to pick up the pieces by taking on hundreds of billions of dollars worth of risk. Ironically, when the housing bubble finally burst, the resulting wave of foreclosures stemming from loans the GSEs forced into the market will likely end up reducing homeownership rates across the country, a direct contradiction to the stated purpose of Fannie and Freddie that their supporters for so long sought to advance.

Credit Rating Agencies. In order to sell subprime securities to investors, those securities first had to be rated by the credit rating agencies. Like so many other players, the credit rating agencies were caught up in the pursuit of fees generated from the real estate boom. This overwhelming desire to maximize their profits from the housing bubble is perhaps best captured by an e-mail message from a Standard & Poor's official who wrote that "We rate every deal. It could be structured by cows and we would rate it."[167] To perform their work, these agencies made extensive use of sophisticated modeling in an attempt to predict risk and the likelihood of default on loans. However, much like everyone else, the credit rating agencies falsely assumed that housing prices would never go down nationwide, which meant that their elaborate mathematical models were defective from the start. When mortgage defaults accelerated and home prices began to plummet, securities based on those loans that were once highly rated were downgraded to junk causing a wave of financial turmoil for scores of market participants at every level.

But the failure of the credit rating agencies would not have generated the disastrous consequences that it did had that failure not been compounded by further misguided government policies, which

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[163] House Financial Services Committee, Oral remarks of Rep. Barney Frank, *Hearing on H.R. 2575, The Secondary Mortgage Market Enterprises Regulatory Improvement Act* (Sept. 25, 2003) (online at financialservices.house.gov/media/pdf/108-54.pdf).

[164] *What They Said About Fan and Fred*, Wall Street Journal (Oct. 2, 2008).

[165] *Id.*

[166] House Financial Services Committee, Statement of Rep. Maxine Waters, *Hearing on Housing Government Sponsored Enterprises* (July 16, 2002) (online at financialservices.house.gov/media/pdf/071602wa.pdf).

[167] House Committee on Oversight and Government Reform, *Hearing on Credit Rating Agencies and the Financial Crisis*, 111th Cong. (Oct. 22, 2008) (online at oversight.house.gov/documents/20081023162631.pdf).

had effectively allowed the credit rating agencies to operate as a cartel. For decades, federal financial regulators have required that regulated entities heed the ratings of a select few rating agencies. For example, since the 1930s regulators have not allowed banks to invest in bonds that are below "investment grade," as determined by the select few rating agencies as recognized by the government. Although the goal of having safe bonds in the portfolios of banks may be a worthy one, bank regulators essentially delegated a major portion of their safety assessments to the opinions of these rating agencies.

This delegation of authority by bank regulators was further compounded in 1975, when the SEC also delegated its safety judgments regarding broker-dealers to the credit rating agencies. As an attempted safeguard against unqualified agencies from participating in the process, the SEC created a new Nationally Recognized Statistical Rating Organization (NRSRO) designation for qualified entities, and immediately grandfathered the three large rating agencies into this category. Following the SEC, other financial regulators soon adopted the NRSRO category for their delegations, assuming this government stamp of approval would ensure the continued quality of the ratings produced by those agencies.

Over the next 25 years, the SEC allowed only four more rating firms to achieve the NRSRO designation, but mergers among the NRSROs eligible to issue ratings recognized by the regulators shrunk the number of NRSROs back to three by year-end 2000. In 2006, Congress passed legislation (P.L. 109-291) to address part of this situation which required that the SEC cease being a barrier to entry for legitimate rating agencies, and gave it limited regulatory powers over the NRSROs. Although the SEC has designated six additional NRSROs since 2000,[168] competition and transparency in the ratings agency system remains inadequate. The SEC has never developed criteria for the designation and, once designated, NRSROs have for too long been allowed to operate without further scrutiny by the SEC for competence or accuracy.

By adopting this NRSRO system, the SEC thus established an insurmountable barrier to entry into the rating business, eliminating market competition among the rating agencies. No one could be surprised that once they were spared the market discipline, the quality of the work by protected rating agencies would diminish.

Market Behavior. Government policies that dominated and distorted the nation's housing market clearly set the stage for the housing crisis. But there were also significant mistakes made by private-sector participants at each step of the originate-to-distribute model of mortgage financing which compounded the government's failure. The benefits of this system—such a lower financing costs and the efficient distribution of risk—were significant. Over time, however, the belief that home prices would continue their relentless, upward path distorted began to distort decision making at every step along the path.

The belief that real estate prices would only go up led borrowers, originators, lenders, securitizers, and investors to conclude that these investments were risk free. As a result, the traditional underwriting standards, based on the borrower's character, capacity to repay, and the quality of collateral were abandoned. What many failed to realize was that those standards were designed not

[168] AEI Center for Regulatory and Market Studies, Lawrence J. White, *Lessons from the Debacle of '07-'08 for Financial Regulation and Its Overhaul* (Jan. 2009) (Working Paper No. 09-01).

only to protect the participants in the system from the consequences of a bubble, but also to protect the underlying financial system itself.

Borrowers. Building on that belief that housing prices could never go down, borrowers were encouraged to borrow as much as possible and buy as much house as they possible could, or else invest in other properties that could always later be resold for a profit. The result was that borrowers often ended up with mortgage products that they failed to understand, that they could not afford, or that ended up exceeding the value of the property securing the mortgage. Those concerns were less important as property values continued to rise, since borrowers could always refinance or sell to benefit from the continued appreciation of the property. However, when property values began to fall, in many cases borrowers soon realized that the economically rational course of action for them was to mail in their keys to the mortgage servicer and simply walk away. Since mortgages are non-recourse loans, doing so meant that someone else was bearing the downside risk. While the vast majority of borrowers continue to honor their commitments and pay their mortgages, for many of those who put little or no money down their mortgages became a "heads I win, tails you lose" proposition.

Mortgage Originators. Because mortgage originators were compensated on the quantity rather than the quality of loans they originated, there was little incentive to care if the loans they originated would perform. The compensation of mortgage brokers was also tied to the interest rates and fees paid by customers, which created a financial incentive for some brokers to direct borrowers to loans that may not have otherwise been in their best interest. For example, some originators who advocated for certain subprime loans received commissions that were more than twice as high as the commissions they would have received for higher-quality loans. This incentives model put a much higher premium on quantity over quality, which only diminished the safety and soundness of the entire system as even more risks were externalized while profits were internalized.

Mortgage Fraud. Integral to understanding the root causes of our current credit crisis is an acknowledgement of the rampant mortgage fraud that took place in the mortgage industry during the boom years. Fueled by low interest rates and soaring home values, the mortgage industry soon attracted both unscrupulous originators as well as disingenuous borrowers, resulting in billions of dollars in losses. As early as 2004, FBI officials in charge of criminal investigations foresaw that mortgage fraud had the potential to mushroom into an epidemic. In 2008, the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) announced a 44 percent increase in Suspicious Activity Reports from financial institutions reporting mortgage fraud, with some 37,313 mortgage fraud reports filed in 2006, and 52,868 mortgage fraud reports filed in 2007. According to FinCEN, mortgage loan fraud was the third most prevalent type of suspicious activity reported, lagging behind only money laundering and check fraud. From 2000 to 2007, FinCEN found that the reporting of suspected mortgage loan fraud had increased an astounding 1400 percent from 3,515 cases in 2000 to 52,868 cases in 2007.[169]

Unfortunately, law enforcement officials failed to stop the epidemic that they had accurately diagnosed because they did not devote adequate resources to the problem. Even though the FBI and the Justice Department are charged with the responsibility of investigating and prosecuting illegal

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[169] Financial Crimes Enforcement Network, *FinCEN Assessment Reveals Suspected Mortgage Loan Fraud Continues to Rise* (Nov. 3, 2007).

activities by originators, lenders, and borrowers, the focus of those agencies was trained on national security and other priorities. As a result, inadequate attention was paid to many of the white-collar crimes that contributed to the financial crisis. For example, by 2007, the number of agents pursuing mortgage fraud shrank to around 100.[170] By comparison, the FBI had about a thousand agents deployed on banking fraud during the S&L bust of the 1980s and 1990s. Although the FBI later increased the number of agents working on mortgage fraud to 200, others have pointed out that the agency might have averted much of the problem had it heeded its own warning about widespread mortgage fraud.[171]

<u>Lenders.</u> The belief that housing prices would rise forever, coupled with the ability to package loans for sale to investors, profoundly changed the way in which lenders underwrote loans. While underwriting had traditionally been based on the borrower's ability to repay a loan, as measured by criteria such as employment history, income, down payment, credit rating, and loan-to-value ratios, rising home prices pushed lenders to abandon these criteria. Little concern was paid to the risks of this change, given that in a worst-case scenario, servicers could always foreclose upon a property to satisfy the mortgage in full. As a result, lenders pioneered new mortgage products, such as no-doc and low-doc loans, low- and no-down-payment loans, and innovations that took rising home prices for granted. That is not to say that these exotic products are illegitimate; each may have its own appropriate use for borrowers in specific circumstances. But the broad application of these tailored products to *any* person in *any* circumstance invariably led to some borrowers receiving loans that were wholly inappropriate for their needs and capacity to repay. The ability to securitize these loans further degraded lending standards by allowing lenders to shift the risk of nonperforming mortgages onto the investors that purchased securities built around these products. In a world in which lenders could securitize even the most poorly underwritten of mortgages, what mattered most to lenders was that the loan did not default within an agreed-upon period—typically 90 or 180 days. Whatever happened after that time was someone else's problem.

<u>Securitizers.</u> Securitizers pooled mortgages of all types and quality together to create complex and often opaque structured products from these loans, such as mortgage-backed securities (MBS) and collateralized debt obligations (CDO). Securitizers knew that some portion of the mortgages they securitized would fail, but they believed that by structuring these mortgages into securities with different levels of risk, they could effectively eliminate any risk from those defaults with the guarantee of safer, performing loans. This belief grew from the assumption that others along the chain—the mortgage brokers and lenders—had adequately underwritten the loans so that any defaults would be manageable, and that housing prices would never go down. Those false assumptions belied the fact remains that in any finance model, you can never eliminate risk from a system of lending; at best, you can hope to control it by offsetting smaller sections of riskier loans with larger sections of safer loans. But that risk, while controlled, is always there, a lesson which the entire financial system is currently experiencing firsthand.

<u>Investors.</u> Like so many others, private investors in pursuit of risk-free investments failed to appreciate that if housing prices could go up, they could also go down. Rather than performing their due diligence on these mortgage-backed securities, many investors put their faith in the rating

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[170] Richard B. Schmitt, *FBI Saw Threat of Loan Crisis,* Los Angeles Times (Aug. 25, 2008).

[171] *Id.*

agencies and other proxies, and did not fully appreciate the risks they faced. Some large institutions further compounded their mistakes by holding their mortgage investments off-balance-sheet, using a loophole set forth in the regulatory capital requirements that permitted them to hold low-risk investments in special investment vehicles or conduits. And other large institutions—such as the former investment banks—availed themselves of an exemption granted by the SEC that permitted them to ignore traditional debt-to-net capital ratios—traditionally 12:1—and lever up as much as 40:1.[172] It was in this way that the once highly sought but ultimately poorly underwritten mortgages came to be the "troubled assets" that have now caused the collapse of so many in our financial system. Using first the assumption, and by 2008 the proof, that the government would deem certain institutions that had gambled on these assets to be too big or too interconnected to fail, these institutions and their creditors succeeded in making the taxpayer the ultimate bag holder for the risks they took, demonstrating yet again that the standard governing the housing boom and bust was "heads I win, tails you lose."

Mark-to-Market Accounting. The boom and bust nature of the housing and financial markets in recent years was amplified by the application of financial accounting standards that required financial institutions to write down their MBS assets to "market value" even if no market existed. As a result, institutions that held mortgage-backed securities found themselves facing the withdrawal of financing, often forcing them to sell these assets at distressed or liquidation prices, even though the underlying cash flows of these portfolios might not have been seriously diminished. In a liquidity-starved market, more and more distressed sales took place, further pulling down asset prices. These declining prices in turn created more lender demands for additional collateral to secure their loans, which in turn resulted in more distressed sales and further declines in asset values as measured on a mark-to-market basis. The result was a procyclical engine which magnified every downward price change in a recursive spiral, all of which might have otherwise been avoided had the mark-to-market standard provided better guidance on how to value assets in non-functioning markets.

Summary. The financial crisis which has unfolded over the past two years has numerous causes, and decisions made in the private sector were, in many cases, unwise. But the failure of government policy and the market distortions it caused stand at the center of the crisis. Whether by the Federal Reserve's engineering an artificially low interest rate, Congress's well-intentioned but misguided efforts to expand home ownership among less creditworthy borrowers, or the GSEs' securitization and purchase of risky mortgage-backed securities, the federal government bears a significant share of the responsibility for the challenges that confront us today.

To address these challenges, what is needed most is not simply reregulation or expanded regulation, but a modernized regulatory system that is appropriate to the size, global reach, and technology used by today's most sophisticated financial service firms. At a time when our nation's economy desperately needs to attract new investment and restore the flow of credit to where it can be used most productively, we must at all costs avoid regulatory changes under the label "reform" that have the unintended consequence of further destabilizing or constricting our economy. We should carefully consider the so-called lessons of the subprime crisis to be sure that whatever changes we adopt actually address the specific underlying causes of the crisis. These reforms should require the

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[172] Stephen Labaton, *Agency's '04 Rule Let Banks Pile on New Debt,* New York Times (Oct. 2, 2008).

participants in the financial system to bear the full costs of their decisions, just as they enjoy the benefits. They should also enhance market forces, add increased transparency, and strip away counterproductive government mandates.

Perhaps above all, we should avoid creating a system in which market participants rely upon an implicit or explicit government guarantee to bear the risk for economic transactions gone wrong. If the events of the past two years have demonstrated anything, it is that whenever government attempts to subsidize risk—from efforts to stabilize home prices to the latest government-engineered rescues of financial institutions deemed too big to fail—those efforts are usually costly, typically ineffectual, and often counterproductive. We should all know by now that whenever government subsidizes risk, either by immunizing parties from the consequences of their behavior or allowing them to shift risk to others at no cost, we produce a clear moral hazard that furthers risky behavior, usually with disastrous consequences.

Any regulatory reform program must recognize the ways in which government is part of the problem, and should guard against an overreaction that is certain to have unintended consequences. Perhaps Harvard economist Edward L. Glaeser put it best: "We do need new and better regulations, but the current public mood seems to be guided more by a taste for vengeance than by a rational desire to weigh costs and benefits. Before imposing new rules, we need to think clearly about what those rules are meant to achieve and impose only those regulations that will lead our financial markets to function better."[173]

Recommendations for Federal Regulatory Reform

Developing an agenda for reform is an inherently controversial enterprise. As with any suggested change, some will stand to benefit while others might be forced to adjust to the new realities of a different regulatory scheme. The recommendations contained here are not immune from this charge, and there will invariably be disagreement over the advantages and disadvantages of some of these proposals. However, we believe that the following recommendations remain true to our objectives of helping to make markets more competitive and transparent, empowering consumers with effective disclosure to make rational decisions, effectively policing markets for force and fraud, and reducing systemic risk.

In considering the appropriateness of each item, the devil will always be in the details regarding how any of these recommendations might be enacted. Even the best idea, if poorly implemented, would lose many of the potential benefits it might otherwise yield. Thus, these recommendations are best understood as conceptual proposals rather than specific instructions for how to improve our regulatory system.

Given the limited time and resources available to the Panel to conduct this review, in many cases there are still unanswered questions about certain aspects of these reforms and in some cases even a few qualified reservations between the authors. Nevertheless, we believe that each proposal contains clear benefits for our economy, and has been structured to avoid the potential for unintended consequences. They deserve open consideration and debate in the public arena, and the opportunity

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[173] Edward L. Glaeser, *Better, Not Just More, Regulation*, Economix (Oct. 28, 2008) (available at economix.blogs.nytimes.com).

to stand or fall on their own merits—a fitting tribute to the competitive free-market system that we are dedicated to strengthening and preserving.

1. Reform the Mortgage Finance System. The current financial crisis originated in the mortgage finance system, and much of the resulting turmoil can be traced to government interventions in the housing sector which helped fuel a classic asset bubble. Reform must begin with Fannie Mae and Freddie Mac, the GSEs whose influence drove the deterioration of underwriting standards, growth in subprime mortgage backed securities, and whose subsidized structure will result in hundreds of billions of dollars in taxpayer losses. The mortgage origination market itself should also be improved by establishing clearer standards, transparency, and enforcement.

1.1 Re-charter the housing GSEs as mortgage guarantors, removing them from the investment business.

At the center of the need for reform are Fannie Mae and Freddie Mac. As Charles Calomiris and Peter Wallison of AEI recently wrote: "Many monumental errors and misjudgments contributed to the acute financial turmoil in which we now find ourselves. Nevertheless, the vast accumulation of toxic mortgage debt that poisoned the global financial system was driven by the aggressive buying of subprime and Alt-A mortgages, and mortgage-backed securities, by Fannie Mae and Freddie Mac. The poor choices of these two GSEs—and their sponsors in Washington—are largely to blame for our current mess."[174]

The GSEs fueled the housing bubble through their ever expanding appetite for increasingly risky investments that they held in their massive portfolios. They financed these investments by borrowing at low, subsidized rates, and over time the firms became ever more dependent on their high yields to meet their earning targets. At one time, Fannie and Freddie accounted for more default risk than all other U.S. corporations combined—default risk implicitly backed by the federal government.[175] These risks to the taxpayer and the financial system were obvious, and should have been dealt with long ago.

Now that the GSEs have been taken into conservatorship, Congress has the opportunity to ensure that the damage they inflicted will never be repeated. This can be accomplished in one of two ways. One option is for Congress to phase out the GSEs' government charter and privatize them over a reasonable period of time following a model similar to that of the successful Sallie Mae privatization a decade ago. Legislation to that effect was introduced in the 110th Congress and will likely be re-introduced in the current Congress. These firms can and should compete effectively in the financial service marketplace on a level playing field without implicit or explicit taxpayer guarantees.

Alternatively, Congress could opt to recharter the GSEs as government entities whose only mandate is to guarantee and help securitize mortgages. Such a structure would remove them entirely from the investment business by prohibiting them from maintaining massive investment portfolios which have proven to be a tremendous source of systemic risk. In either alternative, Congress must avoid a

[174] *Blame Fannie Mae and Congress for the Credit Mess*, Wall Street Journal (Sept. 23, 2008).

[175] Peter Wallison, *Regulating Fannie Mae and Freddie Mac* (May 13, 2005) (online at www.aei.org/publications/pubID.22514/pub_detail.asp).

return to the flawed public purpose/private ownership model that permitted the GSEs' shareholders to profit at taxpayer expense.

1.2 Simplify mortgage disclosure.

The events of the past year have made painfully clear that the vitality of our financial system depends on a well-functioning housing market in which borrowers are able and willing to abide by the terms of the mortgage contracts into which they have entered. Unfortunately, the needless complexity involved in obtaining a mortgage appears designed to keep borrowers from fully understanding these important agreements. One way to minimize this complexity is to place essential information for borrowers in a simple, one-page document that makes clear what borrowers need to know before they enter into what will be for many the biggest financial transaction they will ever undertake. This information will permit borrowers to make an appropriate decision regarding the costs and affordability of borrowing to buy a house. This one-page document would include such items as monthly payments, interest rate, fees, and possible changes in the amount of payments for adjustable rate mortgages including the maximum possible interest rate on the loan and the maximum monthly payment in dollars. The one-page document should also include the warning that home values can go down as well as up, and that the consumer is responsible for making the mortgage payments even when the price goes down.

1.3 Establish minimum equity requirements for government guaranteed mortgages.

Because federally guaranteed mortgages put the taxpayer on the hook for any potential associated losses, the taxpayer needs to be protected from opportunistic borrowers that might otherwise walk away from a mortgage if housing prices fall. One way to protect the taxpayer is require the borrower to provide a bigger downpayment. If the taxpayer is going to take on risk, it is only fair that the borrower share in that risk as well.

FHA loans currently require at least a 3.5 percent downpayment, which is clearly too low. The minimum downpayment for all government-insured or securitized mortgages should be raised immediately to at least 5 percent, and to as much as 10 percent or higher over the next several years as market conditions improve. Lest the advocates of government-subsidized mortgages in which taxpayers bear the risk complain that 5 percent is too high, it bears pointing out that would still be *four times* as lenient as the 20 percent standard that was in place two decades ago.

1.4 Allow Federal Reserve mortgage lending rules to take effect and clarify the enforcement authority for mortgage origination standards.

In July 2008, the Federal Reserve approved a comprehensive final rule for home mortgage loans that was designed to improve lending and disclosure practices. The new Federal Reserve rule was designed to prohibit unfair, abusive or deceptive home mortgage lending practices, and it applies to all mortgage lenders, not just those supervised and examined by the Federal Reserve.

The final Federal Reserve rule adds four protections for "higher priced mortgage loans," which encompasses virtually all subprime loans. The final rule:

1. Prohibits lenders from making loans without regard to a borrower's ability to repay the loan.
2. Requires creditors to verify borrowers' income and assets.

3. Bans prepayment penalties for loans in which the payment can change during the first four years of the loan (for other higher-priced loans, a prepayment penalty period cannot last for more than two years).
4. Requires creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

In addition, the Federal Reserve issued the following protections for all loans secured by a consumer's principal dwelling:

1. Creditors and mortgage brokers are prohibited from coercing a real estate appraiser to misstate a home's value.
2. Companies that service mortgage loans are prohibited from engaging in certain practices, such as pyramiding late fees.
3. Servicers are required to credit consumers' loan payments as of the date of receipt and provide a payoff statement within a reasonable time of request.
4. Creditors must provide a good faith estimate of the loan costs, including a schedule of payments, within three days of a consumer applying for a mortgage loan.

Finally, the rule sets new advertising standards, which require additional information about rates, monthly payments, and other loan features. It also bans seven advertising practices it considers deceptive or misleading, including representing that a rate or payment is "fixed" when it can change.

These new rules represent a change in federal regulation that, regardless of whether or not one agrees with the degree to which consumers might benefit from all of these rules, will significantly alter the way in which the mortgage lending industry operates. Thus, before policymakers succumb to the desire to write additional rules and regulations, they should allow the Federal Reserve's new guidelines to take effect, monitor their impact upon mortgage origination, and clarify the authority for enforcing these new federal standards. Additionally, for these new rules to work effectively, they must be appropriately enforced. In particular, Congress should ensure that federal and state authorities have the appropriate powers to enforce these laws, both in terms of resources and actual manpower, for all mortgage originators.

1.5 Enhance securitization accountability standards.

The advent of securitization has been a tremendous boon to the mortgage industry, and countless millions of Americans have directly or indirectly benefited from the liquidity it has created. Nevertheless, the communicative nature of loans in the securitization process has helped diminish accountability among market participants, eroding the quality of many loans. Thus, to restore accountability, minimum standards should be set for all loans that are to be securitized so that securitizers retain some risk for nonperforming loans.

One proposal would be to link the compensation securitizers receive for packaging loans into mortgage-backed securities to the performance of those loans over a five year period, rather than the six-month put-back period that is the current standard. This change in compensation would thus give the securitizer an economic stake in the loan's long-term performance, aligning the securitizer's incentives with those of borrowers, investors, and the broader economy. Further, consideration should be given to applying additional limitations on the ability to securitize loans that

carry with them an explicit government guarantee.

2. Modernize the Regulatory Structure for Financial Institutions. It has become a cliché to observe that if one were designing a regulatory system from scratch, one would not come up with the patchwork system of agencies with overlapping jurisdictions and conflicting mandates. The U.S. financial regulatory system is fractured among eleven federal primary regulatory agencies in addition to scores of state regulatory agencies. The system developed over a 200-year period, during which institutions largely lacked the ability to transact business nationwide, let alone globally. Insurance, securities, and bank products were sold by different institutions, and little cross-market competition existed.

During the past thirty years, changes in size and technology have opened financial markets to buyers and sellers around the globe, transaction times are now measured in fractions of a second, and consumers have been given access to a broad range of valuable products from a single provider. Innovations in products and technology, and the global nature of financial markets are here to stay. An unnecessarily fragmented and outdated regulatory system imposes costs in several ways: inefficiencies in operation, limitations on innovation, and competition restraints that are difficult to justify.

2.1 Consolidate federal financial services regulation.
The benefits of a more unified federal approach to financial services regulation have been a constant theme in proposals for regulatory reform, some of which were under consideration and announced before the onset of the current financial crisis. For example, the Group of 30, in its very first recommendation, called for "government-insured deposit taking institutions" to be subject to "prudential regulation and supervision by a single regulator."[176] The Committee on Capital Markets Regulation has similarly called for a consolidated U.S. Financial Services Authority (USFSA) that "would regulate all aspects of the financial system including market structure and activities and safety and soundness."[177] Treasury's Blueprint for a Modernized Financial Regulatory Structure recommends a Prudential Financial Regulatory Agency (PFRA) with oversight over "financial institutions with some type of explicit government guarantee associated with their business operations."[178]

The current regulatory structure for oversight of federally chartered depository institutions is highly fragmented, with supervision spread among at least five agencies including the OCC, OTS, FDIC, National Credit Union Administration (NCUA), and the Federal Reserve. Thus, Congress should streamline oversight of these federally chartered and insured institutions.

2.2 Modernize the federal charter for insured depository institutions.
There are many kinds of insured depositories operating under unique charters including national

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[176] The Group of 30, *Financial Reform: A Framework for Financial Stability* (Jan. 15, 2009) (online at www.group30.org/pubs/recommendations.pdf).

[177] The Committee on Capital Markets Regulation, *Recommendations for Reorganizing the U.S. Financial Regulatory Structure* (Jan. 14, 2009) (online at www.capmktsreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Structure.pdf).

[178] U.S. Department of Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (Mar. 31, 2008) (online at www.ustreas.gov/press/releases/reports/Blueprint.pdf) (hereinafter "Blueprint").

banks, thrifts, state chartered members of the Federal Reserve system, state chartered nonmembers, credit card banks, federal and state credit unions, and state charted industrial loan corporations. While this vast array of institution type may have had a sound historical basis, changes in the national economy and regulatory landscape have made many of these differences functionally obsolete. Although regulatory competition can prove beneficial, the current state of duplicative banking regulation has several negative consequences as well, including unnecessary consumption of federal regulatory resources, consumer transparency, and differences in charters for largely similar institutions, which can lead to unfair competitive advantages for institutions governed by certain charters over others.

In particular, the OCC and the OTS play a very similar role for two classes of depository institutions which were once were quite different in nature, but now compete for the same customers, offering similar services. The thrift charter was originally instituted to foster the creation of financial services organizations to encourage home ownership by ensuring a wide availability of home mortgage loans. Due to a number of national policy changes that have been instituted over the last several decades to encourage homeownership and the decreasing share thrifts have of the residential mortgage market in relation to commercial banks, a unique thrift charter is no longer necessary to meet this goal. Moreover, the constraints of the thrift charter limit the diversification of thrifts' loan portfolios, which only exacerbates their ability to remain financially healthy in a weak real estate market.

Many individuals and organizations reviewing the current regulatory landscape have come to the conclusion that these agencies, and their corresponding federal thrift, and federal bank charters should be unified. In fact, back in 1994, former Federal Reserve Governor, John P. LaWare recommended combining the OCC with the OTS.[179] Similarly, in 1996, the GAO recommended that primary supervisory responsibilities of the OTS, OCC, and the FDIC be consolidated into a new, independent Federal Banking Commission.[180]

Congress should consider other steps to modernize and rationalize the federal charter system. Each class of charter should be reviewed for purpose, structure, cost and distinct characteristics. Unnecessary differences are potential sources of confusion, conflict, or taxpayer risk, and should be eliminated wherever possible.

2.3 Consolidate the SEC and CFTC.

Similar to the rationalization that is needed in banking regulation, consolidation of securities regulation in the U.S. through the merger of the SEC and the CFTC should also be undertaken. Most countries have vested the power to oversee all securities markets in one agency, and for good reason—more efficient, consistent regulation that protects consumers in a more uniform manner.

As the Treasury Blueprint states: "Product and market participant convergence, market linkages, and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient. The realities of the current marketplace have

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[179] Congressional Research Service, Walter Eubanks, *Federal Financial Services Regulatory Consolidation: An Overview*, at 14.

[180] General Accountability Office, *U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure* (Nov. 1996) (online at www.gao.gov/archive/1997/gg97023.pdf).

significantly diminished, if not entirely eliminated, the original rationale for the regulatory bifurcation between futures and securities markets."[181]

It further notes that: "Jurisdictional disputes have ensued as the increasing complexity and hybridization of financial products have made 'definitional' determination of agency jurisdiction (i.e., whether a product is appropriately regulated as a security under the federal securities laws or as a futures contract under the CEA) increasingly problematic. This ambiguity has spawned a history of jurisdictional disputes, which critics claim have hindered innovation, limited investor choice, harmed investor protection, and encouraged product innovators and their consumers to seek out other, more integrated international markets, engage in regulatory arbitrage, or evade regulatory oversight altogether."[182]

In testimony before this panel, Joel Seligman, President of the University of Rochester and a leading authority on securities law, agreed, stating, a "pivotal criterion to addressing the right balance in designing a regulatory system is one that reduces as much as is feasible regulatory arbitrage. Whatever the historical reasons for the existence of a separate SEC and CFTC, the costs of having a system where in borderline cases those subject to regulation may choose their regulator is difficult to justify."[183]

The most significant obstacle to this proposal is a political one. Congressional oversight of the two agencies is split between two committees in both the House and Senate. Consolidation would most likely mean that one committee would lose out, leading to a classic turf war. Since the nature of futures trading has evolved significantly over the years, and is now dominated by non-agricultural products, the Senate Banking and House Financial Services Committees would be the appropriate venue for all congressional securities oversight.

2.4 Establish an optional federal charter for national insurance firms.

The U.S. federal financial service regulatory infrastructure contains no agency or organization responsible for oversight of national insurance firms. As far back as 1871, regulators saw the need for uniform national standards for insurance. That year, former New York Insurance Commissioner, George W. Miller, who founded the National Association of Insurance Commissioners (NAIC), made the following statement: "The Commissioners are now fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all States, not reciprocal but identical, not retaliatory, but uniform."[184] That need for uniform standards has grown quite considerably during the past 138 years.

Congress should institute a federal charter that may be utilized by insurance firms to underwrite, market, and sell products on a national basis. While individual state insurance regulators have effectively managed state guarantee pools, as well as safety and soundness within their jurisdiction,

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[181] Blueprint, *supra* note 178.

[182] *Id.*

[183] Seligman, *supra* note 18.

[184] House Financial Services Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Testimony of Rep. Sue Kelly, *NARAB & Beyond: Achieving Nationwide Uniformity in Agent Licensing* (May 16, 2001) (online at financialservices.house.gov/media/pdf/051601ke.pdf).

they simply are not equipped to effectively oversee a global firm such as AIG, which had 209 subsidiaries at the time the federal government acted to prevent its collapse in the fall of 2008. Of the 209 subsidiaries, only twelve fell under the jurisdiction of the New York insurance commissioner, which was effectively AIG's primary regulator.[185]

By allowing insurance firms to choose between a unified national charter or maintaining operations under existing state regulation, Congress can build upon the success of state guarantee pools and maintain state jurisdiction over premium taxes. A national charter would also allow regulators to take a comprehensive view of the safety and soundness of large insurance companies and to better understand the potential risks they may pose to the strength of the broader U.S. economy. Lastly, a federal insurance regulator would be able to implement effective consumer protection, provide a clear federal voice to coordinate global insurance regulation with foreign counterparts, and ensure appropriate access for U.S. insurance companies in overseas markets.

3. Strengthening Capital Requirements and Improving Risk Management. The experience of the past two years demonstrates that our financial system was far more susceptible to shocks from the housing sector than it should have been, as a result of capital requirements that were insufficient to sustain financial institutions in time of stress. Those weaknesses were in turn further exacerbated by certain standards and practices, such as a heavy reliance on credit rating agencies and the application of mark-to-market accounting standards. To ensure that our financial system can better withstand these kinds of shocks, capital requirements should be strengthened and risk management should be enhanced.

3.1 Strengthen capital requirements for financial institutions.
One of the key lessons that has emerged from this crisis is that our financial institutions did not have adequate capital reserves to weather the turmoil in the housing market due in large part to the fact that many of the assets they held were inextricably linked to this market. One way to address this problem would be to ensure that regulators can demand that financial institutions increase their capital during flush times. Those reserves could then serve as a cushion during bad times when capital is much harder to raise. The provisioning requirements would be based on the health of the economy as a whole, thus building upon systemic strength and buffering against systemic weakness.

These countercyclical requirements would be quite different from those governing the regulatory capital that financial institutions are required to hold today. The current capital rules for lending are out of date, subject to manipulation, and do not accurately reflect the risks associated with lending activities. That said, there are also significant flaws and risks associated with the new capital rules called for by the Basel II regime.

Much of the initial modeling now available suggests that average capital requirements for banks subject to Basel II methodologies would decrease. The determination to allow the largest and most complex banks to use internally developed, historical models for the purpose of determining capital risk charges merits further and closer scrutiny. Given the current financial crisis and the federal guaranty on deposits that banks enjoy, weak capital requirements called for by Basel II could leave taxpayers on the hook yet again.

[185] John Sununu, et al., *Insurance Companies Need a Federal Regulator*, Wall Street Journal (Sept. 23, 2008) (online at online.wsj.com/article/SB122212967854565511.html).

3.2 End conduits and off-balance-sheet accounting for bank assets.
Apart from its procyclicality, Basel II permitted banks and other financial institutions to keep assets such as mortgage-backed securities off their books in conduits or structured investment vehicles on the grounds that these assets were high-quality and low-risk. Even if such an assessment were accurate—and the past two years have demonstrated that it was not—off-balance-sheet arrangements such as this permit financial institutions to game the regulatory requirements in place. These off-balance-sheet arrangements were made even more dangerous by the perception that their liabilities were implicitly guaranteed by the institutions that sponsored them, which permitted even greater leverage to build before the credit crisis hit. Thus, all assets and liabilities of a financial institution should be held on the balance sheet. If nothing else, one of the lessons of this credit crisis is the necessary steps should be taken to eliminate the notion of an "implicit guarantee" of anything in our markets.

3.3 Adjust the application of mark-to-market accounting rules.
Fair value accounting should be revised and reformed. As things stand now, the accounting rules magnify economic stress and can have serious procyclical effects. When markets turn sour or panic, assets in a mark-to-market accounting system must be repeatedly written down, causing financial institutions to appear weaker than they might otherwise be. A superior accounting system would not require financial institutions to write down their assets at a time when prices have fallen precipitously during a rapid downturn as in the collapse of a bubble. Thus, alternative asset valuation procedures—such as discounted cash flow—should be used, and it should be made easier for financial institutions to declare assets as held-to-maturity during these periods. In normal markets, prices will fluctuate within a limited range, and will rise slowly if at all. But in times of crisis—such as the one we are facing—write-downs beget fire sales, which beget further write-downs.

In late September 2008, the SEC released guidelines that allowed companies greater flexibility in valuing assets in a nonfunctioning market. Such changes are encouraging. Moving forward, accounting rules have to provide transparency and the most accurate depiction of economic reality as possible. It is for the best that the development of accounting rules should not be conducted in the political arena. However, it is clear that the rules need to be improved, taking into account the lessons learned from recent events. Ultimately, greater transparency and accuracy in accounting standards are necessary to restore investor confidence.

3.4 Eliminate the credit rating agencies' cartel.
The failure of the credit rating agencies in the financial crisis could not be more apparent. Much like the GSEs, the credit rating agencies benefited from a unique status conferred upon them by the government. They operated as an effective oligopoly to earn above-market returns while being spared market discipline in instances where their ratings turned out to be inaccurate. The special status of the rating agencies should be ended so as to open the ratings field to competition from new entrants and to encourage investors and other users of ratings not to rely upon a ratings label as a substitute for due diligence.

3.5 Establishing a clearinghouse for credit default swaps
Despite recent criticism heaped upon them, the thriving credit default swaps (CDS) market demonstrates the valuable role that innovation plays in improving the functioning of our financial markets. Through the use of CDS, investors and lenders can hedge their credit exposures more

efficiently, thereby freeing up additional credit capacity, which has in turn enabled banks to expand credit facilities and reduce costs of funds for borrowers. CDS have enabled asset managers and other institutional investors to adjust their credit exposures quickly and at a lower cost than alternative investment instruments, and have enabled market participants to better assess and manage their credit. CDS have also enabled market participants to value illiquid assets for which market quotations might not be readily available.

Despite their many benefits and the crucial role that CDS have come to play in the financial system in managing risk, legitimate concerns have arisen regarding the transparency of the system and the management of counterparty risk. To address these concerns, the Federal Reserve, the CFTC, and the SEC have recently agreed on general principles to provide consistent oversight of one or more clearinghouses for CDS trades. The proposed guidelines will result in more public information on potential risks being provided to counterparties and investors, as well as the mitigation of any systemic losses caused by potential fallout from the CDS market.

These principles constitute a valuable first step in creating a CDS clearinghouse and will further improve a product that has thus far proven invaluable in managing risk when prudently used. A properly structured clearinghouse, capitalized by its members, spreads the risk of default and fosters market stability by acting as the sole counterparty to each buyer and seller. A clearinghouse will allow performance risk to be isolated to net exposure, rather than related to the much larger gross positions in the market.

A number of reforms have already reduced risk in the CDS market. The CDS market has already dramatically increased margin, mark-to-market and collateral requirements for hedge funds and other investment institutions on the other side of any trade. And at the behest of the New York Federal Reserve and other regulators, record keeping has improved; trade confirmations, for example, now must be tendered quickly. Buyers of CDS protection now also must formally approve any switch of their coverage from one insurer to another. Previously, the insured might not know who was its latest counterparty.

A clearinghouse, however, may not be appropriate for the most complex and unique over-the-counter derivatives. Moreover, because a clearinghouse arrangement spreads risk to other market participants, it could encourage excessive risk taking by some, especially if risks associated with more exotic products are not priced properly due to information asymmetry. Policy makers and regulators should continue to work with the private sector to facilitate a CDS clearinghouse that provides greater transparency and reduces systemic risk in the broader financial markets.

4. Address Systemic Risk.

4.1 Consolidate the Work of the President's Working Group and the Financial Stability Oversight Board to create a cross-agency Panel for identifying and monitoring systemic risk.

Systemic risk can materialize in a broad range of areas within our financial system: at both depository and nondepository institutions, within either consumer or commercial markets, as a result of poor fiscal or monetary policy, or initiated by domestic or global activity. Thus, it is impractical, and perhaps a dangerous concentration of power, to give one single regulator the power to set or modify any and all standards relating to such risk. Systemic risk oversight and management must be a collaborative effort, bringing together the leading authorities for addressing safety and soundness, managing economic policy, and ensuring consumer protection.

One alternative to a single systemic risk regulator would be to develop a panel of federal agencies to consider jointly these important questions. The Presidential Working Group (PWG) was established after the stock market crash of 1987 to make recommendations for enhancing market integrity and investor confidence. Similarly, the Financial Stability Oversight Board (FSOB) was established under the EESA in 2008 as a cross-agency group to oversee the Troubled Assets Relief Program (TARP) and evaluate the ways in which funds might be used to enhance market stability. Both groups include the Treasury, the Federal Reserve, and the SEC. The PWG adds the CFTC, while the FSOB includes the Housing Secretary and the Director of the Federal Housing Finance Agency (FHFA), which oversees the housing GSEs.

While the quarterly evaluation of TARP operations provided by the FSOB will continue through the life of the program, the broad mission and structure of these two organizations are, in many respects, redundant. Moreover, they represent the collaborative, cross-agency structure that would best provide insight in to the practices, policies, and trends that might contribute to systemic risk within the financial system.

By combining and refocusing the efforts of these two organizations, Congress can establish a body with the requisite tools to identify, monitor, and evaluate systemic risk. The panel can make specific legislative recommendations, as well as encourage immediate action consistent with the significant regulatory powers already vested in its members.

A Panel comprised of the Federal Reserve, the Treasury, the primary regulator of federally insured depository institutions, and the combined SEC/CFTC, would have authority to access detailed financial information from regulated financial institutions, require disclosure of information necessary to evaluate risk, and require that financial institutions to undertake corrective actions to address systemic weakness.

Disagreement With Panel Regulatory Recommendations

In far too many areas, the Panel Report offers recommendations or policy options that are rife with moral hazard and the potential for unintended consequences. Given that some of the principal causes of this financial crisis include the moral hazard embedded in the charter of Fannie Mae and Freddie Mac, market-distorting housing mandates like the CRA, and the unintended consequences of a credit rating agency certification process which restricted competition, we must be particularly mindful of these risks. In some cases, a highlighted action may appear benign, but the more detailed summary includes proposals or policy “options” that cannot be supported.

Other sections, such as those dealing with systemic risk and leverage, include highly proscriptive proposals that would be difficult, if not impossible to implement outside the walls of academia. Finally, the Panel Report all but ignores the critical role played by the Federal Reserve’s highly accommodative monetary policy, and the host of troubles created by the government charter and implicit backing of the GSEs. Avoiding discussion of such important components of the crisis will inevitably lead one to set the wrong priorities for reform. While not exhaustive, the following represents a list of the more significant disagreements held with the Panel Recommendations for Improvement:

1. The Panel Report calls for a “body to identify and regulate institutions with systemic significance” and “[i]mpose heightened regulatory requirements for systemically significant

institutions." The recommendations suggest that firms designated as such are to be subjected to unique capital and liquidity requirements, as well as special fees for insurance. Although it is important that regulators work to identify, monitor, and address systemic risk, such explicit actions are more likely to have unintended and severe negative consequences.

Publicly identifying "systemically significant institutions" will create significant moral hazard, the cost of which will far outweigh any potential regulatory benefits. Consider the two possible effects of being identified as such. First, in one case, the cost and burdens of additional capital and regulatory requirements (as recommended) place a firm at a competitive disadvantage relative to its peers. Thus, the competitive strength of a systemically significant firm is impaired, raising the probability of a business failure—an undesirable outcome.

In the alternative case, the market may view designation as a *de facto* guarantee of public support in during times of financial stress. The firm attains a beneficial market status, and enjoys advantages such as a lower cost of capital in the public markets. The costs of failure are thus socialized, while profits remain in private hands (much as was the case for the GSEs, Fannie Mae and Freddie Mac). Recent events make clear that this scenario is perhaps an even more undesirable outcome than the former.

Unfortunately, these are the only two practical outcomes of any designation—either markets will view it as a competitive burden, or as a competitive advantage. It is unrealistic to argue that such a "significant'" designation would be viewed as competitively neutral. Moreover, it is unreasonable to assume that government will manage the potential moral hazard more effectively than was done in the case of the GSEs.

2. The Panel Report recommends the formation of "a single federal regulator for consumer credit products." Such an action would isolate the activity of creating and enforcing consumer protection standards from oversight of safety and soundness in financial institutions.

The regulation of any federal financial firm requires the balancing of multiple policy choices and should be done by one institution. Experience has shown us with the GSE model that having two stated goals, one for safety and soundness and one for social policy, inherently will lead to conflict. Since the new consumer product regulator would be able to affect all financial institutions, eventually those rules will conflict with a bank's profitability, capital levels, and ultimately, solvency. Under this Panel proposal, an independent agency would have power to impose regulations that could well undermine the health of banks, but would not be responsible for the safety and soundness of those banks.

This balance is of particular significance within institutions that have been provided with explicit taxpayer funded guarantees, such as FDIC Insurance. By placing both responsibilities with the same regulator, greater assurance is provided that taxpayer interests will not be placed in jeopardy by regulations that unnecessarily weaken capital or competitive position.

3. The Panel Report broadly calls for the adoption of new regulations to "to curtail leverage." While the recommendation implies that regulators across the spectrum of financial institutions set inappropriate standards for leverage, this simply is not the case.

Few, if any, observers of the current crisis have argued that capital standards set by the FDIC and

other federal and state banking regulators overseeing depository institutions were set at dangerously low levels. To the extent that FDIC insured institutions have become troubled, it has been largely the results of deteriorating loan quality. Thousands of such institutions across the country remain strong and healthy. Raising their capital standards now in an effort to "curtail leverage" would be highly procyclical and would sharply limit the availability of credit for consumers and businesses.

Without question, there were some financial firms, notably non-depository institutions such as broker-dealers, that were allowed to raise their leverage ratios substantially in recent years. The SEC ruling issued in 2004, which allowed alternative net capital requirements for broker-dealers, contributed significantly to the failures of both Bear Sterns and Lehman Brothers. The regulatory decision to rely on internal models for risk weighting assets appears, in retrospect, to have been a major miscalculation.

Moreover, prudent regulators may wish to consider adopting capital policies that are more counter-cyclical as well, to encourage the building of stronger reserves during good times and ensure greater stability in periods of financial stress. Blanket mandates to "curtail leverage," however, will only restrict access to credit and limit successful lending models where they are needed most.

4. The Panel Report argues that: "Hedge funds and private equity funds are money managers and should be regulated according to the same principles that govern the regulation of money managers generally." The recommendation fails to recognize the important distinctions between investment firms and fails to explain why these distinctions should be ignored.

There exist clear and dramatic differences between managing capital allocation on behalf of a $5 billion dollar pension fund, and investing funds placed in a personal IRA or 401k. Under current law, private equity, venture capital, and hedge funds may not be marketed to retail investors. While they remain subject to all regulations regarding trading and exchange rules and regulations, they are not subject to the marketing and registration requirements designed to protect smaller, unsophisticated investors, because they do not serve that market.

Suggesting that more regulation should be imposed on these entities in light of the current crisis ignores the fact that even under the tremendous financial upheaval of the past year, no major hedge funds have declared bankruptcy, and taxpayers have been exposed to no losses resulting from failed hedge fund or private equity investment activity.

Finally, it may be worth noting that several high-profile hedge fund management firms were among the first to publicly and accurately assess the dangers inherent in the housing finance system, mortgage backed securities, and Fannie Mae and Freddie Mac.

5. The Panel Report call for Congress to "[e]liminate federal pre-emption of application of state consumer protection laws to national banks." Such a change would effectively defeat the purpose of a uniform federal charter for insured depository institutions.

As previously mentioned, the regulation of any federal financial firm requires the balancing of multiple policy choices and should be done by one institution. By giving state regulators the power to affect bank profitability, capital levels, and solvency standards, this proposal would greatly enhance risk and curtail innovation in our system. Under the Panel proposal, states would not be responsible for the safely and soundness of federally chartered banks, but would have authority to

impose regulations that could well undermine the health of those banks.

Allowing states to impose their own consumer protection laws also undermines the fundamental purpose of a federal banking charter. Congress established federal financial charters to enable firms to offer products and services on a uniform national basis. Standardization of products and services lowers costs, and acts as an incentive for innovation by enabling new products to be brought to market sooner. Allowing every state to impose its own set of product or business standards on national banks would represent a step backwards, away from strong well-balanced federal regulation that allows national firms to compete effectively with global peers.

6. The Panel Report calls for new "tax incentives to encourage long–term-oriented pay packages," which would represent an unprecedented intervention in the operation of private employment markets.

The Federal Government should not structure the tax code to reward, penalize or manipulate compensation. Congress attempted to do this in the Omnibus Reconciliation Act of 1993 (P.L. 103-66), which contained the so-called "Million-Dollar Pay Cap" (Sec. 13211). It not only failed to achieve the stated goals of its authors, it had unintended consequences: by raising taxes on cash compensation, more firms chose to compensate executives with large packages of stock options, resulting in numerous high-profile multimillion-dollar "pay days" when the options were exercised.

Compensation committees should establish executive pay policies that are fair, encourage sound long-term decisions, and are fully disclosed to shareholders and the public. Using the tax code to design an ideal pay structure will certainly have unintended negative consequences, as has been demonstrated by past action, nor will it be successful in deterring companies from paying their employees what they wish to attract and retain the best available talent.

7. The Panel Report calls upon Congress to "consider creating a Credit Rating Review Board" which would be given the sole power to approve ratings required by pension fund managers and others to purchase investment securities.

The credit rating system is badly in need of reform, but the main weakness in the current system has been the existence and operation of, effectively, a duopoly—a status created by the restraints of the government certification process. Giving a government operated Credit Review Board the power to sign off on all credit ratings brings the system to a single point of failure, and becomes a significant source of systemic risk. Improving the credit rating system will require more competition, an elimination of conflicts, and accountability. Regulators can facilitate this accountability by tracking the default levels of rated securities over time, and publicly disclosing the best and worst rating agency performance.

Appendix: Other Reports on Financial Regulatory Reform

Other reports on financial regulatory reform that are comparable to this report in various respects are itemized in the following list and then briefly summarized in the table below. Reports in both list and table appear in reverse chronological order by the name of the issuing organization. In the list, each item is followed by a short-form reference in brackets.

Group of 30 (G-30). *Financial Reform: A Framework for Financial Stability*. January 15, 2009. http://www.group30.org/pubs/pub_1460.htm.
[G-30 January 2009]

Committee on Capital Markets Regulation. *Recommendations for Reorganizing the U.S. Financial Regulatory Structure*. January 14, 2009. http://www.capmktsreg.org/.
[CCMR January 2009]

Robert Kuttner, Prepared for Dēmos. *Financial Regulation After the Fall*. January, 2009. http://www.demos.org/pubs/reg_fall_1_8_09%20(2).pdf).
[Kuttner/Dēmos January 2009]

United States Government Accountability Office (GAO). *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System.* (GAO-09-216). January, 2009. http://www.gao.gov/new.items/d09216.pdf.
[GAO January 2009]

North American Securities Administrators Association. *Proceedings of the NASAA Financial Services Regulatory Reform Roundtable*. December 11, 2008. http://www.nasaa.org/content/Files/Proceedings_NASAA_Regulatory_Reform_Roundtable.pdf.
[NASAA December 2008]

President's Working Group On Financial Markets (PWG). *Progress Update on March Policy Statement on Financial Market Developments*. October, 2008. http://www.ustreas.gov/press/releases/reports/q4progress%20update.pdf
[PWG October 2008]

Group of 30 (G-30). *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*. October, 2008. http://www.group30.org/pubs/pub_1428.htm.
[G-30 October 2008]

Financial Stability Forum (FSF). *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience and the Follow-Up on Implementation*. April 7, 2008 and October 10, 2008. http://www.fsforum.org/about/overview.htm.
[FSF April 2008 and October 2008]

Basel Committee on Banking Supervision. *Principles for Sound Liquidity Risk Management and Supervision*. September, 2008. http://www.bis.org/publ/bcbs144.htm.
[Basel Liquidity Risk Management September 2008]

Professor Lawrence A. Cunningham, for Council of Institutional Investors. *Some Investor Perspectives on Financial Regulation Proposals*. September, 2008. http://www.cii.org/UserFiles/file/Sept2008MarketRegulation.pdf. [Cunningham/CII September 2008]

The Counterparty Risk Management Policy Group (CRMPG) III. *Containing Systemic Risk: The Road to Reform*. August 6, 2008. http://www.crmpolicygroup.org/docs/CRMPG-III.pdf. [CRMPG III August 2008]

Institute of International Finance (IIF). *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Financial Services Industry Response to the Market Turmoil of 2007–2008*. July, 2008. http://www.ieco.clarin.com/2008/07/17/iff.pdf. [IIF July 2008]

Securities Industry and Financial Markets Association (SIFMA). *Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force*. July 2008. http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf. [SIFMA July 2008]

United States Securities and Exchange Commission Staff. *Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies*. July, 2008. http://www.sec.gov/news/studies/2008/craexamination070808.pdf. [SEC Staff July 2008]

International Organization of Securities Commissions Technical Committee (IOSCO). *Report On the Subprime Crisis*. May, 2008. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf. [IOSCO Subprime Crisis May 2008]

International Organization of Securities Commissions Technical Committee (IOSCO). *The Role of Credit Rating Agencies in Structured Finance Markets*. May, 2008. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf. [IOSCO CRA May 2008]

President's Working Group on Financial Markets (PWG). *Policy Statement on Financial Market Developments*. March, 2008. http://www.ustreas.gov/press/releases/hp871.htm. [PWG March 2008]

Senior Supervisors Group (SSG). *Observations on Risk Management Practices in the Recent Market Turbulence*. March 6, 2008. http://www.newyorkfed.org/newsevents/news/banking/2008/ssg_risk_mgt_doc_final.pdf. [SSG March 2008]

United States Department of the Treasury. *Blueprint for a Modernized Financial Regulatory Structure*. March, 2008. http://www.treas.gov/press/releases/reports/Blueprint.pdf. [Treasury March 2008]

Financial Services Roundtable (FSR). *The Blueprint for U.S. Financial Competitiveness*. November, 2007, http://www.fsround.org/cec/blueprint.htm.
[FSF April 2007 and October 2007]

United States Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century. *Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century*. March 2007. http://www.uschamber.com/publications/reports/0703capmarketscomm.htm.
[Chamber of Commerce March 2007]

Mayor Michael Bloomberg and Senator Charles Schumer, with McKinsey & Company and New York City Economic Development Corporation. *Sustaining New York's and the US' Global Financial Services Leadership.* January, 2007. http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.
[Bloomberg/Schumer January 2007]

Committee on Capital Markets Regulation (CCMR). *Interim Report of the Committee on Capital Markets Regulation*. November, 2006. http://www.capmktsreg.org/.
[CCMR November 2006]

Name of Issuer	**Group of 30 (G-30)**
Name of Report	*Financial Reform: A Framework for Financial Stability*
Date of Report	January 15, 2009
Background of Issuer	"The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers." http://www.group30.org/

Objectives of the Report
The report considers how the financial system should be organized after the present crisis. It seeks a consensus on future arrangements that will be useful both in the long term and in restoring confidence in the present. The report examines the policy issues related to redefining the scope and boundaries of prudential regulation; the structure of prudential regulation, including the role of central banks, the implications for the workings of "lender-of-last-resort" facilities and other elements of the official "safety net," and the need for greater international coordination; improvements in governance, risk management, regulatory policies, and accounting practices and standards; and improvements in transparency and financial infrastructure arrangements.

Name of Issuer	**Committee on Capital Markets Regulation**,
Name of Report	Recommendations for Reorganizing the U.S. Financial Regulatory Structure
Date of Report	January 14, 2009
Background of Issuer	The Committee on Capital Markets Regulation is a not-for-profit research organization addressing issues in United States capital

	markets. Its membership, focus, and activities are described at http://www.capmktsreg.org/index.html.

Objectives of the Report
Its 2009 report recommends "sweeping" changes in regulatory organization. The report focuses on the federal regulatory structure, not discussing—but stating the potential for commentary in a future report—on the role or states or self-regulatory organizations, internal agency organization, and global coordination.

Name of Issuer	**Robert Kuttner, prepared for Dēmos**
Name of Report	*Financial Regulation After the Fall*
Date of Report	January 9, 2009
Background of Issuer	Robert Kuttner, founder and co-editor of *The American Prospect*, prepared this paper for Dēmos. Dēmos is a non-partisan public policy research and advocacy organization headquartered in New York City.

Objectives of the Report
Kuttner writes that "This paper is an effort to catalogue abuses and suggest ways to think about regulatory remedies. Because of the continuing undertow of the market-fundamentalist ideology and the continuing political power of the very people and institutions that brought us this catastrophe, some of the most robust remedies will seem at the margins of mainstream debate. But, in order to move them to center stage where they can gain a proper hearing, it is necessary to at least inject these ideas into discussion."

Name of Issuer	**United States Government Accountability Office (GAO)**
Name of Report	*Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory*

	System (GAO-09-216)
Date of Report	January, 2009
Background of Issuer	The United States Government Accountability Office (GAO) is an independent, nonpartisan agency that works for Congress. Its work is done at the request of congressional committees or subcommittees or is mandated by public laws or committee reports, and the GAO also undertakes research under the authority of the Comptroller General. http://www.gao.gov/about/index.html

Objectives of the Report
The Government Accountability Office report describes the origins of the current financial regulatory system, market developments and changes shaping the regulatory systems, and suggests issues to be addressed in designing and evaluating proposals for change. It describes structural gaps and stresses in the system rather than evaluates agencies' implementations of regulatory programs.

Name of Issuer	**North American Securities Administrators Association**
Name of Report	*Proceedings of the NASAA Financial Services Regulatory Reform Roundtable*, *December 11, 2008*
Date of Report	December 11, 2008
Background of Issuer	Organized in 1919, the North American Securities Administrators Association (NASAA) is the oldest international organization devoted to investor protection. NASAA is a voluntary association with a membership consisting of securities administrators in the fifty states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico http://www.nasaa.org/home/index.cfm

Objectives of the Report

This document summarizes statements by state securities regulators in a discussion of regulatory reform designed to provide advice to the incoming administration of President Obama. The report stems from the NASAA's core principles for regulatory reform, found at http://www.nasaa.org/issues___answers/legislative_activity/9775.cfm.

Name of Issuer	**President's Working Group On Financial Markets (PWG)**
Name of Report	*Policy Statement on Financial Market Developments and Progress Update on March Policy Statement on Financial Market Developments*
Date of Report	March, 2008 and October, 2008
Background of Issuer	The President's Working Group on Financial Markets (PWG) consists of the Department of the Treasury, the Federal Reserve, Securities and Exchange Commission, and the Commodity Futures Trading Commission. The Treasury Secretary chairs the group. The PWG worked with the Office of the Comptroller of the Currency and Federal Reserve Bank of New York in preparing these reports.

Objectives of the Report
These policy statements offered recommendations to improve the future state of U.S. and global financial markets. The March statement addressed the causes of the market crisis and offered proposals to mitigate systemic risk, restore investor confidence, and facilitate stable economic growth. The October statement reviewed interim developments and provided a progress report on these initiatives.

Name of Issuer	**Group of 30 (G-30)**
Name of Report	*The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*

Date of Report	October, 2008
Background of Issuer	"The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers." http://www.group30.org/

Objectives of the Report
In July 2007, the Group of 30 (G-30) commenced a seventeen-jurisdiction review of financial regulatory approaches. The G-30 Report outlines four approaches to financial supervision in use in jurisdictions around the world and assesses the strengths and weaknesses of each approach. Work on the October 2008 Report began before the current crisis, and thus it does not assess how different regulatory regimes performed in response to the crisis.

Name of Issuer	**Financial Stability Forum (FSF)**
Name of Report	*Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience and the Follow-Up on Implementation*
Date of Report	April 7, 2008 and October 10, 2008
Background of Issuer	The Financial Stability Forum (FSF), first convened in 1999, consists of senior representatives of national financial authorities, international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. The FSF is serviced by a secretariat housed at the Bank for International Settlements. The FSF assesses vulnerabilities in the international financial system, identifies and oversees appropriate responses, and improves coordination and information exchange among the various authorities responsible for financial stability. It seeks to strengthen financial systems and the stability of international financial

	markets, and any recommended changes are enacted by the relevant national and international financial authorities. http://www.fsforum.org/about/overview.htm

Objectives of the Report
In October 2007, the G7 Ministers and Central Bank Governors asked the Financial Stability Forum to analyze the causes and weaknesses producing the financial crisis and make recommendations by April 2008 to increase the resilience of markets and institutions. Collaborating in the work were the Basel Committee on Banking Supervision (BCSB), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum, the International Accounting Standards Board (IASB), the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and national authorities in key financial centers. The FSF also drew on private sector participants. The follow-up report in October reviewed the implementation of the recommendations made in the April report.

Name of Issuer	**Basel Committee on Banking Supervision**
Name of Report	*Principles of Sound Liquidity Risk Management and Supervision*
Date of Report	September, 2008
Background of Issuer	The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. http://www.bis.org/bcbs/

Objectives of the Report

Citing its review of banks' response to recent market turmoil, the committee faulted banks for failing to pay attention to basic principles of liquidity risk management. The committee found that many banks did not have an adequate framework in place to account for liquidity risks posed by products and business lines, causing incentives to be "misaligned" with overall risk tolerance. In an attempt to "underscore the importance of establishing a robust liquidity risk management framework that is well integrated into the bank-wide risk management process," the report contains principles and related best practices recommendations designed to increase banks' resilience to liquidity stress.

Name of Issuer	**Professor Lawrence A. Cunningham, for Council of Institutional Investors**
Name of Report	*Some Investor Perspectives on Financial Regulation Proposals*
Date of Report	September, 2008
Background of Issuer	The Council of Institutional Investors (CII) is a nonprofit association of public, union, and corporate pension funds with combined assets that exceed $3 trillion. Member funds are major long-term shareowners. Professor Lawrence A. Cunningham, author of the paper, is Henry St. George Tucker III Research Professor of Law at George Washington University Law School.

Objectives of the Report
Professor Lawrence A. Cunningham of George Washington University Law School wrote this paper for the Council of Institutional Investors (CII). It assesses, "from an investor's perspective," mutual recognition in securities regulation, integration of securities and futures regulation, and a model of financial regulation relying on a single agency to oversee all financial markets. The analysis examines the U.S. Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure*.

Name of Issuer	**The Counterparty Risk Management Policy Group (CRMPG) III**

Name of Report	*Containing Systemic Risk: The Road to Reform*
Date of Report	August 6, 2008
Background of Issuer	The Counterparty Risk Management Policy Group III is a group of senior officials and staff from a number of major financial institutions. This is the third report prepared by the CRMPG focusing on improving risk management and financial infrastructure, with the earlier reports issued in 1999 and 2005.

Objectives of the Report
The CRMPG sets out a series of private initiatives intended to complement official oversight to help contain systemic risk. These include reconsideration of accounting standards for consolidation under U.S. GAAP of entities currently off balance sheet coming on balance sheet; measurement and management of high-risk financial instruments; improvements in risk monitoring and management; and measures to strengthen the resiliency of financial markets generally and the credit markets in particular, with a special emphasis on OTC derivatives and credit default swaps. The report also highlights important emerging issues.

Name of Issuer	**Institute of International Finance (IIF)**
Name of Report	*Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Financial Services Industry Response to the Market Turmoil of 2007–2008*
Date of Report	July, 2008
Background of Issuer	The Institute of International Finance, established in 1983 in response to the international debt crisis, is a global association of financial institutions. Its members include most of the world's largest commercial and investment banks and a growing number of insurance companies and investment management firms. http://www.iif.com/

Objectives of the Report
The IIF Committee on Market Best Practices set out principles of conduct, best practice recommendations, and considerations for officials. The report examined risk management; compensation policies; liquidity risk; structured vehicles such as conduits and securitization; valuation; credit underwriting, ratings, and investor due diligence in securitization markets; and transparency and disclosure. The committee suggested that rigorous self-assessment and monitoring are necessary to improve conduct in each of these areas. However, higher industry standards can only work within an effective and efficient regulatory framework.

Name of Issuer	**Securities Industry and Financial Markets Association (SIFMA)**
Name of Report	*Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force*
Date of Report	July, 2008
Background of Issuer	The Securities Industry and Financial Markets Association (SIFMA) is a principal trade association of the financial services industry. Its membership consists of securities firms, banks, and asset managers. Its stated mission is to promote policies and practices to expand and improve financial markets, help to create new products and services and create efficiencies for member firms, and preserve and enhance the public's trust and confidence in financial markets and the industry.

Objectives of the Report
The Securities Industry and Financial Markets Association (SIFMA) Credit Rating Agency Task Force is a global task force formed to examine credit ratings and credit rating agencies (CRAs). It includes experts in structured finance, corporate bonds, municipal bonds, and risk and members from the United States, Europe, and Asia. The President's Working Group on Financial Markets (PWG) designated the task force as the private-sector group to provide the PWG with industry recommendations on credit rating matters. The task force identified the credit-rating-related causal variables contributing to the current crisis; ranked, in order of importance designated by its members, sixteen key issues; and addressed those issues in its recommendations.

Name of Issuer	**United States Securities and Exchange Commission Staff**
Name of Report	*Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies*
Date of Report	July, 2008
Background of Issuer	United States Securities and Exchange Commission exercises regulatory jurisdiction over the credit rating process.

Objectives of the Report
In August 2007, the staff of the Securities and Exchange Commission conducted examinations of three leading credit rating agencies (CRAs) to review their role in market turmoil. The staff focused on the rating agencies' activities with respect to subprime residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) linked to RMBSs. In July 2008, the staff issued its summary report on issued identified by those examinations.

Name of Issuer	**International Organization of Securities Commissions Technical Committee (IOSCO)**
Name of Report	*Report on the Subprime Crisis*
Date of Report	May, 2008
Background of Issuer	The member agencies of the International Organization of Securities Commissions cooperate to develop and maintain high standards of regulation; exchange information on their respective experiences in order to promote the development of domestic markets; seek to establish standards and an effective surveillance of international securities transactions; and provide mutual

	assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

Objectives of the Report
IOSCO's May *Report on the Subprime Crisis* identified causes of the market crisis and made recommendations to mitigate the current crisis and prevent such breakdowns in the future.

Name of Issuer	**International Organization of Securities Commissions Technical Committee (IOSCO)**
Name of Report	*The Role of Credit Rating Agencies in Structured Finance Markets*
Date of Report	May, 2008
Background of Issuer	The member agencies of the International Organization of Securities Commissions cooperate to develop and maintain high standards of regulation; exchange information on their respective experiences in order to promote the development of domestic markets; seek to establish standards and effective surveillance of international securities transactions; and provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

Objectives of the Report
Because of apparent failures in the credit rating process, the IOSCO Technical Committee asked its Credit Rating Agency Task Force to analyze the role CRAs play in structured finance markets and to recommend changes to the IOSCO CRA Code of Conduct as necessary. The May 2008 Report and related revisions to the IOSCO Code of Conduct for CRAs are the outgrowth of this effort.

Name of Issuer	Senior Supervisors Group (SSG)
Name of Report	*Observations on Risk Management Practices in the Recent Market Turbulence*
Date of Report	March 6, 2008
Background of Issuer	The Senior Supervisors Group is composed of seven international supervisory agencies, including the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, the U.K. Financial Services Authority, and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Federal Reserve.

Objectives of the Report
In 2007 the Financial Stability Forum, which promotes international financial stability through information exchange and regulatory cooperation, initiated a study of risk management practices by firms preceding and during the financial crisis. The Senior Supervisors Group (SSG) surveyed eleven global banking organizations and securities firms in 2007 regarding their oversight and risk management, meeting with select firms' senior management in November 2007 and industry representatives in February 2008. Based principally on a survey and access to information on the firms' operations, it identified risk management practices differentiating firms' performance in weathering the crisis. Firms varied in how effectively their senior management team, business line risk owners, and control functions worked together to manage risks.

Name of Issuer	United States Department of the Treasury
Name of Report	*Blueprint for a Modernized Financial Regulatory Structure*

Date of Report	March, 2008
Background of Issuer	The Department of the Treasury plays a central role in U.S. financial regulatory policy. For example, the Secretary of the Treasury chairs the President's Working Group on Financial Markets (PWG), currently consisting of the Treasury, Federal Reserve, Securities and Exchange Commission, and Commodity Futures Trading Commission.

Objectives of the Report
The Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure* calls for reorganization of the financial regulatory system. The work on the report began before the market downturn, so the *Blueprint* does not focus on many of the specific problems surfaced by the financial crisis, nor limits itself to proposing "emergency relief" for current economic ills. Rather, the *Blueprint* focuses on what it describes as regulatory gaps, redundancies and inefficiencies in the U.S. regulatory system and proposes broad reforms to the domestic regulatory regime.

Name of Issuer	**Financial Services Roundtable (FSR)**
Name of Report	*The Blueprint for U.S. Financial Competitiveness*
Date of Report	November, 2007
Background of Issuer	The Financial Services Roundtable is an organization of banking, securities, insurance, and investment organizations.

Objectives of the Report
The FSR Blue Ribbon Commission on Enhancing Competitiveness developed a set of Guiding Principles for what it called a more balanced, consistent, and predictable legal and financial regulatory system; articulated a financial services reform agenda based upon the application of the Guiding Principles to important legal and regulatory issues; and proposed changes in systems of chartering for existing financial services institutions. The Blueprint

for U.S. Financial Competitiveness proposed ten policy reforms.

Name of Issuer	**United States Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century (the Commission)**
Name of Report	*Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century*
Date of Report	March, 2007
Background of Issuer	The Chamber of Commerce indicates that it is "the world's largest business federation, representing 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations…. As the voice of business, the chamber's core purpose is to fight for free enterprise before Congress, the White House, regulatory agencies, the courts, the court of public opinion, and governments around the world." http://www.uschamber.com/about/default.htm

Objectives of the Report
The Commission stated that it "believes that with quick and decisive adjustments in the U.S. legal and regulatory framework, U.S. government regulators and market participants will be better positioned to ensure that U.S. investor and business interests are best served in the global marketplace. To better protect investors and promote capital formation, the Commission is setting forth a series of recommendations that would significantly improve the U.S. position in the global markets. These recommendations can be implemented quickly and without overly burdensome costs."

Name of Issuer	**Mayor Michael Bloomberg and Senator Charles Schumer, with McKinsey & Company and New York City Economic Development Corporation**

Name of Report	*Sustaining New York's and the US' Global Financial Services Leadership*
Date of Report	January, 2007
Background of Issuer	To obtain a "comprehensive perspective" on the competitiveness of the U.S. financial services sector, with a particular focus on New York's contribution, Senator Schumer and Mayor Michael Bloomberg commissioned McKinsey & Company and the New York City Economic Development Corporation (NYCEDC) to interview business leaders, subject matter experts in regulatory, legal, and accounting professions, and investor, labor, and consumer groups.

Objectives of the Report
In their January 2007 report, New York City Mayor Michael Bloomberg and Senator Charles Schumer considered whether New York and the United States were at risk of ceding leadership in the financial services industry to international competitors. To obtain a "comprehensive perspective" on the competitiveness of the U.S. financial services sector, with a particular focus on New York's contribution, Senator Schumer and Mayor Bloomberg commissioned McKinsey & Company and the New York City Economic Development Corporation (NYCEDC) to interview business leaders, subject matter experts in regulatory, legal, and accounting professions, and investor, labor, and consumer groups.

Name of Issuer	**Committee on Capital Markets Regulation (CCMR)**
Name of Report	*Interim Report of the Committee on Capital Markets Regulation*
Date of Report	November, 2006
Background of Issuer	The Committee on Capital Markets Regulation is a not-for-profit research organization addressing issues in United States capital markets. Its membership, focus, and activities are described at http://www.capmktsreg.org/index.html.

Objectives of the Report
The Interim Report articulated concerns regarding the impact of regulatory policy and private litigation on United States capital markets.

Declaration of the Summit on Financial Markets and the World Economy November 15, 2008, Washington DC

1. We, the Leaders of the Group of Twenty, held an initial meeting in Washington on November 15, 2008, amid serious challenges to the world economy and financial markets. We are determined to enhance our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems.

2. Over the past months our countries have taken urgent and exceptional measures to support the global economy and stabilize financial markets. These efforts must continue. At the same time, we must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again. Our work will be guided by a shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment, and poverty reduction.

Root Causes of the Current Crisis

3. During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.

4. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.

Actions Taken and to Be Taken

5. We have taken strong and significant actions to date to stimulate our economies, provide liquidity, strengthen the capital of financial institutions, protect savings and deposits, address regulatory deficiencies, unfreeze credit markets, and are working to ensure that international financial institutions (IFIs) can provide critical support for the global economy.

6. But more needs to be done to stabilize financial markets and support economic growth. Economic momentum is slowing substantially in major economies and the global outlook has weakened. Many emerging market economies, which helped sustain the world economy this decade, are still experiencing good growth but increasingly are being adversely impacted by the worldwide slowdown.

7. Against this background of deteriorating economic conditions worldwide, we agreed that a broader policy response is needed, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging market economies and developing countries. As immediate steps to achieve these objectives, as well as to address longer-term challenges, we will:

- Continue our vigorous efforts and take whatever further actions are necessary to stabilize the financial system.
- Recognize the importance of monetary policy support, as deemed appropriate to domestic conditions.
- Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.
- Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support. We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.
- Encourage the World Bank and other multilateral development banks (MDBs) to use their full capacity in support of their development agenda, and we welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance.
- Ensure that the IMF, World Bank and other MDBs have sufficient resources to continue playing their role in overcoming the crisis.

Common Principles for Reform of Financial Markets

8. In addition to the actions taken above, we will implement reforms that will strengthen financial markets and regulatory regimes so as to avoid future crises. Regulation is first and foremost the responsibility of national regulators who constitute the first line of defense against market instability. However, our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. Regulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage, and support competition, dynamism and innovation in the marketplace. Financial institutions must also bear their responsibility for the turmoil and should do their part to overcome it including by recognizing losses, improving disclosure and strengthening their governance and risk management practices.

9. We commit to implementing policies consistent with the following common principles for reform.

- Strengthening Transparency and Accountability: We will strengthen financial market transparency, including by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure by firms of their financial conditions. Incentives should be aligned to avoid excessive risk-taking.

- Enhancing Sound Regulation: We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct. We will also make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanded trade in financial products and services. We commit to transparent assessments of our national regulatory systems.

- Promoting Integrity in Financial Markets: We commit to protect the integrity of the world's financial markets by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from non-cooperative jurisdictions. We will also promote information sharing, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency.

- Reinforcing International Cooperation: We call upon our national and regional regulators to formulate their regulations and other measures in a consistent manner. Regulators should enhance their coordination and cooperation across all segments of financial markets, including with respect to cross-border capital flows. Regulators and other relevant authorities as a matter of priority should strengthen cooperation on crisis prevention, management, and resolution.

- Reforming International Financial Institutions: We are committed to advancing the reform of the Bretton Woods Institutions so that they can more adequately reflect changing economic weights in the world economy in order to increase their legitimacy and effectiveness. In this respect, emerging and developing economies, including the poorest countries, should have greater voice and representation. The Financial Stability Forum (FSF) must expand urgently to a broader membership of emerging economies, and other major standard setting bodies should promptly review their membership. The IMF, in collaboration with the expanded FSF and other bodies, should work to better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response.

Tasking of Ministers and Experts

10. We are committed to taking rapid action to implement these principles. We instruct our Finance Ministers, as coordinated by their 2009 G20 leadership (Brazil, UK, Republic of Korea), to initiate processes and a timeline to do so. An initial list of specific measures is set forth in the attached Action Plan, including high priority actions to be completed prior to March 31, 2009.

In consultation with other economies and existing bodies, drawing upon the recommendations of such eminent independent experts as they may appoint, we request our Finance Ministers to formulate additional recommendations, including in the following specific areas:

- Mitigating against pro-cyclicality in regulatory policy;
- Reviewing and aligning global accounting standards, particularly for complex securities in times of stress;
- Strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of over-the-counter markets;
- Reviewing compensation practices as they relate to incentives for risk taking and innovation;
- Reviewing the mandates, governance, and resource requirements of the IFIs; and
- Defining the scope of systemically important institutions and determining their appropriate regulation or oversight.

11. In view of the role of the G20 in financial systems reform, we will meet again by April 30, 2009, to review the implementation of the principles and decisions agreed today.

Commitment to an Open Global Economy

12. We recognize that these reforms will only be successful if grounded in a commitment to free market principles, including the rule of law, respect for private property, open trade and investment, competitive markets, and efficient, effectively regulated financial systems. These principles are essential to economic growth and prosperity and have lifted millions out of poverty, and have significantly raised the global standard of living. Recognizing the necessity to improve financial sector regulation, we must avoid over-regulation that would hamper economic growth and exacerbate the contraction of capital flows, including to developing countries.

13. We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome. We instruct our Trade Ministers to achieve this objective and stand ready to assist directly, as necessary. We also agree that our countries have the largest stake in the global trading system and therefore each must make the positive contributions necessary to achieve such an outcome.

14. We are mindful of the impact of the current crisis on developing countries, particularly the most vulnerable. We reaffirm the importance of the Millennium Development Goals, the development assistance commitments we have made, and urge both developed and emerging economies to undertake commitments consistent with their capacities and roles in the global economy. In this regard, we reaffirm the development principles agreed at the 2002 United Nations Conference on Financing for Development in Monterrey, Mexico, which emphasized country ownership and mobilizing all sources of financing for development.

15. We remain committed to addressing other critical challenges such as energy security and climate change, food security, the rule of law, and the fight against terrorism, poverty and disease.

16. As we move forward, we are confident that through continued partnership, cooperation, and multilateralism, we will overcome the challenges before us and restore stability and prosperity to the world economy.

Action Plan to Implement Principles for Reform

This Action Plan sets forth a comprehensive work plan to implement the five agreed principles for reform. Our finance ministers will work to ensure that the taskings set forth in this Action Plan are fully and vigorously implemented. They are responsible for the development and implementation of these recommendations drawing on the ongoing work of relevant bodies, including the International Monetary Fund (IMF), an expanded Financial Stability Forum (FSF), and standard setting bodies.

Strengthening Transparency and Accountability

Immediate Actions by March 31, 2009

- The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.
- Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles.
- Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.
- With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.
- Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.

Medium-term actions

- The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard.
- Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards.
- Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution' financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis.

Enhancing Sound Regulation

Regulatory Regimes

Immediate Actions by March 31, 2009

- The IMF, expanded FSF, and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends.

Medium-term actions

- To the extent countries or regions have not already done so, each country or region pledges to review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalized financial system. To this end, all G20 members commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessments of countries' national regulatory systems.
- The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be undertaken.
- National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.
- Definitions of capital should be harmonized in order to achieve consistent measures of capital and capital adequacy.

Prudential Oversight

Immediate Actions by March 31, 2009

- Regulators should take steps to ensure that credit rating agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets.
- The international organization of securities regulators should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance.
- Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence. International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities.
- Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.

Medium-term actions

- Credit Ratings Agencies that provide public ratings should be registered.
- Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks.

Risk Management

Immediate Actions by March 31, 2009

- Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to reexamine their internal controls and implement strengthened policies for sound risk management.
- Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions.
- Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across products and geographies.
- Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts.
- The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate.

- Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking.
- Banks should exercise effective risk management and due diligence over structured products and securitization.

Medium-term actions

- International standard setting bodies, working with a broad range of economies and other appropriate bodies, should ensure that regulatory policy makers are aware and able to respond rapidly to evolution and innovation in financial markets and products.
- Authorities should monitor substantial changes in asset prices and their implications for the macroeconomy and the financial system.

Promoting Integrity in Financial Markets

Immediate Actions by March 31, 2009

- Our national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.
- National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.
- National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.

Medium -term actions

- National and regional authorities should implement national and international measures that protect the global financial system from uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity.
- The Financial Action Task Force should continue its important work against money laundering and terrorist financing, and we support the efforts of the World Bank - UN Stolen Asset Recovery (StAR) Initiative.
- Tax authorities, drawing upon the work of relevant bodies such as the Organization for Economic Cooperation and Development (OECD), should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.

Reinforcing International Cooperation

Immediate Actions by March 31, 2009

- Supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessment of the risks it faces.
- Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.

Medium-term actions

- Authorities, drawing especially on the work of regulators, should collect information on areas where convergence in regulatory practices such as accounting standards, auditing, and deposit insurance is making progress, is in need of accelerated progress, or where there may be potential for progress.
- Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner.

Reforming International Financial Institutions

Immediate Actions by March 31, 2009

- The FSF should expand to a broader membership of emerging economies.
- The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.
- The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.
- We should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and stand ready to increase them where necessary. The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.
- We should explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment.
- In cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, multilateral development banks must ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies.

Medium-term actions

- We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.
- The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial sector assessment programs. On this basis, the role of the IMF in providing macro-financial policy advice would be strengthened.
- Advanced economies, the IMF, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards.

Source: White House

Tackling the global financial crisis: For a new relationship between government and markets | 03 NOVEMBER 2008

Statement of the Socialist International Commission on Global Financial Issues, meeting in Vienna, Austria

It is today beyond dispute that the current global financial crisis is the worst in the last twenty-five years and may well be the worst since the Great Depression.

At first, response to the crisis was to address the immediate bailing out of financial institutions in the developed economies. Huge sums of tax payer's money were to be handed over to the banking system to compensate their losses.

Very quickly, progressive voices around the world rightly labeled this "cash for trash". We called for transparency and accountability. We called for the democratic monitoring of these moneys. Government supervision in order to guarantee that the average citizen, those in mainstreet, do not pay for the criminal acts of the "Wall Streets". Practices, which were at the heart of the crisis.

From the very beginning of this crisis, at the centre of our concerns have been people's jobs, housing, pensions, access to health and education services, in short the livelihood and social protection of citizens.

The social democratic vision of the economy and financial markets is that they should serve the citizens of our society. Financial markets are a means to an end, not an end in themselves. It is not necessarily the case that what is good for Wall Street or other financial centres is good for the rest of the economy. Moreover, trickle down economics - the notion that helping those at the top will benefit all - has been repeatedly rejected.

Four principles guide the social democratic response: solutions to the crisis must be consistent with basic values of social justice and social solidarity as well as basic notions of fairness. The bonds of social solidarity must go across national boundaries; we cannot take actions which help ourselves at the expense of those in the developing world. They must reflect an understanding of the necessary balance between government and markets. Fourthly, any response must respect basic principles of democratic due process, including full transparency.

These principles take on a greater sense of urgency today, as what started as a financial crisis has become very quickly a crisis of the real economy, with the threat of recession a reality around the world. Now we are entering a new phase where emerging and developing economies are suffering the consequences of this crisis as well. Lack of financial regulation triggered the crisis, while fiscal weakness and large public debts have hindered many governments' ability to formulate policies to tackle it. At the same time, serious deficiencies in the global financial system have also been exposed, such as the limitations of the Bretton Woods institutions to guard against macroeconomic imbalances and provide liquidity to those economies in need; inadequate supervision of financial markets in developed economies and under-representation of emerging economies in the governance of the main multilateral lending institutions.

We will not be able to restore confidence in our financial markets unless we change their behaviour, through regulation. And regulation must be comprehensive. Too often, the regulatory process, and more widely the democratic process, has been captured by those who were supposed to be regulated. While some shareholders profited, the voice of the

stakeholders was marginalised. The voice of those injured as a result of inadequate regulation—pensioners who lose their life savings, homeowners who lose their homes, workers who lose their jobs—has to be paramount. Such regulation could encourage real innovation, not the kind that has marked financial markets in recent years, like the derivatives that were supposed to manage risk but instead created it; but innovations that might allow average citizens to remain in their homes in the face of the economic vicissitudes which they face. Banks were allowed to become too big to fail and that was dangerous for all of us.

Given that the restructuring of global finance will take time, the Commission on Global Financial Issues proposes five immediate programmes to protect people today in countries most directly affected by the crisis:

- The creation of a Social Protection Fund to assist developing countries that have inadequate or underfunded social protection schemes to set up social security systems to provide minimum social protections, including provisions for the unemployed, for health, and for retirees;

- The creation of a Small Enterprises Development Fund to facilitate credit and capital flows to small businesses, as a sector which provides the major source of employment and a large contribution to the GDP, and assisting their technological development and expanding decent work;

- The creation of a Financing Infrastructure Fund to help stimulate the economy. Such a fund would simultaneously stimulate the economy in the short run and help our societies meet the long run challenges they face; some funds might be directed, for instance, towards helping meet the challenges posed by global warming; others might be directed at the informal economy from which so many poor earn their living, for example with local programmes for small power plants, rural roads and markets, and technology parks.

- The Commission equally supports the immediate and urgent establishment by the International Monetary Fund of a short-term liquidity line for emerging and developing economies which face a liquidity crisis caused not by deficient domestic policies but by sources of financing being severed due to the systemic crisis, as internationally active banks hoard liquidity, capital is repatriated to financial centres and rich countries' GDP contract. This liquidity facility must allow access to countries by broadening the eligibility criteria in a fair way, so giving support to hundreds of millions of people who are now unwitting victims of this crisis; and it should be provided without the severe conditionalities often imposed in the past.

- New sources of funding, and new lending facilities, have to be given urgent consideration. There is a growing consensus that there are insufficient financial resources in multilateral institutions and regional development banks to provide adequate support for the many economies that may face difficulties. Since the sources of liquid funds in the world today are in countries that have inadequate representation within the IMF, the World Bank, and other existing multilateral institutions, it will be imperative to create new governance structures for these lending facilities that are more representative. These new governance structures should be thought of as a precursor to the more fundamental reforms in the global economic governance that have long been demanded, and may entail more active involvement of other international institutions with wider and more diverse representation, including the various agencies of the UN family, such as UNDP and the International Labour Organisation.

Transparent and sustainable financial governance requires robust regulation of the world of finances which, as stated by the Presidium of the Socialist International, should include the establishment of a World Financial Organisation. The nature and extent of such regulation should itself emerge from global, democratic processes. Well designed regulation should focus on financial institutions and products whose failure puts the entire economy at risk. Elements will include, but not be limited to, demands for more transparency, restrictions on compensation schemes, especially those that encourage short sighted and excessively risky behaviour, restrictions on conflicts of interest, oversight of credit rating agencies, and control of other aspects of the behaviour of financial institutions that have imposed large social costs, without commensurate social benefits. Deficiencies in corporate governance that have given rise to compensation schemes that have benefited corporate managers at the expense of other stakeholders, including even shareholders, need to be given urgent consideration. Tax havens should be ended; and, a tax on short-term transactions considered.

There are other reforms to the international financial system that must be addressed if we are to have a more stable, prosperous, and equitable global economy. These include a reform of the global reserve system, better macro-economic coordination, with more attention paid to the consequences of policies for unemployment, and better ways of dealing with cross border bankruptcies and defaults, including those of sovereigns. The system in which countercyclical monetary and fiscal policies were pursued in the advanced industrial countries while pro-cyclical policies were imposed on developing countries has contributed to global volatility and imposed huge costs on developing countries. The current crisis has given new urgency to these long delayed reforms.

The reform process itself must be open, transparent, inclusive, and democratic; this means that the reform of the global regulatory framework or the way in which financial markets are regulated and supervised must take into account opinions and views of all. For this reason, we propose that discussion about reforms to the regulatory and financial framework for private markets be broadened to include the emerging economies, while at the same time providing a role for contributions from existing institutions that are less representative, such as the Financial Stability Forum.

Social democrats have always stood for markets with social responsibility. Markets that put our citizens first. And, therefore, for democratic governance, a role for government in the economy and rules and regulation in the market. 75 years ago John Maynard Keynes explained how government action could help the economy recover from the Great Depression. In today's crisis, he has been rediscovered. And his ideas have become part of conventional wisdom. Our values, ideas, social democratic policies and their proposals for preventing another such calamity, as the one we are living through today, will in time also be accepted as conventional wisdom. But time is of the essence: the quicker governments can act, the shorter will be our downturn, and the fewer the number of innocent bystanders whose lives and dreams will be dashed in this tragic episode. We are living in a man-made crisis that should never be allowed to happen again. Our Commission is committed to contributing to that end, by constructing a roadmap, in which democracy, inclusion, fairness and green development will find a place in a new political, social and economic vision required for these times.

General Assembly of the United Nations
Panel on the Financial Crisis

Francois Houtart. Founder and President of the *Centre Tricontinental* and Professor Emeritus of Sociology at the *Université Catholique de Louvain*.

30 October 2008

Ladies and Gentlemen, Delegates, and Dear Friends:

The world needs alternatives and not merely regulation. It is not enough to rearrange the system; we need to transform it. This is a moral duty. In order to understand why, we must adopt the point of view of the victims of this system, Adopting this point of view will allow us to confront reality and to express a conviction, the reality that the whole ensemble of crises which currently afflict us –finances, food supply, water, energy, climate, social— are the result of a common cause, and the conviction that we can change the course of history.

Confronting Reality

When 850 million human beings live below poverty level, and their number increases, when every twenty-four hours tens of thousands of human being die of hunger, when day after day entire peoples, whole cultures and ways of life simply disappear, putting in peril humanity's patrimony, when the climate deteriorates to the point that one wonders whether or not it is worth the trouble to live in New Orleans, the Sahel, the islands of the Pacific, Central Asia, or along the coasts of our continents, we cannot content ourselves with speaking about the financial crisis.

Already this latter crisis has had consequences which are more than merely financial: unemployment, rising prices, exclusion of the poor, vulnerability of the middle classes. The list of victims grows ever longer. Let us be clear. This crisis is not the product of some bad turn taken by one economic actor of another, nor is it just the result of an abuse which must be punished. We are witnessing the result of a logic which defines the economic history of the past two centuries. From crisis to regulation and from regulation to crisis, the unfolding of the facts always reflects the dynamics of the rate of profit. When it rises we deregulate; when it falls we regulate, but always in service to the accumulation of capital, which is understood as the engine of growth. What we are seeing today is, therefore, far from new. It is not the first crisis of the financial system and it will not be the last.

Nevertheless, the financial bubble, created over the course of the past few decades, thanks, among other things, to the development of new information and communication technologies, has added fundamentally new dimensions to the problem. The economy has become more and more virtual and differences in income have exploded. To accelerate growth in the rate of profit, a whole new architecture of derivatives was put in place and speculation became the *modus operandi* of the economic system. The result has been a convergence in the logic governing the disorders which characterize the current situation.

The food crisis is an example. The increase in food prices was not the result of declining production, but rather of a combination of reduced stocks, speculation, and the increased production of agrofuels. Human lives were, in other words, subordinated to profit taking. The behavior of the Chicago Commodity Exchange demonstrates this.

The energy crisis, meanwhile, goes well beyond a conjunctural explosion in the price of petroleum. It marks the end of cheap fossil fuels, which encouraged profligate use of energy, making possible accelerated economic growth and the rapid accumulation of capital in the middle term. The superexploitation of natural resources and the liberalization of trade, especially since the 1970s, expanded the transport of commodities around the world and encouraged the use of automobiles rather than public transportation, without consideration of either the climatic or the social consequences. The use of petroleum derivatives as fertilizers became widespread in a productivist agriculture. The lifestyle of the upper and middle classes was built on this squandering of energy resources. In this domain as well exchange value took precedence over use value.

Today, with this crisis threatening gravely the accumulation of capital, there is a sudden urgency about finding solutions. They will, however, respect the underlying logic of the system: to maintain the rate of profit, without taking into account externalities –that is to say what does not enter into the accounting of capital and the cost of which must be born by individuals and communities. That is the case with agrofuels and their ecological and social consequences: destruction by monoculture of biodiversity, of the soil and of underground water and the expulsion of millions of small peasants who then go on to populate the shantytowns and aggravate the pressures to emigrate.

The climate crisis, the gravity of which global public opinion has yet to take the full measure, is, according to the International Group of Climate Experts, the result of human activity. Nicolas Stern, formerly of the World Bank, does not hesitate to say that "climate change is the biggest setback in the history of the market economy." In effect, here as before, the logic of capital does not taken into account "externalities" except when it reduces the rate of profit.

The neoliberal era, which led to the increase of the later, coincided as well with growing emissions of greenhouse gases and accelerated global warming. The growth in the utilization of raw materials and in transportation, as well as deregulation in the ecological sphere, augmented the devastation of our climate and diminished the regenerative capacity of nature. If nothing is done in the near future, 20%-30% of all living species could disappear in the next quarter century. The acidity of the oceans is rising and we can expect between 150 and 200 million climate refugees by the middle of this century.

It is in this context that we must understand the social crisis. Developing spectacularly the 20% of the world's population capable of consuming high value added goods and services, is more interesting from the standpoint of private accumulation in the short and middle term than responding to the basic needs of those whose purchasing power has been reduced to nothing. Indeed, incapable of producing value added and having only a feeble capacity to consume, they are nothing but a useless mob, or at best the of object welfare policies. This phenomenon is

accentuated with the predominance of finance capital. Once more the logic of accumulation has prevailed over the needs of human beings.

This whole ensemble of malfunctions opens up the possibility of a crisis of civilization and the risk that the planet itself will be purged of living things, something which also signifies a real crisis of meaning. Regulation, then? Yes, if they constitute steps towards a radical and permanent transformation and point towards an exit from the crisis other than war. No, if they merely prolong a logic which is destructive of life. A humanity which renounces reason and abandons ethics loses the right to exist.

A conviction

To be sure, apocalyptic language is by itself a sufficient catalyst for action. On the contrary, a radical confrontation with reality like that suggested above can lead to reaction. Finding and acting on alternatives is possible, but not without conditions. It presupposes a long term vision, a necessary utopia, concrete measures spaced out over time, and social actors who can carry these projects and who are capable of carrying on a struggle the violence of which will be proportional to the resistance to change.

This long term vision can be articulated along several major axes. In the first place, a rational and renewable use of natural resources, which presupposes a new understanding of our relationship with nature: no longer an exploitation without limits of matter, with the aim of unlimited profits, but rather a respect for what forms the very source of life. "Actually existing" socialist societies made no real innovations in this domain.

Second, we will privilege use value over exchange value, something which implies a new understanding of economics, no longer as the science of producing value added as a way of encouraging private accumulation but rather as an activity which assures the basis for human life, material, cultural, and spiritual, for everyone everywhere. The logical consequences of this change are considerable. From this moment forward, the market must serve as a regulator between supply and demand instead of increasing the rate of profit for a minority. The squandering of raw materials and of energy, the destruction of biodiversity and of the atmosphere, are combated by taking into account ecological and social "externalities." The logic governing the production of goods and services must change.

Finally, the principle of multiculturalism must complement these others. It is a question of permitting all forms of knowledge, including traditional forms, all philosophies and cultures, all moral and spiritual forces capable of promoting the necessary ethic, to participate in the construction of alternatives, in breaking the monopoly of westernization. Among the religions, the wisdom of Hinduism in relationship to nature, the compassion of Buddhism in human relations, the permanent quest for utopia in Judaism, the thirst for justice which defines the prophetic current in Islam, the emancipatory power of the theology of liberation in Christianity, the respect for the sources of life in the concept of the land itself among the indigenous peoples of the Americas, the sense of solidarity expressed in the religions of Africa, can all make

important contributions in the context of mutual tolerance guaranteed by the impartiality of political society.

All of this is utopian, to be sure. But the world needs utopias, on the condition that they have concrete, practical results. Each of the principles evoked above is susceptible to concrete applications which have already been the object of propositions on the part of numerous social movements and political organizations. A new relationship with nature means, among other things, the recovery by states of their sovereignty over their natural resources and an end to their private appropriation, the end of monocultures and a revaluation of peasant agriculture, and the ratification and deepening of the measures called for by the Kyoto and Bali protocols on climate change.

Privileging use value requires the decommodification of the indispensible elements of life: seeds, water, health, and education, the re-establishment of public services, the abolition of tax havens, the suppression of banking secrecy, the cancelation of the odious debts of the States of the global South, the establishment of regional alliances on the basis not of competition by of complementarity and solidarity, the creation or regional currencies, the establishment of multipolarity, and many other measures as well. The financial crisis simply gives us a unique opportunity to apply these measures.

Democratizing societies begins with fostering local participation, includes the democratic management of the economy, and extends to the reform of the United Nations. Multiculturalism means the abolition of patents on knowledge, the liberation of science from the stranglehold of economic power, the suppression of monopolies on information and the establishment of religious liberty.

But who will carry this project? The genius of capitalism is to transform its own contradictions into opportunities. *How global warming can make you wealthy!* reads an ad in US Today from the beginning of 2007. Can capitalism renounce its own principles? Obviously not. Only a new set of power relations can get us where we need to be, something which does not exclude the engagement of some contemporary economic actors. But one thing is clear: the new historic actor which will carry the alternative projects outlined above is *plural*. There are the workers, the landless peasants, the indigenous peoples, women (who are always the first victims of privatization) the urban poor, environmentalists, migrants, and intellectuals linked to social movements. Their consciousness of being a collective actor is beginning to emerge. The convergence of their organizations is only in its early stages. Real political relationships are often lacking. Some states, notably in Latin America, have already created the conditions for these alternative projects to see the light of day. The duration and intensity of the struggles to come depends on the rigidity of the system in place and the intransigence of the protagonists.

Offer them, therefore, a platform in the General Assembly of the United Nations, where they can express themselves and present their alternatives. This will be your contribution to changing the course of history –something which is *must* happen if humanity is to recover the space to live and once again find reason to hope in the future.

REFORM OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

Observations by François Houtart (27.12.08)

1. **The document sent by the chairman of the Commission indicates rightly the impact of the Financial crisis on "the growth and stability of the developing countries and …on the distribution of income within countries" (p.1). Therefore analysis and solutions need a global approach.**

2. **As it is suggested p. 38 of the same document, effects and solutions are related to other crises. This has to be taken into consideration, in order to avoid incomplete analyses and unwilling side effects of some solutions. Therefore a holistic approach is needed.**

3. **There are two conjectural crises (with a vocation of becoming structural): the financial and the food crisis, and two structural ones: the energetic and the climatic crisis. Their conjunction is provoking a profound social and humanitarian crisis and reveals the need for a new economic model.**

4. **It appears from the document of the chairman, that the Monetary and Financial sectors of the economy have become ends instead of means, with grave consequences for the economic and for the social systems. The need for a redefinition implies a set of measures (regulations) to restore their instrumental function, a democratic control of their application, but also a clear vision of the aims of the economic system to achieve mankind's common good.**

5. **What would be, indeed, the use of a well regulated Monetary and Financial system, if it serves:**

- **to save an automobile industry, increasing climatic damages and promoting individual mobility to the point of urban paralysis.**
- **To promote monocultures for agrofuel, destructive of soils, water and biodiversity and provoking massive migrations of peasants expelled from their land.**
- **To support carbon stock exchanges encouraging the ongoing production of greenhouse effects gazes in the industrialized countries.**
- **To accelerate the constitution of monopolies or oligopolies in key sectors of the physical and cultural survival of mankind, such as seed, health, education.**
- **To finance wars for the control of natural resources irrationally wasted.**

6. The discourse of Franklin D. Roosevelt on the New Deal of March 4th 1933 is worth of rereading for its correspondence with the present situation. Will it be necessary in 75 years from now to write it again, after a 3rd World War and a new global depression ?

7. Therefore it is suggested to recommend to the General Assembly of the United Nations to prepare a Universal Declaration of Global Governance, parallel to the Universal Declaration of Human Rights. The main chapters would be: sustainable use of natural resources, superiority of use values on exchange values, generalization of democracy to all social relations, including economic and multiculturality as basis for a global ethics. Such principles could be translated into concrete rights and obligations.

8. The Commission could also recommend to the heads of States to reach a "mutual agreement of coercition "on some major common strategic objectives (avoiding the word priorities) and to be implemented in a given timing.

A Social Democratic Response to the Financial Crisis (draft)

There is by now a consensus that the current global financial crisis is the worst in the last 25 years and may well be the worst since the Great Depression. As solutions are proposed, there is strong pressure from Wall Street to make sure that their way of doing business is protected. They don't want to see finance suffer from too much regulation.

In times of crisis, we all have to pull together; sacrifices may be asked of us all. But in a democracy, that does not mean silent ascension to whatever is proposed. The voices of Social Democrats and those who reject the free market mantra of the US, should be listened to as the debate about how to proceed moves forward . We must be allowed to help formulate the government responses to the crisis. There are stark differences of opinion as to the best way to proceed—just look at the differences between the measures taken by the UK's Gordon Brown over those proposed by US President George Bush and Treasury Secretary Tim Paulson.

Four principles guide the social democratic response: solutions to the crisis must be consistent with basic values of social justice and social solidarity as well as basic notions of fairness. The bonds of social solidarity go across national boundaries; we cannot take actions which help ourselves at the expense of those in the developing world. They must reflect an understanding of the necessary balance between government and markets. And any response must respect basic principles of democratic due process, including full transparency.

The response of the US should have focused more on helping the millions of Americans who were losing their homes, ensuring that the economy not go into the predictable (and predicted) recession into which it is now sinking, and minimizing the inevitable resulting hardship. The US has one of the worst unemployment schemes in the advanced industrial countries, but President Bush still refuses to extend unemployment benefits beyond 39 weeks. Three quarters of a million Americans will shortly be without benefits. America is one of the few countries that does not recognize access to medicine as a basic human right; and when Americans lose their jobs, they lose their health insurance. President Bush even vetoed a health insurance program for uninsured children in July 2007, saying the country could not afford it; yet somehow, more than a trillion dollars were found to finance Wall Street's bailouts. This says something about priorities and values.

The American bail-outs were arranged behind closed doors; some were bailed-out, others not; some were bailed out under punitive terms, others walked away with marked increases in marked value as a result of government capital injections. Some of the financial institutions being helped were told to change their management, others were not. The only consistency is the lack of consistency and non-transparency, and the failure to do anything direct about the underlying problems. While money was being poured into the banks, they were allowed to pour money out to their shareholders in dividends. No obligation to increase lending was imposed.

The Social Democratic response begins with concerns about equity; but the social democratic response is based on a deeper understanding of market economics than do the responses of the right. The failure, for instance, of President Bush to take effective actions to stimulate the economy and to stem the wave of foreclosures will hurt even the banks, as more and more mortgages will go into foreclosures and more and more loans will go sour.

The social democratic response begins too from the perspective that the economy and financial markets should serve the citizens of our society. They are a means to an end, not an end in themselves. It is not necessarily the case that what is good for Wall Street is good for the rest of the economy.

Moreover, any response cannot be based on trickle down economics—the notion that helping those at the top will benefit all has been repeatedly rejected. The U.S. response was predicated on exactly that proposition: throw enough money at Wall Street, and eventually, some of the benefits may eventually help ordinary Americans.

If managers of firms have incentives for distorted accounting, excessive risk taking, or a focus on short term profits they will take risks and focus only on the short-term. Non-transparent stock options and bonuses based on short term aggravate this problem. Market failures arise from conflicts of interest and lack of good information that can ensure sound allocation of resource allocations. Where there is a separation ownership and control, managers do not necessarily act in the best interests of shareholders, let alone other stakeholders. Unregulated markets do not act in society's best interests. American financial managers' unbridled pursuit of self-interest—greed—has imposed a high cost on all of us.

We will not be able to restore confidence in our financial markets unless we change their behavior, through regulation. Regulation must be comprehensive. Regulatory institutions too have to be reformed; too often, the regulatory process has been captured by those who were supposed to be regulated. The voice of those injured as a result of inadequate regulation—pensioners who lose their life savings, homeowners who lose their homes, workers who lose their jobs—has to be paramount. Such regulation could encourage real innovation, not the kind focusing on regulatory, accounting, and tax arbitrage that has marked America's financial markets in recent years, or the derivatives that were suppose to manage risk but instead created it; but innovations that might allow average citizens to remain in their homes in the face of the economic vicissitudes which they face. Banks were allowed to become to big too fail and that was dangerous of all of us.

It is ironic that Social Democrats are sometimes accused of not understanding market fundamentals. After all it was the great economist John Maynard Keynes who some 75 years ago, saved capitalism from the capitalists. It was Keynes who explained how government action could help the economy recover from the Great Depression. Today, his ideas have become part of conventional wisdom, agreed to by the right and the left. Once again, social democrats are providing a roadmap for saving capitalism from the

capitalists. Their proposals for recovery, and for preventing another such calamity, will in time by accepted as conventional wisdom. But time is of the essence: the quicker that governments can rally behind these ideas, the shorter will be our downturn, the quicker will be our recovery, and the fewer the number of innocent bystanders whose lives and dreams will be dashed in this tragic episode. We are living in a man-made crisis that was made in the U.S.A. It could have been avoided, had Social Democratic principles been more widely adopted and implemented.

JES

PROPOSALS FOR REGULATORY REFORM

IPD Policy Brief

Stephany Griffith-Jones
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Introduction

It is useful to put crises and responses to it into a historical context. Firstly, is it important to stress that after the Great Depression, the financial sector – particularly, but not only, in the US – was re-regulated carefully, most notably by the Glass-Steagall Act of 1933. During the next 40 years, the financial sector was closely regulated, capital accounts around the world were fairly closed, and there were practically no financial crises. Since the 1970's, and especially during the 1980's and 1990's, there was massive de-regulation, both at national and international level. Since the 1980's, there have been very frequent and very deep financial crises, both in the developing and developed world.

Though crises have complex causes, it seems evident that liberalization of financial markets, especially if not accompanied by appropriate regulation, seems to almost always lead to costly and damaging crises (see for example, Kaminski and Reinhart, 1999), for empirical evidence) This implies that financial crises are not inevitable, but may be prevented or ameliorated, by appropriate public policy, and especially by effective regulation.

The only silver lining that appears during these costly crises – such as the current one – is that they provide a political opportunity to carry out desirable regulatory reforms. The task of improving regulation is an urgent one because the political window of opportunity is a narrow one and can close quickly. This was, for example, an important lesson learned in the wake of the East Asian crises. Even though there was such a major debate about reforming the international financial architecture, including regulation – during and after the crises – in practice very little progress was actually made once the crises was contained, (Griffith-Jones and Ocampo, 2003).

However, the current crisis originated – and is extremely deep – in the developed economies, and particularly in the United States. It has led to massive bail-outs and very costly public recapitalizations of many financial institutions in those countries. The crisis threatens to lead to an unacceptably serious recession in developed countries and a massive slowdown globally. As a consequence, political appetite for more and better regulation is significant. Indeed, steps are beginning to be taken to improve regulation.

The key question in policy circles at present is therefore not whether to regulate, but how best to do it. In thinking about the future shape of the financial system and its regulation, it is important to be clear about its purpose. The financial sector should be seen as a means to an end (Stiglitz, 2008); it should serve the real economy, and thus the needs of households and enterprises, to consume and invest. On the positive side, governments should encourage the financial sector to create financial innovations that support growth in a sustainable way. Governments should also use regulation to avoid systemic risk being generated, thus preventing future crises, that can be so negative for the real economy.

The principles on which financial regulation needs to be built are, to an important extent, based on the causes of this and previous crises. The first relates to the inherent flaws in the way that banking and capital markets operate; in particular, the main market failure of those markets is their boom-bust pattern, linked – as market participants themselves describe it – to cycles of greed and fear. To help overcome these pro-cyclical patterns of behaviour, a first principle of regulation needs to be that of counter-cyclicality.

The second major cause of crises is rapid liberalization within and across countries,

accompanied by insufficient, incomplete and inappropriate financial regulation. Indeed, the excesses of financial liberalization and the major mistakes of regulation, as well as its incompleteness, imply a massive policy failure.

Principles of regulation

To overcome the failures – both of markets and of policy – that have been major factors contributing to the crisis, two key principles of regulation need to be followed: one is that of introducing counter-cyclicality at the heart of regulation, the second is the need for regulation to be comprehensive, so that the domain of regulation coincides with the domain of the market.

a) Comprehensiveness

We will start first with the principle of comprehensiveness.

Financial systems – both nationally and internationally – have undergone very large changes. Regulation has clearly not kept up.

In the United States, and also in other developed countries like the UK, there had been a massive shift of savings from banks to capital markets. As pointed out in d'Arista and Griffith-Jones (2008), only 25% of the US financial systems' assets belonged to commercial banks in 2007.

However, commercial banks were the only part of the financial system that were regulated for capital requirements and even that regulation was partial as off-balance sheet instruments, such as Structured Investment Vehicles, were practically unregulated. Investment banks were very lightly regulated. Other financial actors, like hedge funds, were not at all regulated. Neither were powerful rating agencies, nor were many mortgage lenders. For some of the financial instruments, like Over-the-Counter (OTC) derivatives that grew the most in the last decade to astronomical levels, there was no transparency and even less regulation. Off-shore centres are subject to no or extremely light regulation.

A massive "shadow financial system" was allowed to emerge, which has no or very little transparency or regulation. Indeed, regulatory arbitrage – the wish to avoid regulations – often drove, or at least strongly encouraged, the growth of this financial activity and of related risk taking. Thus, many of the problems that caused the financial crisis arose mainly in institutions (e.g. mortgage lenders) or instruments (e.g. credit default swaps) that were not regulated. This is similar to many previous developing country financial crises, where also the most liberalized and unregulated parts of the financial system were major causes of crises.

In capital markets, there was practically no formal regulation. Private actors, such as insurance companies, pretended they were able to sell systemic risk insurance, like credit default swaps (CDS). Some of those major insurance companies, like AIG in the US, had to be rescued and effectively nationalized, as they essentially became bankrupt during the crisis. This was because they did not have sufficient capital and reserves to fulfil credit swap insurance contracts that had a massive amount of systemic risk. Indeed, no entity – except

the governments – was capable of fulfilling credibly such a contract once the crisis spread. Thus, the government not only became the lender of last resort, but also the insurer of last resort, because it had not previously exercised regulation to limit the risk that afterwards it had to assume.

To summarize, regulation has to be comprehensive, both nationally and internationally, so that the domain of the regulator coincides with the domain of the market; if not, regulatory arbitrage will be inevitable. Another reason – illustrated by recent events, when bail-outs and rescues have been massive – is that there is a need to have comprehensive regulation to avoid moral hazard.

It needs to be pointed out that most developing countries are bank based; even when they have developed capital markets, the commercial banks tend to be the largest players. Thus, most savings tends to be in the banking sector. However, other actors like non-financial corporations often play an important financial role; for example they can provide large volumes of credit or speculate on currencies. Therefore there are challenges for comprehensive regulation in emerging countries, but these may be somewhat different from those in developed countries. Developing countries also need to have a keen interest in comprehensive regulation in developed countries, as problems in those countries financial markets can spill over to them, especially in crises.

A pre-condition for effective comprehensive regulation is comprehensive transparency. Thus, for example,Over-the-Counter derivatives should all be brought on the exchanges (even if this implies certain micro-economic costs, we believe these would be far smaller than the benefits for limiting systemic risk of bringing OTC derivatives on the exchanges). Off-balance sheets instruments, like Structured Investment Vehicles, should be brought into balance sheets, and on-site inspection of banks and other financial institutions should be expanded. The fact that, in developed countries, governments now own capital in many financial institutions should facilitate this process.

Comprehensive regulation should relate both to liquidity and solvency. As regards solvency, equivalent regulation of different actors, instruments and activities should aim at equivalent limits on leverage, as excessive leverage has been such a major source of systemic risk. However, as the longevity of funding is an important variable, it may be desirable to restrict leverage (and require more capital) for assets funded by short-term liabilities. This will not just protect the solvency of financial institutions, but also encourage them to seek more long term funding. Furthermore account needs to be taken of how different activities and institutions can generate systemic risk in dissimilar ways.

b) Counter-cyclicality

As pointed out, the most important market failure in financial markets through the ages is their pro-cyclicality. In fact, risk is mainly generated in the booms, even though it becomes apparent in the bust. Therefore, the time for regulators to act – to prevent excessive risk taking – is precisely in the boom. Indeed, one of their key functions is “to take away the punch-bowl when the party is at its best.” As a consequence, financial regulation has to follow the principle of counter-cyclicality. This will both help ensure banks build up resources in good times, to help cushion the shock on them in bad times-“protecting banks

from the economic cycle"- and also moderate lending in good times as well as facilitate lending in the downturn,-"protect the cycle from banks"(Gieve,2008). Countercyclical regulation needs to happen through simple rules which cannot be easily changed by regulators so they will not become "captured" by the general over-enthusiasm that characterizes booms and relax regulatory standards nor by capture by vested interests.

i) Counter-cyclical regulation of provisions and/or capital

Counter-cyclical bank regulation can be easily introduced, either through banks' provisions or through their capital. Introducing counter-cyclical bank provisions has already been successfully done for some time in Spain and Portugal showing that it is feasible. Recently, Switzerland has introduced countercyclical regulations. The Spanish system requires higher general provisions when credit grows more than the historical average, linking provisioning to the credit and business cycle. This both discourages (though does not eliminate) excessive lending in booms and strengthens the banks for bad times, when they can draw on the general provisions. An advantage is that it does not require precise estimates of the length of the cycle, or predictions when the cycle will turn; it also can be capped, to avoid very large growth of reserves in a long upswing.

According to the Deputy Governor of the Bank of England (Gieve, op cit, 2008), as a result of this system of provisioning, Spanish banks were better placed than their counterparts in other countries to absorb losses, without eating into their core capital; indeed, the Bank of Spain estimates the 2008 level of general provisions could absorb losses associated with a doubtful asset ratio of 9%,(the current level is 1.5%).

Introducing counter-cyclical (dynamic) provisions in Spain was facilitated by the fact that the design of accounting rules was under the authority of the Central Bank of Spain. This helped overcome the issue that accountants do not readily accept the concept of "latent" or expected losses, on which the Spanish system is based, preferring to focus on actual losses, the latter information being more relevant for short-term investors. However, accounting principles should be designed in ways that balance the short-term needs of investors with those of individual and systemic bank stability. Unfortunately, even the Bank of Spain was obliged to make some changes to its dynamic provisioning when the European Union in 2005 adopted standards issued by the International Accounting Standards Board. It is paradoxical that just as Bank of Spain dynamic provisions were being increasingly studied and praised internationally they had to be changed somewhat to comply with accounting standards.

An alternative approach for counter-cyclical bank regulation is through capital. Here, Goodhart and Persaud, G-P, (2008) have presented a specific proposal: increasing Basle II capital requirements by a ratio linked to recent growth of total banks' assets. This provides a clear and simple rule for introducing counter-cyclicality into regulation of banks. Another virtue of this proposal is that it could be fairly easily implemented, in that it builds on Basle II. Finally, it has the advantage that having fairly similar effects, it does not face the accounting difficulties outlined above for provisioning.

In this proposal, each bank would have a basic allowance of asset growth, linked to macro-economic variables, such as inflation and the long-run economic growth rate. It would

measure actual growth of bank assets as a weighted average of annual growth (with higher weights for recent growth).

Two issues arise. Should the focus just be on increase in total bank assets, or should there also be some weighting for excessive growth of bank lending in specific sectors that have grown particularly rapidly (such as recently to real estate)? Often crises have arisen due to excessive lending during boom times to particular sectors or countries (e.g. emerging economies). However, most systemic bank failures have also been preceded by excessive growth of total bank assets.

Secondly, such a simple non risk based rule could potentially penalize banks that increase their assets through lending to less risky borrowers than their competitors do (Bank of England 2008). However, by integrating this with a reformed Basle II, as the G-P proposal does, this problem could be overcome

Finally, for any such regulatory change, there is the crucial issue of timing. It seems key to approve such changes soon, while the appetite for regulatory reform remains high. However, their introduction should be done with a lag, so as to avoid increased capital requirements (especially linked to the weighting given to growth in recent years in the G-P formula, which would be high) putting pressure on currently weak banks and accentuating the credit crunch. Indeed, leverage has to be reduced, but this needs to be done gradually.

Some of the least regulated parts of the financial system may have some of the strongest pro-cyclical impacts, including on emerging economies. One such example is the role that hedge funds and derivatives play in carry trade; there is increasing empirical evidence that such carry trade has very pro-cyclical effects (on over or under shooting) of exchange rates of both developed and developing economies, with negative effects often on the real economy.

For regulation to be comprehensive, as argued above, there should be minimum capital requirements for all derivatives dealers and minimum collateral requirements for all derivatives transactions, so as to reduce leverage and lower systemic risk. Collateral requirements for financial transactions function much like capital requirements for banks.

An issue to explore is whether for example regulation of derivatives' collateral and capital requirements should also have counter-cyclical elements. This would seem desirable. It would imply that when derivatives positions, either long or short, were growing excessively (for example, well beyond historical averages), collateral and capital requirements could be increased.

An important additional reason to extend countercyclical regulation to non bank actors and activities is that if countercyclical regulation were only implemented for banks, this would – by increasing the cost of their lending in booms-create incentives for the growth of intermediation outside the banks, which could be undesirable.

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Financing Global Public Goods

A key challenge for international cooperation in the 21st century is the financing of global public goods. As the world economy has integrated further and continues to do so, the need for the provision of global public goods increases. These range form the protection of our climate to financial stability, from the control of infectious diseases to the diffusion of knowledge. The eradication of extreme poverty should also be considered a global public good. Many consider it a moral imperative which we agree with. But it also provides benefits to the international community as a whole because it reduces the risk of disease, state failure, piracy, terrorism, and environmental degradation and therefore, indirectly at least, contributes to the provision of global public goods.

In principle it is possible to finance GPGs through national taxation and provide them through internationally coordinated expenditure programs. In practice this is turning out increasingly difficult to achieve. GPGs are under-financed and therefore under-provided. Countries have found it very difficult to allocate tax revenues to cross border purposes. A good example is the failure for decades to honour an international commitment by the rich countries to allocate 0.7 percent of GDP to development assistance. Only very few Northern European countries achieve or exceed that goal. The current economic crisis will generate strong fiscal pressures throughout the world and notably in donor countries. There is the danger that the financing of GPGs through traditional budget processes will become even more difficult in the next few years.

A promising way to facilitate the financing and provision of GPGs is to create new sources of revenue that from the start have a more “global” flavor than traditional tax revenues. Taking into account decades of discussions and analysis on this subject, three such potential sources of revenues appear particularly promising : the purchasing power associated with the issuance of new global liquidity in the form of SDRs, revenues derived from the auctioning of carbon emission permits or internationally coordinated carbon taxes, and, a (very small) tax that could be imposed on cross border financial transactions or foreign exchange transactions. Very considerable resources could be mobilized if there was an agreement to use these three sources of revenue and there would probably be efficiency gains associated with them – not losses. This is most obvious for the auctioning of carbon emission permits, but it is true also for SDR emissions and likely for small transaction taxes on the extremely volatile foreign exchange markets.(throwing “sand” into those markets may help make them less unstable).

The US has been traditionally completely opposed to such instruments, interpreting them as “global taxes” and a move towards too much “supranationality”. It is clear that a move away from the dollar to the SDRs as “reserve” asset, will cause a “seignoriage” loss to the US. As against that, however, could be set the benefit of greater macroeconomic stability world wide and in the US itself. As far as cross border financial transaction taxes and the allocation of some carbon emission auction revenues to GPGs are concerned, these need not at all lead to an equivalent net loss for the US as the US will benefit from the GPGs financed in that way. Of course in so far as some global redistribution objectives are built into the GPG financing system, the US and other rich countries would be expected to allow some implicit or explicit channeling of real resources from the rich to the developing countries. Finally it is not at all necessary to implement such new financing mechanism in the form of some kind of global

taxation. The mechanisms can remain fully subject to national legislative controls and their implementation can take the form of cooperation between sovereign nation states.

The coming into office of the Obama administration should allow a new attempt to gain US support for the provision of key GPGs of huge importance to the world and to the US by the use of new, innovative financing methods. In the preparation of the G-20 meeting this could and should be a major theme. If the meeting could at least signal a willingness by all to seriously discuss these new financing sources and set up a follow up mechanism to do that, this would constitute a huge step forward.

Kemal Derviş   December 2008

The road map of the reform of the international monetary and financial system

-- Some Thoughts on Current International Financial Crisis and East Asia's Responses

Yu Yongding

IWEP, CASS, Jan.20, 2009

Safeguarding Asian Assets in the US

The global financial and economic crisis has reached a critical stage. The most fundamental challenges faced by decision makers are: on the one hand, the fall of the global economy should be contained as soon as possible; on the other hand, the global financial system should not be destabilized in the long-run because of reckless expansionary monetary and fiscal policy. In fact, in its effort for unfreezing the money market, preventing credit crunch from worsening, and prompting up financial institutions that are on the edge, the Fed has resorted to pump-priming. Value of goods depends on the scarcity. When helicopter-Ben drops tons and tons of dollar bills from the sky, what value does the dollars still have? When the balance sheet of the Fed is no better than a junk bond fund, it becomes a kind of junk bond fund. The Fed knows very well the inflationary consequences of the extremely loosen monetary policy. Hence it has brought forward some new schemes, such as paying interest on reserves and possible selling Fed bonds to the financial institutions. However, the basic question is still unanswered: when the situation has changed, can the Fed withdraw the liquidity quickly enough to prevent current liquidity shortage and credit crunch from turning into hyperinflation and a free fall of the US dollar? In other words, will the US inflate away its debt burden? The result of such an inflation and devaluation scenario, let alone defaults, will be devastating for China, Japan and the rest of East Asian countries, which hold some 3 trillion USD foreign exchange reserves, collectively.

Currently, the Chinese government is facing two major challenges: minimizing the negative impact of the US financial crisis-led global slowdown on economic growth, and preserving the value of its foreign exchange reserves, which mostly are in the form of the US treasuries. More or less, this is a issue common to all North Asia. Hence the discussion of the reform of international financial system should put the issue of preserving the value of foreign exchange reserves high on the agenda.

No matter what policies the US government has adopted and will adopt, the stabilization of

US financial market and US economy should not be achieved at the expense of the rest of the world. No matter whether it is a devious attempt or unintended result, if serous inflation and dramatic fall of the US dollar are allowed to happen, the consequences will be extremely grave. In other word, US policy in dealing with current financial crisis is not a pure sovereign matter but that it is an international matter. To achieve long-term stability, western countries' policy aimed at unfreezing money markets, pumping up failing financial institution, and financing stimulus plans should be discussed not only among G7. There should be a new framework to facilitate policy coordination among all major sovereign stake-holders in the world.

In the long-run, the key issue is that the US dollar's hegemonic position as virtually the sole international reserve currency should be changed. Because America's liabilities are denominated in terms of dollars, held by foreign countries as American assets, there are no effective disciplines can be imposed on the US monetary authority, and the smooth functioning of other sovereign countries will dependant entirely on the good- will and competency of the US monetary authority. The current US financial crisis has damaged the credibility of US authorities and the dollars permanently, and shown that to use the dollar as the only store of value, unite of account, and vehicle money is an un-affordable luxury for the rest of the world. The US financial crisis is still unfolding. We do not know what will be the next step or misstep of the Fed and the Ministry of Treasury will take, let alone the possible consequences. China, as the biggest holder of the US Treasuries, is asking the question as Rogoff did : "Why would a government refuse to pay its domestic public debt in full when it can simply inflate the problem away?" The Chinese government has demanded guarantees by the US government for the safety of China's assets in the US. I do know whether the Chinese government has got such any guarantees, or whether the US government has the ability to keep the promise, if they were given. No matter whatever the result is, the long-term solution lies in the reform of the international financial system that is characterized by the fact that the US dollar is the major reserve currency The issue of a new reserve currency, a basket of reserve currencies or whatever, which will not be subject to the influence of a major country's domestic policy, should be high on the agenda of the reform of international financial system. Otherwise, the discussion of the reform of the international financial system cannot be very meaningful.

From China's perspective, there are three basic roads for the reform of the international

monetary system: reform within the current framework of international monetary system, strengthening regional financial cooperation and integration, and the internationalization of the RMB.

The reform of post Breton Wood system from within

The reform within the current framework means the reform of the IMF. Since the Asian Financial Crisis, IMF's authority and credibility have deteriorated rapidly by its own missteps. Before 2007, the IMF failed to do anything to supervise, regulate, and contain the huge asset bubbles in international capital market. It even failed to forewarn the world on the coming subprime crisis in any significant way, let alone to had done anything to prevent the crisis from forming and breaking out since the turn of the century. Has IMF ever exposed the excess of the US financial institutions? Has the IMF ever pointed out that MBS, CDO and CDS have dangerous implications to the financial stability? Now has the IMF ever raised any questions on the Fed's desperate monetary policy? In 2008, the most important decision taken by the IMF was to toe the line of the US government to designate China as exchange rate manipulator. Here there is no need to discuss whether China erred or not. The thing is that the IMF has lost the sense of direction. I do not doubt the intellectual competency of IMF staffers. The thing is political influence. Lack of independence has damaged the authority of the IMF irretrievablely. Any reform of the IMF less than a total overhaul is not acceptable. As a first step, voting share should be redistributed, and the role of East Asian countries should be increased significantly.

To make the IMF a more balanced international organization. The influence of the US should be reduced. Asia must have bigger say in the organization. At the operational level, there are five major issues should be discussed. *First,* the SDR should play a more important role. The question of whether and how the SDR should replace the US dollar as a reserve currency should be considered seriously. *Second*, how the BIS and the IMF should strengthen their cooperation so as to improve the supervision of financial stability in the global financial market. *Third,* IMF conditionality should be totally reconsidered. The action taken by the US government in dealing with current financial crisis has totally discredited the prescriptions provided to and imposed on the crisis-affected countries during the Asian Financial Crisis. *Fourth,* now we have G7-8, G20 and G whatever. How the division of labor of these forums and the IMF should be defined more

clearly. Maybe, the UN should have more say on international finance and the IMF should be more cooperative with the UN. *Last but not least, t*he IMF has been pushing capital account liberalization dogmatically. It should play a more positive role in helping developing countries in strengthening the management of Cross-Border Capital Flows. So far, the impact of the US financial crisis on Korea seems gravest in East Asia. I am wondering whether this is attributable to the unhindered cross-border capital flows. Korea allowed too much capital aimed at arbitrage and speculation to inundate its financial market after having implemented faithfully the IMF prescriptions during the Asian financial crisis. Now the Korea seems have no effective means to prevent capital from flowing out, which is attributable to the unwinding of carry-trade, and withdrawing of foreign capital because of liquidity shortage, credit crunch and need for capital injections. The IMF should adjust its position on capital account liberalization. The blindly push of free flows of cross-border capital flows should be stopped and a more measured attitude should be adopted by the IMF.

The regional financial cooperation

The dissatisfaction felt by Asian countries to IMF's insensitivity towards Asian countries' suffering found its initial expression in Japan's proposal of establishing an Asian Monetary Fund (AMF). The most essential function of the proposed AMF is to provide emergency financial support to would-be crisis-affected countries. Ideally, the emergency financial support provided by the AMF will be more speedy and the condition for providing such support will be less harsh and more in line with "Asian way".

The "Chiang Mai Initiative"(CMI) is the most important milestone of Asian financial crisis. According to The Joint Ministerial Statement of the ASEAN + 3 Financial Ministers Meeting, published on 6 May 2000, Chiang Mai, Thailand, the ASEAN + 3 agreed to strengthen policy dialogues and regional cooperation activities in the areas of capital flows monitoring, self-help and support mechanism and international financial reforms. They recognized a need to establish a regional financing arrangement to supplement the existing international facilities. They agree to establish a network of research and training institutions to conduct research and training on issues of mutual interests. Besides these general statements, the statement declared that the "Chiang Mai Initiative" involves an expanded ASEAN Swap Arrangement that would include ASEAN counties,

and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea. The swap arrangement marked an important turning point in the road for Asian financial cooperation in history. In recent years, the swap arrangements have developed from bilateral to multilateral agreements. Now a prototype AMF is taking shape. However, currently, the problems faced by East Asia as a whole and by individual countries in the region are very different from those during the Asian Financial Crisis.

On the whole, during the current global financial crisis, the performance of the East Asian governments in terms of financial cooperation and coordination is rather disappointing. The only result so far is China-Japan-Korea currency swap agreements. It is pitiful that when the cooperation is most needed, the cooperation is basically nonexistent. If even at such critical juncture as current one, the ASEAN10+3 cannot coordinate somewhat, then what cooperation and coordination we can expect for this grouping in the future. Why the 13 countries cannot get together and take concerted acts to demand the US government to safeguard the safety of their hard-earned foreign exchange reserves, which mostly are in the form of the US government securities. Are the governments in the region so sure that their people's assets are safe and the US government will not get rid off its huge debt burden by inflation, devaluation of the US dollar and defaults? The East Asia has been ripped off once during the Asian Financial Crisis. This time around the East Asia seem ready to be ripped off for the second time even without murmuring.

Over the past decade since the Asian Financial Crisis, discusses among economists have been concentrated in exchange rate coordination. However, no significant result has been achieved. And now when the global financial crisis has worsened rapidly, the issue of exchange rate coordination seems as irrelevant as ever. The Euro countries' performance seems rather disappointing. Maybe, regional financial cooperation needs to find another rally point. The urgency of exchange rate coordination may have faded into a place of secondary importance.

The internationalization of RMB

China's situation under current financial crisis is paradoxical. On the one hand, as a captured lender to the US, it is facing the danger of making big losses. In the words of some financial observers, China has lost a lot already without knowing it clearly, or at all. On the other hand, due

to China's huge foreign exchange reserves and the appreciation of the RMB, China's currency—RMB is at a very favorable position. Hence, China is facing a historical opportunity for the internationalization of the RMB. Both the reasons why China should be interested in internationalizing its currency and the possible problems arisen following the internationalization are obvious. I will not dwell on them. Here, I just wish to mention a few possible measures that China may take to promote the internationalization of the RMB while minimizing the losses as a result of the biggest holder of US treasury securities.

Currency swaps

On the whole, in Asia, liquidity shortage and credit crunch have not been as serious as in the US and European countries. However, due to various reasons, in many East Asian countries, commercial banks are becoming more and more reluctant to lend, which has affected the real economy significantly. How to provide liquidity for foreign firms in the domestic markets has become a serious issue. For example, a Japanese firm operating in China may need RMB loans. In this case, government currency swaps will help. Due to the changes in the situation, compared with situation during the Asian Financial Crisis, the money pooled together in line with Chang Main Initiative may find a better use for stabilizing the regional financial system.

In the early May 2008, Finance ministers from China, Japan, South Korea and the Association of Southeast Asian Nations (ASEAN) agreed to expand their system of bilateral currency swaps under the Chiang Mai Initiative to a more multilateral system. Under the currency swaps, an Asian country hit by a foreign exchange crisis could borrow US dollars from another country to bolster its reserves until the crisis had passed. Finance ministers from 13 Asian nations, including South Korea, Japan and China, agreed to create a pool of at least $80 billion in foreign-exchange reserves to be tapped to protect their currencies.

On Dec. 12 2008, China and Japan agreed with South Korea on bilateral currency swap accords in an effort to ensure financial stability in Asia. China and South Korea will sign an accord worth 38 trillion won ($28 billion). According to the accord, China gives South Korea access to 38 trillion won worth of yuan at any time for the next three years. The central banks of China, South Korea and Japan will meet again in 2009, starting regular consultations to ensure currency stability in Asia.

On 19 December 2008 the Central Government announced that 14 measures would be undertaken in seven areas to support Hong Kong's financial stability and economic development, including agreeing to the signing of a currency swap agreement between the People's Bank of China (PBoC) and the Hong Kong Monetary Authority (HKMA).

With the establishment of a currency swap arrangement, short-term liquidity support can be provided to the Mainland operations of Hong Kong banks and the Hong Kong operations of Mainland banks in case of need. This will bolster confidence in Hong Kong's financial stability, and will also help to promote financial stability in the region and the development of renminbi-denominated trade transactions between Hong Kong and the Mainland. The currency swap agreement has a term of three years, which can be extended upon agreement by both parties. It can provide liquidity support up to RMB200 billion / HK$227 billion.

Settlement in RMB

In December 2008, China announced that it will allow the settlement of trade in RMB with Hong Kong Macau and ASEAN nations on a trial basis. The pilot RMB trade settlement program will be tested in Guangdong province, the Yangtze River Delta, Hong Kong and Macau. The RMB trial will also be implemented between Guangxi and Yunnan provinces and the neighboring countries of the ASEAN trade group.

Panda Bonds

There are countries which need dollars, while there are other countries which wish to get rid of dollars in the region. China has huge amount of foreign exchange reserves which China has not intention to accumulate further. But for China, to provide dollar loans directly to foreign borrowers seems to risky, due to exchange rate risk and default risk. Furthermore, China lacks necessary expertise to lend dollars to foreign borrowers. There are many ways China can help its neighbors: consortium loans, panda bonds and so on. Countries that need dollars can borrow from China by selling Panda bonds. ADB and some private international financial firms can involve in issuance, underwriting, credit rating, legal service and so on. Anyway, governments and ADB can get together to discuss the possibility of issuance of Asian Bonds. By doing so, the regional financial can be promoted and the role of the US dollars can be replaced by local currencies

gradually.

Loans to foreign banks

Three Chinese banks are the second, third and forth most cash rich commercial enterprises at the moment. Presently, no international bank has any meaningful liquidity available. In contrast, Chinese banks are sloshed with excess liquidity. It is possible for those Chinese banks to lend long term RMB subordinated term loans to qualified foreign banks. Borrowers can buy dollars with the RMB borrowed from the Chinese banks and repay the RMB over a specified period of time.

Wider Use of Local Currencies

The credibility of US dollars has been decreased significantly. Efforts should be made by countries in the region to reduce the use of US dollar as median of exchanges, vehicle money, counting unit and so on. Efforts should be made by countries with strong currencies and advanced capital markets to encourage the use their currencies as store of value, or reserve currencies.

Free Trade Should Be Safeguarded

FTAs should be promoted continuously. No tax and non-tax barriers should be erected. Trade disputes should be solved between relevant parties in an amicable manner. No countries in the region should resort to beggar-thy-neighbor policy of devaluation and trade subsidies.

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

16 October 2008

Excellency

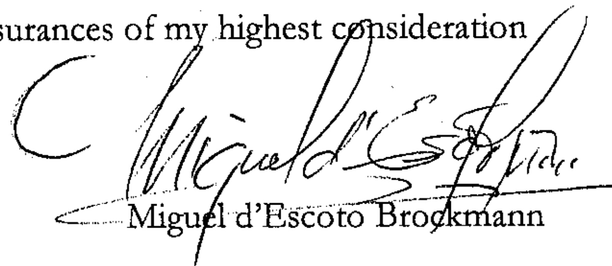
As the global financial crisis deepens, it is even more evident that we are facing global challenges that can produce serious setbacks in the efforts to reduce poverty and achieve the Millennium Development Goals and other international agreements.

In this context and in anticipation of the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus in Doha, I would like to invite you to an Interactive Panel on the Global Financial Crisis to be held on Thursday, 30 October 2008 beginning at 9 a.m. The purpose of the panel is to give Member States the opportunity to address this issue and interact with a well-recognized number of economists and sociologists in order to place the current crisis into a macroeconomic and social context. It represents an important step in an ongoing effort to develop proposals regarding the economic and development agenda of the United Nations and the role that the United Nations should play in the search for new policy initiatives.

The panelists that I have invited to lead this discussion are: Prof. Joseph Stiglitz (USA); Dr. François Houtart (Belgium); Prof. Prabhat Patnaik (India) and Dr. Pedro Paez (Ecuador) The concept and programme of the Panel is attached herewith for your information.

Your opinions, points of view and comments will greatly contribute to clarify not only where we are but in which direction the United Nations should move.

Please accept, Excellency, the assurances of my highest consideration



Miguel d'Escoto Brockmann

All Permanent Representatives
and Permanent Observers to the
United Nations

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

21 October 2008

Excellency,

Further to my letter of 9 October 2008 on the preparation of the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus, to be held in Doha, Qatar, from 29 November to 2 December 2008, I should like to refer to the provisions of the note by the Secretary-General on organizational matters (A/63/345) that deals with the engagement of intergovernmental organizations, civil society and the business sector, in particular to paragraphs 28 and 30 of that note. In that connection, I have the honour to enclose herewith for your consideration the lists of intergovernmental and civil society organizations seeking accreditation to the Doha Review Conference (see annexes I and II).

In the absence of any objection by 30 October 2008, I intend to bring this matter to the attention of the Second Committee, for appropriate action under agenda item 48. Background information on the intergovernmental and civil society entities included in the list may be obtained, as required, from the Financing for Development Office of the Department of Economic and Social Affairs of the United Nations Secretariat (room DC2-2158, tel: (212) 963-3664).

I also wish to take this opportunity to advise all delegations that, in accordance with paragraph 5 (a) of General Assembly resolution 62/187 of 19 December 2007, registration to the Conference is now open to all non-governmental organizations that are in consultative status with the Economic and Social Council or were accredited to the Monterrey Conference or its follow-up process. For further information, please refer to the following webpage: www.un.org/esa/ffd/doha/registration.htm.

Pleazse accept, Excellency, the assurances of my highest consideration.

Miguel d'Escoto Brockmann

All Permanent Representatives
and Permanent Observers to the
United Nations
New York

Annex I

List of intergovernmental organizations seeking accreditation to the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus (Doha, Qatar, 29 November - 2 December 2008)

1. **Global Digital Solidarity Fund (DSF)**
   Mr. Alain Clerc
   Executive Secretary

Address: 20 Avenue de la Concorde, 1203 Geneva, Switzerland
Tel: +41 22 979 32 23
Fax: +41 22 979 32 51
Email: cisse.kane@dsf-fsn.org
Website: http://www.dsf-fsn.org/
Membership: International

The DSF is a global financing foundation, which tries to build a solidarity-based and inclusive information society through the reduction of the digital divide and the dissemination of information and communication technologies.

2. **The Global Fund to Fight AIDS, TB and Malaria**
   Mr. Michel Kazatchkine
   Executive Director

Address: Chemin de Blandonnet 8, 1214 Geneva, Switzerland
Tel: +41 22 791 17 00
Fax: +41 22 791 17 01
Email: susanne.Luithlen@theglobalfund.org
Website: http://www.theglobalfund.org
Membership: International

The Global Fund to Fight AIDS, TB and Malaria finances programs against the three diseases in more than 130 countries, though country-owned programmes. The Global Fund explores innovative financing opportunities to increase resources for public health.

3. **UNITAID**
   Mr. Jorge Bermudez
   Executive Secretary

Address: 20 Avenue Appia 20, CH - 1211, Geneva 27, Switzerland
Tel: + 41 22 791 55 03
Fax: + 41 22 791 48 90
Email: daoup@who.int
Website: http://www.unitaid.eu
Membership: International

UNITAID is an international drug purchase facility, established to provide long-term, sustainable and predictable funding to increase access and reduce prices of quality drugs and diagnostics for the treatment of HIV/AIDS, malaria and tuberculosis in developing countries.

Annex II

List of non-governmental organizations seeking accreditation to the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus (Doha, Qatar, 29 November - 2 December 2008)

1. **Alliance for African Women Initiative (AFAWI Ghana)**
   Ms. Eva Asiedu
   Chairperson

Address: P.O.BOX TA 551 Taifa, Greater Accra 00233, Ghana
Tel: +233 21 410 746
Fax: +233 21 410 746
Email: info@afawigh.org
Website: http://www.afawigh.org
Membership: Regional

AFAWI is a development-oriented, non- profit, non-sectarian, non-governmental organization that seeks to ensure equitable development for both rural inhabitants and poor urban dwellers, especially women and children.

2. **Asociación Latinoamericana de Organizaciones de Promoción al Desarrollo (ALOP)**
   Mr. Miguel Santibáñez
   President

Address: Benjamín Franklin 186, Col. Escandón, Del. Miguel Hidalgo - México
Tel: +52 555 273 3400
Fax: +52 555 273 3449
Email: info@alop.org.mx
Website: http://www.alop.org.cr
Membership: Regional

ALOP includes various NGOs from Latin America that focus on development issues. The organization devises proposals for the promotion of global development, taking into account the knowledge and experience from its partner organizations.

3. **Association Femmes et Actions pour le Développement (FAD)**
   Ms. Mariam Camara
   President

Address: Siège sociale, Conakry, République de Guinée BP 2176
Tel: +224 60 58 77 78 / +224 64 29 31 12
Fax: N/A
Email: fadguinee@yahoo.fr
Website: N/A
Membership: National

FAD offers capacity building for children and women, through training, education and development of communication skills, in order to enable them to play a greater role in the society, particularly in defending their rights.

4. **Centre d'accompagnement des alternatives locales de développement**
Ms. Collet Bitibinen
President

Address: **B.P.** 2441, Yaoundé, Messamena, EST, Cameroon
Tel: +237 99 88 58 06
Fax: N/A
Email: nzoager@yahoo.fr
Website: N/A
Membership: Local

The organization commissions studies and research on financing for development through collaboration with development financing institutions.

5. **Centre for Rights and Development (CEFRAD)**
Mr. Mathew Servina
President and CEO

Address: Hermitage Street, Victoria, Mahe Island, Seychelles
Tel: +248 768028
Fax: N/A
Email: cefrad@seychelles.sc
Website: N/A
Membership: National

CEFRAD encourages citizens to participate proactively in sustainable development at community, national, regional and global levels.

6. **Civil Power Africa**
Mr. Braide Given
Chair, Board of Governors

Address: 2 Nnewi Street, Rumuomasi, 14187 Port Harcourt, Rivers State, Nigeria
Tel: +234 802 784 4602
Fax: +234 802 784 4602
Email: cpafric@yahoo.com
Website: N/A
Membership: Local/National

Civil Power Africa promotes micro-enterprise, education and health initiatives in Nigeria and in the Niger Delta in particular.

7. **Dennis-MMEK International Care**
Mr. Kanu Paschal Nnmaso
Executive Head

Address: 37 Azikiwe Rd., P.O.BOX 3112, Umuahia, Abia State, Nigeria
Tel: +234 8 056 660176
Fax: N/A
Email: noblehouse37@yahoo.com
Website: N/A

Membership: Regional

Dennis-MMEK International Care promotes human rights, women and youth empowerment, as well as micro-credit activities in Abia State and other rural communities.

8. **Development Wheel (DEW)**
Mr. Salam Shah Abdus
Executive Head

Address: 13-A/4-A (3rd floor), Babar Road, Mohammadpur, 1207 Dhaka, Bangladesh
Tel: +880 2 811 5579
Fax: +880 2 913 7196 (or 913 5499)
Email: dewsalam@gmail.com, dewhc@bdonline.com
Website: http://www.dewbd.org
Membership: National

DEW is a non-profit organization that seeks to train workers employed in the arts and crafts sector in Bangladesh, with a view to help them to market their products.

9. **Equit Institute**
Ms. Graciela Rodriguez
General Coordinator

Address: Rua da Lapa, 180, Sala 909, 20021-180 Rio de Janeiro, Brazil
Tel: +55 21 2221 1182
Fax: +55 21 2221 1182
Email: graciela@equit.org.br
Website: N/A
Membership: International

Equit Institute is a non-governmental organization carrying out research, capacity building programmes and political advocacy on issues related to gender and economics.

10. **European Parliamentary Forum on Population and Development (IEPFPD)**
Mr. Neil Datta
Secretary

Address: Rue Montoyer 23, 1000 Brussels, Belgium
Tel: +32 2 500 8650
Fax: +32 2 511 6762
Email: secretariat@iepfpd.org
Website: http://www.iepfpd.org
Membership: International

EPFPD is a Brussels-based parliamentary network that serves as a platform for cooperation and coordination for the 25 all-party groups in parliaments throughout Europe that focus on improving sexual and reproductive health and rights at home and abroad through national and regional health and foreign aid budgets.

11. Evangelical Lutheran Mission Leipzig (LMW)
Mr. Michael Hanfstaengl
Director

Address: Paul List Strasse 19, 04103 Leipzig, Saxony, Germany
Tel: +49 341 994 0622
Fax: +49 341 994 0690
Email: info@LMW-mission.de
Website: http://www.lmw-mission.de/e/index.htm
Membership: International

LMW provides financial assistance and advisory support to their partners in India, Tanzania, and Papua New Guinea. LMW works on issues related to globalization, climate change, external debt and innovative financing.

12. Foundation for widows and less privileged (FOWALP)
Ms. Dabota Bull
Founder

Address: 15 New Road, 500001 Bonny Islands, Rivers State, Nigeria
Tel: +234 803 339 0980
Fax: N/A
Email: dabota_bull@yahoo.com
Website: http://www.fowalp.org
Membership: National/International

FOWALP seeks to alleviate poverty and advance the social and economic conditions of the widows traumatized by the loss of their husbands, particularly in rural communities.

13. Freedom from Debt Coalition (FDC)
Mr. Walden Bello
National President

Address: 11 Matimpiin Street, Barangay Pinyahan, 1100 Quezon City, Metro Manila, Philippines
Tel: +632 921 1985
Fax: +632 924 6399
Email: mail@fdc.ph
Website: http://www.fdc.ph
Membership: National

FDC is a nation-wide, multi-sector coalition of people's organizations, sectors, NGOs and individuals. It conducts advocacy work on debt, public finance, privatization of essential services and commons, as well as climate change.

14. GGS Institute of Information Communication Technology - India
Mr. Guru Amar Singh Sidhu
Secretary General

Address: 9827 St No 6 Joshi Nagar, 141106, Ludhiana, Punjab, India
Tel: +91 161 230 1853
Fax: +91 161 461 1210

Email: gsingh1950@gmail.com
Website: N/A
Membership: International

The Institute works in the area of renewable energy in rural areas.

15. Global Call to Action against Poverty - Liberia (GCAP-Liberia)
Mr. Christian Peah
National Coordinator

Address: 231Broad Street, Monrovia, Montserrado County, Liberia
Tel: +231 653 3015
Fax: N/A
Email: gcapliberia2015@yahoo.com
Website: N/A
Membership: National

GCAP-Liberia is a member of GCAP global and an alliance of over 37 civil society organizations that promote the MDGs in Liberia.

16. Global Network for Environment and Economic Development Research
Dr. Joseph Adelegan
Founder and Executive Director

Address: 16 Ladoke Akintola Avenue, New Bodija Estate, 20005, Ibadan, Oyo State, Nigeria
Tel: +234 806 284 3428
Fax: +234 2 810 6202
Email: dr_joseph_adelegan@yahoo.com
Website: N/A
Membership: International

This organization is involved in researching and implementing environmental, social and economic projects in Africa. Recent projects include the construction of a bio-gas plant to transform poisonous wastes into cheap domestic energy for poor families and into fertilizers for low-income farmers.

17. Groupe d'Action "Qui Veut Peut"
Ms. Zossougbo Berthe
President

Address: Quidah, Quidah/Atlantique B.P. 291, Benin
Tel: +229 97 83 31 44
Fax: N/A
Email: insekpat@yahoo.fr; gaquivep@yahoo.fr
Website: N/A
Membership: National

This organization fights the spread of HIV/AIDS and other sexually transmitted diseases. It also seeks to spur agricultural development through the promotion of crop picking techniques.

18. **Hope Worldwide - Pakistan**
Dr. Khurram Shahid Malik
President and Executive Director

Address: Office No.2, Riffat Plaza, Afshan colony, Dhoke Chaudrian, 46000, Rawalpindi, Punjab, Pakistan
Tel: +92 51 511 0050
Fax: +92 51 579 4546
Email: hopeworldwide@hotmail.com
Website: http://www.hopeworldwide.org.pk
Membership: International

Hope Worldwide - Pakistan is a faith-based non-governmental organization founded in 1991 by the International Churches of Christ. Its non-sectarian programmes serve disadvantaged children, women and elderly by providing education and delivering medical services in developing urban and rural communities.

19. **IBON Foundation Inc.**
Ms. Jazminda Lumang Buncan
Executive Head

Address: IBON Centre, 114 Timog Avenue, 1103 Quezon City, Metro Manila, Philippines
Tel: +63 2 927 9061/2
Fax: +63 2 927 6981
Email: scruz@ibon.org
Website: http://info.ibon.org
Membership: International

IBON Foundation Inc. is a non-governmental organization committed to serve marginalized people through research, education, information and advocacy programmes.

20. **International Foundation for African Children (IFAC)**
Mr. Alex Duduyemi
Chief Executive Officer

Address: 6 Lake Street, Opp. John Holt Building, 101001, Apongbon, Lagos, Nigeria
Tel: +234 1 811 2119
Fax: N/A
Email: africanchildren@hotmail.com
Website: N/A
Membership: International

IFAC seeks to address concerns of African children and improve their fate through development programmes.

21. **Job Creation Trust**
Mr. William Madisha
Executive Head

Address: 5th Floor, Braamfontein Centre, 23 Jorrissen Street, Braamfontein 2017, Johannesburg, SouthAfrica
Tel: +271 1 339 1486
Fax: +271 1 339 2069

Email: sgarnie@ljct.org.za
Website: N/A
Membership: National

The Job Creation Trust seeks to create job opportunities mostly for rural communities.

22. Jonction
Mr. Ababacar Diop
President

Address: HLM Grand-Médine N° 512, 4126, Dakar, Senegal
Tel: +221 645 4246
Fax: +221 825 7492
Email: jonction_jonction@yahoo.fr
Website: http://jonctionsenegal.free.fr
Membership: Local/Regional/National

Jonction is a non-governmental organization that focuses on the promotion of sustainable development and equitable rights for people from Africa and Senegal in particular.

23. Jubilee South
Ms. Lidy Nacpil
International Coordinator

Address: 34 Matiyaga, Central District, Diliman, 1104 Quezon City, Metro Manila, Philippines
Tel: +63 925 3036
Fax: +63 925 3036
Email: jubileosur@wamani.apc.org
Website: http://www.jubileesouth.org
Membership: International

Jubilee South seeks to promote collective action to overcome the negative effects of external debt on developing countries.

24. La Colombe
Mr. Katanga Shaba
President

Address: 20 bis, AV.BAS-CONGO, 243, Kinshasa, Democratic Republic of the Congo
Tel: +243 818 12 9288
Fax: N/A
Email: lacolombe2@hotmail.com
Website: N/A
Membership: National

La Colombe is a non-governmental organization that promotes environmental management, sustainable development and poverty alleviation.

25. LDC Watch
Mr. Arjun Karki
Executive Head

Address: 288 Gairidhara Marg, Kathmandu, Nepal
Tel: +977 14 434 165
Fax: N/A
Email: akarki@ldcwatch.org
Website: http://www.ldcwatch.org
Membership: International

LDC Watch is a global alliance of regional and national civil society organizations that monitor the implementation of the Brussels Programme of Action for the Least Developed Countries and other internationally agreed development goals.

26. Magnificat Environment Association
Mr. Peter Kabongo Tambwe
Executive Head

Address: 348 Rue Moretan Gbadago, 228, Lome, Maritime, Togo
Tel: +228 338 8379
Fax: +228 220 8077
Email: magnificat_environment@yahoo.fr
Website: N/A
Membership: National

The Association's activities focus on improving living conditions of people, especially through the promotion of socio-economic justice, environmental education and socio-cultural and sustainable development.

27. Manav Kalyan Pratisthan
Mr. Ramesh Chandra Tiwari
Secretary

Address: 72-Ismailganj, 212601, Fatehpur, UP, India
Tel: +91 941 506 5534
Fax: +91 518 022 4647
Email: manavkalyanftp17@rediff.com
Website: N/A
Membership: Regional

The Organization supports integrated health and rural development projects that result in job creation and income generation for village unemployed women.

28. Médecins du Monde
Mr.Pierre Micheletti
President

Address: 62 Rue Marcadet, 75018, Paris, France
Tel: +33 1 449 21488
Fax: +33 1 449 21612
Email: marie-alexia.delerue@medecinsdumonde.net
Website: http://www.medecinsdumonde.org
Membership: International

Medecins du Monde is an international aid and support association founded in 1980. Its mission is to provide care to the most vulnerable populations in situations of crisis and deprivation.

29. Network for Women Rights in Ghana (NETRIGHT)
Ms. Rose Mensah-Kutin
Executive Head

Address: 9th Ollenu Street, East Legon, Greater Accra, Ghana
Tel: +233 21 511 189, (500 419, 500 419)
Fax: +233 21 511 188
Email: netright@twnafrica.org
Website: N/A
Membership: National

NETRIGHT is a coalition of non-governmental organizations and individuals working together to promote women's rights in Ghana through critical analysis of the gender dimensions of national and international processes and policies.

30. Pakistan Community Peace Foundation (PCPFI)
Ms.Salamat Bhatti
Chairman

Address: Flat # 3, First floor, Humza Plaza, G.T. Road Nawababad, 47040, Wah cantt, Punjab, Pakistan
Tel: +92 51 454 2812
Fax: +92 51 454 5448
Email: info@pcpfi.org
Website: http://pcpfi.org
Membership: International

PCPFI is an international non-governmental organization focusing on human rights and humanitarian aid. Its work also includes initiatives to preserve the environment, as well as education and healthcare projects for youth and women.

31. Polli Dustha Kallyan Shangstha (PDKS)
Mr. Abdur Rashid Mollah
Chairman

Address: 92 DIT Road, Third Floor,1349 Dhaka, Bangladesh
Tel: +880 2 7701 272
Fax: +880 2 7701 272
Email: pdks_ngo@yahoo.com
Website: N/A
Membership: Local

PDKS works on projects in the areas of microfinance, child and maternal health, water and sanitation, relief and rehabilitation and disaster preparedness management.

32. Population Action International
Ms. Amy Coen
President and CEO

Address: 1300 19th Street, NW, Second Floor, 20036, Washington, DC, United States
Tel: +1 202 557 3434
Fax: +1 202 728 4177
Email: sdennis@popact.org
Website: http://www.populationaction.org
Membership: International

Population Action International works to improve individual well-being and preserve global resources by mobilizing political and financial support for population, family planning and reproductive health policies and programmes.

33. Reality of Aid Network
Mr. Antonio Jr. Tujan
Executive Head

Address: IBON Centre, 114 Timog Avenue, 1103 Quezon City, Metro Manila, Philippines
Tel: +63 2 927 9060
Fax: +63 2 927 6981
Email: rpinauin@ibon.org
Website: http://www.realityofaid.org
Membership: International

The Reality of Aid Network aims to achieve more effective strategies to eliminate poverty. Its work is based on principles of solidarity and equity. Through analysis of international aid and development cooperation, it promotes changes in the North-South system of income distribution.

34. Resource Center for Environment and Sustainable Development Organisation (RCESDO)
Chief Nkemnyi Primus
Executive Director

Address: Molyko Buea, 144 Buea, Buea, South West, Cameroon
Tel: +237 753 94838
Fax: +237 333 22844
Email: rcesdo7@yahoo.com
Website: N/A
Membership: National

RCESDO-Cameroon seeks to promote poverty eradication through encouraging, strengthening and educating communities.

35. Seeds for African Relief Agency
Mr. David Duke Arthur Pinto
President

Address: P.O.Box Kn 1332, Kaneshie, Accra, Ghana
Tel: +233 21 673 218
Fax: +233 21 673 218
Email: seeds4african@yahoo.co.uk
Website: N/A
Membership: Regional

The organization's purpose is to collect funds from philanthropists to provide financial assistance to deprived farmers, orphanage homes and street children. It also helps needy students to access scholarship schemes, especially to those who study information technology and markets.

36. Servicios Ecumenicos para Reconciliacion y Reconstruccion
Ms.Cheryl Desmond
Executive Head

Address: 423 Rabbit Hill Lane, Lancaster, PA 17603, USA
Tel: +1 717 871 2002 or +1 717 872 6334
Fax: N/A
Email: tlalibertad@gmail.com
Website: N/A
Membership: International

This US-based entity seeks to promote a culture of peace through development-oriented programmes that include education for youth, especially in El Salvador.

37. Slums Information Development & Resource Centres (SIDAREC)
Ms.Lucy Mathai
Executive Director

Address: P.O.BOX 9687-00300, Landhies Road, NACICO Plaza, 254-20, Nairobi, Kenya
Tel: +254 020-246 961
Fax: N/A
Email: george@sidarec.org.ke
Website: http://www.sidarec.org
Membership: National

SIDAREC is a youth organization operating in the slums of Nairobi and parts of Rift Valley Province to improve the living conditions of the poor.

38. Solidar
Mr. Andrea Maksimovik
International Coordinator

Address: Rue du Commerce 22, Brussels B-1000, Belgium
Tel: +32 2 500 1027
Fax: +32 2 500 1030
Email: andrea@solidar.org
Website: http://www.solidar.org
Membership: International

SOLIDAR is a network of 47 European social and economic justice NGOs. The network provides support to post-conflict and post-tsunami reconstruction and rehabilitation efforts, de-mining activities and promotion of peace, social justice and economic recovery.

39. Stamp Out Poverty
Mr. David Hillman
Executive Head

Address: 83 London Wall, EC2M 5ND, London, United Kingdom
Tel: +44 207 374 0305
Fax: N/A
Email: dhillman@stampoutpoverty.org
Website: http://www.stampoutpoverty.org
Membership: National

Stamp Out Poverty is a network of more than 50 UK organizations, trade unions and faith groups that jointly campaign for additional sources of finance to bridge the massive funding gap required to bring the world's poorest people out of poverty.

40. TB Alert
Mr. Mike Mandelbaum
Chief Executive Officer

Address: Community Base, 113 Queens Road, BN1 3XG Brighton, United Kingdom
Tel: +44 127 323 4008
Fax: N/A
Email: advocacy@tbalert.org
Website: http://www.tbalert.org
Membership: International

TB Alert works towards the control and ultimate eradication of TB by increasing access to effective treatment for all, including through resource mobilization efforts.

41. United Nations (Youth) Association of Cameroon
Mr.Thierry Kammi
Executive Head

Address: c/o Fecaclubs UNESCO, P.O. Box 1171, Yaounde, Centre Province, Cameroon
Tel: +237 965 36160
Fax: +237 222 26262
Email: unacameroon@yahoo.com
Website: N/A
Membership: National

The Association promotes the World Action Programme for Youth through forging collaborative efforts in redressing regulatory bottlenecks that hamper progress in the attainment of MDGs.

42. Unzila Memorial Welfare Organization
Mr. Nadeem Thahim Thahim
Executive Head

Address: Block 11, 74000 Karachi, Sindh, Pakistan
Tel: 92 21 3002 763 472
Fax: N/A
Email: umwo786@yahoo.com
Website: N/A
Membership: Local

The Organization seeks to improve the life of helpless and needy people in rural areas of Sindh, Pakistan.

43. VENRO
Ms. Heike Spielmans
Managing Director

Address: Kaiserstrasse 201 D-53113, Bonn, Germany
Tel: +49 228 94 677 0
Fax: N/A
Email: h.spielmans@venro.org
Website: http://www.venro.org
Membership: Regional

VENRO is an association of German development non-governmental organizations. It works in the fields of development cooperation, emergency assistance, development education and advocacy.

44. Voices for Interactive Choice & Empowerment (VOICE)
Mr. Ahmed Swapan Mahmud
Executive Director

Address: House-67, Block-ka, Pisciculture Housing Society, Shyamoli, 1207 Dhaka, Bangladesh
Tel: +880 2 815 8688
Fax: N/A
Email: exchange.voice@gmail.com
Website: http://www.voicebd.org
Membership: National

VOICE is an activist organization working, both nationally and internationally, on the issues of food sovereignty, aid effectiveness, economic justice and the right to information and communication.

45. Women and Memory Forum (WMF)
Ms. Hoda El Sadda
Chairperson

Address: 83 Shehab Street, Mohandessin, 12411 Giza, Cairo, Egypt
Tel: +202 333 57130 or +202-33040198
Fax: +202 330 40198
Email: wmf@wmf.org.eg
Website: http://www.wmf.org.eg
Membership: National

WMF is a research group that focuses on gender issues in the context of Arab culture and history. It seeks to promote the concept of women empowerment in the Egyptian society.

46. Youth Partnership for Peace and Development - Sierra Leone
Mr.Alhaji Alhassan Sesay
Executive Director

Address: 14 Williams Street, 00232 Freetown, Western Area, Sierra Leone
Tel: +232 77 238 864

Fax: N/A
Email: almuminin2006@yahoo.com
Website: N/A
Membership: National

The Partnership works on issues related to women's and children's rights, youth empowerment and employment, good governance and the fight against HIV/AIDS.

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

24 October 2008

Excellency,

In reference to my letter dated 16 October 2008 on the Interactive Panel on the Global Financial Crisis that will take place on Thursday 30 October 2008 in the Trusteeship Council Chamber at United Nations Headquarters, I have the pleasure to provide further information about the organization and focus of the Panel.

In addition to the four panelists already listed in my earlier letter - Prof. Joseph Stiglitz of the United States, Dr. François Houtart of Belgium, Prof. Prabhat Patnaik of India and Dr. Pedro Páez of Ecuador -, two more panelists have been invited. They are: Prof. Sakiko Fukuda-Parr of Japan and Prof. Calestous Juma of Kenya.

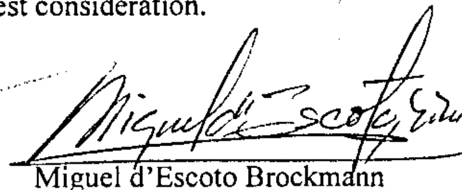
The Interactive Panel will consist of two sessions: from 9 a.m. to 12:30 p.m. and from 3 to 6 p.m. The morning session will start at 9:00 a.m. sharp. There will be a presentation by three of the panelists in the morning and three in the afternoon. After the presentations, an interactive exchange of views will follow. In order to accommodate as many Member States wishing to take the floor, interventions should not exceed more than 5 minutes each.

I am attaching herewith for your perusal a guideline for the panelists that I hope will be useful for Member States in preparing for this Panel discussion as well as the programme of the event.

I invite Member States to make use of this timely opportunity for a frank and stimulating discussion on the most urgent and complex issue confronting us today, with the hope that the exchange can shed some light on the way forward in finding a just and sustainable global solution.

I also wish to inform you that I have appointed Nobel Laureate Professor Joseph Stiglitz as the Chair of a high-level Task Force of Experts to undertake a comprehensive review of the international financial system and to suggest steps to be taken by Member States of the United Nations to secure a more just and stable global economic order. The terms of reference of the Task Force will be announced on 31 October, and I would welcome your suggestions and contributions on the functions and scope of this Task Force before that date.

Please accept, Excellency, the assurances of my highest consideration.



Miguel d'Escoto Brockmann

All Permanent Representatives and
Permanent Observers to the United Nations
New York

Office of the President of the General Assembly

24 October 2008

Interactive Panel on the Global Financial Crisis

Guidelines for Panelists

Background

Recognizing the urgent need for responses to the confluence of uncertainties facing the world community, the President of the United Nations General Assembly is convening an Interactive Panel on the Global Financial Crises on 30 October 2008 in New York. The aim of the meeting is to give Member States the opportunity to address the issues and interact with a panel of economists and sociologists in order to place the current crisis into a macroeconomic and social context. It represents an important step in an ongoing effort to develop proposals regarding the economic and development agenda of the United Nations and the role that the UN should play in the search for new policy initiatives.

There is a widespread concern that the global economic governance arrangements, set in place in 1944 at a meeting in Bretton Woods, New Hampshire officially called the "United Nations' Monetary and Financial Conference," need to be radically reformed to be responsive to current economic conditions. The onset of the food, fuel, and now the financial crisis throws a spotlight on the inadequacies of the current set of global institutions in enforcing accountability for economic decisions and maintaining growth and stability for the majority of the world's peoples.

Developing countries now represent a much larger proportion of world economic activity than they did when the Bretton Woods institutions were founded but their voices and interests are not sufficiently represented in the global councils of economic governance. Developing countries – as a group – are now net creditors to the global economic system and have an abiding interest in a rules-based and impartial revamping of global financial policies and institutions.

The President of the General Assembly has welcomed the initiatives and declarations of the leading industrial countries and developing countries that are actively expressing their concern regarding the current situation and calling for urgent action. As the pressure for change builds up, the design of the new architecture must necessarily be inclusive and democratic to be credible and sustainable. Hence, such an initiative should be convened by the 192 Member States through the General Assembly. The Organization continues to represent the most legitimate forum where the interests of all countries can be articulated.

Guidelines

Your intervention should lead off discussion among participants and may consider among other issues the following:

1. What are the global consequences of the current financial crisis and its impact on the growth and development prospects of developing countries?
2. What can be done to address the systemic root causes of this crisis, including the establishment of a transparent and accountable global system of policy coordination and fundamental reform of the global financial architecture?
3. What should be the underlying ethical and social bases for reforming the current international economic governance system? What are the practical arrangements, decisions, and processes that must be undertaken to justly and democratically implement the needed reforms?
4. What are the long-term challenges to sustaining public oversight and accountability over global market processes and what could be the transformation required in international relations between developed and developing countries and the Global South.
5. What are the developing country concerns and capabilities in playing an active role in global economic governance? What initiatives should developing countries undertake to establish a just and development-promoting economic system?
6. What kind of agreements should the international community reach at the United Nations' Review Conference on Financing for development to contribute to finding a durable systemic solution to the present crisis?
7. What are your views on possible actions required, including deep reform of the global financial architecture and what should be the role of the United Nations General Assembly?

Procedural guidelines for presentations

- Each presentation should last some 20 minutes.
- There will be three presentations in the morning and three in the afternoon. Following the presentations, there will be a Q & A period.
- Each panelist will have 15 minutes for final responses.
- The panel discussion will be webcasted followed by the production of DVD for worldwide distribution.

Programme

I. **The morning interactive session** will be held from **9:00 AM to 12:30 PM** and will be organized as follows:

09:00 - 09:15 AM	Opening remarks and presentation of panelists by the President of the General Assembly.

Panel discussion I:

09:15 - 09:35 AM	Prof. Joseph Stiglitz (USA)
09:35 - 09:55 AM	Prof. Prabhat Patnaik (India)
09:55 - 10:15 AM	Prof. Sakiko Fukuda-Parr (Japan)
10:15 - 11:45 PM	Member States exchange their points of view, comments and opinions in a dialogue format.
11:45 - 12:30 PM	Each panelist will have 15 minutes for final responses.

II. **The afternoon interactive session** will be held from 3:00 to 6:00 PM and will be organized as follows:

Panel discussion II:

03:00 - 03:20 PM	Dr. Pedro Páez (Ecuador)
03:20 - 03:40 PM	Prof. Calestous Juma (Kenya)
03:40 - 04:00 PM	Dr. François Houtart (Belgium)
04:00 - 05:00 PM	Member States exchange their points of view, comments and opinions in a dialogue format.
05:00 - 05:45 PM	Each panelist will have 15 minutes for final responses.
05:45 - 06:00 PM	Closing remarks by the President of the General Assembly.

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

10 November 2008

Excellency,

I have the honour to attach herewith my report of the interactive panel discussion of the General Assembly on the global financial crisis that I organised on Thursday, 30 October 2008.

The panel discussion drew upon the expertise of six invited panellists, and the wide participation of Member States, and it revealed the strong conviction that the global crisis requires a global response. The Representatives attending made an urgent call for the United Nations to play a central role in the search for solutions and the implementation of decisions. There was clear support for the position that only by ensuring input from the United Nations with all its Member States - the "G-192" can - we restore legitimacy to the international financial system.

I look forward to working with you in the follow-up to the United Nations' response to the global financial crisis. The upcoming conference on financing for development in Doha represents the first important opportunity to address these issues in a coherent and inclusive manner.

Please accept, Excellency, the assurances of my highest consideration.

Miguel d'Escoto Brockmann

All Permanent Representatives to the United Nations

Report by the Office of the President of the General Assembly on the Inter Active Panel on the Global Financial Crisis

30 October 2008 United Nations New York

The day-long Interactive Panel on the Global Financial Crisis, convened by the President of the General Assembly, marked the first of what is expected to be a series of intergovernmental consultations on the response to the unfolding financial crisis that is threatening the economic and social fabric of virtually every nation.

The President asked the panel of six eminent experts as well as representatives of Member States to identify steps to secure a more stable and sustainable global economic order.

The exchange, which included presentations of invited panelists and extensive participation by representatives of Member States and Regional Groups, revealed the strong conviction that profound global crisis requires an integral global response. There was also clear support for the position that all Member States - referred to by the President as the "G-192" - have a key role in rebuilding the international rules and institutions that have failed to ensure global financial stability, sustained growth and social progress. The international community must begin by committing itself to develop the institutional instruments for improving the global financial system.

Participants recognized the need for deep changes in the governance of the international financial institutions, particularly in the decision-making process in order to make the system more inclusive and equitable. They also pointed to the importance of introducing new standards and regulatory schemes and effective compliance mechanisms that apply to all.

Participants widely acknowledged that the financial crisis reflects the inadequacies of current financial architecture to prevent crisis and to deal with them in an efficient and equitable way when they occur. Member States repeatedly cited the need for deep structural reforms to better reflect the new conditions and challenges of the 21 century.

Panelists and Member States presented a variety of recommendations for changes in the international financial architecture and views on the role of the United Nations. They insisted that the costs of the crisis be fairly and equitably distributed among nations and that solidarity with developing economies and vulnerable populations guide immediate and longer-term responses by the international community. Resources must be made available to help countries mitigate the social impact of the current crisis. The adverse impacts of financial crisis on the poorest are often hidden from analyses that guide policy choices. It was argued that attention needed to be turned to the crisis' implication on human lives, and in particular the lives of poor women. Coping strategies of poor households in times of financial crisis often lead to less schooling for children and poorer health, which again undermines longer term development for the society as a whole.

Representatives made an urgent call for the United Nations to play a central role in the search for solutions and the implementation of decisions. The United Nations system can credibly ensure that the creation of new mechanisms and policy decisions will reflect input by all 192 Member States which will help credibility and restore legitimacy to the international financial system. It was also pointed out that the UN can provide the technical and operational support for the implementation of reforms due to its close ties with governments and because of the broad ranging mandates of its family of international organizations.

Member States agreed that dealing with the financial crisis requires consideration not only the financial sphere but also must take into account the crises surrounding food, energy and climate change which demand a coordinated response that can be facilitated by the United Nations. It was emphasized that the United Nations ensure that efforts to stem the current crisis do not compromise support for the Millennium Development Goals.

Echoing the position of most Member States, the President underscored the importance of the upcoming conference on Financing for Development in Doha as an important opportunity to reaffirm international solidarity and identify innovative and constructive ways to ensure commitments to official development assistance and to propose systemic transformations of finance for development as a sub-system of the new financial architecture.

The President concluded the meeting with an expression of support for other global initiatives and institutions and the need to work with the United Nations Secretary-General, the Economic and Social Council, the Security Council, Regional Commissions and other members of the UN family to move the process ahead. He welcomed the strong support expressed by the member states for the establishment of the High Level Task Force of Experts to undertake a comprehensive review of the international financial system and forward recommendations to the General Assembly of the United Nations.

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The President of the General Assembly

Doha, 28 November 2008

Excellencies,

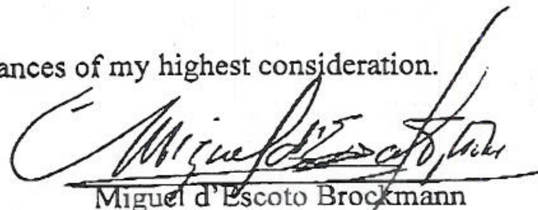
I have the honor of submitting for your review a set of documents relating to the establishment of a Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System. This new Commission will be launched on 29 November at the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus in Doha.

The attached documents include a statement from the Chairman of the Commission, Professor Joseph Stiglitz in which he underscores the role of the international community as a whole in the development of institutions and instruments for increasing the stability and equity of the global financial system. The Commission aims to help ensure that international community responds adequately to the current global financial crisis and begins implementing necessary long-term reforms to have a more stable and prosperous global economy.

In addition, the Terms of Reference provide information on the composition of said Commission of Experts, outline its scope of work and describe a process for carrying out its work, including at least three formal meetings, and producing a final report. The final report will be disseminated as part of a larger United Nations General Assembly initiative to achieve the needed reforms. A list of the approximately 20 members of the Commission confirmed to date is also included.

I am confident that this Commission will be of invaluable assistance to the General Assembly in its efforts to organize its response to the current crisis in an open, inclusive, coherent manner. In this way, the Assembly can contribute to innovative, long-term solutions that benefit all of our Member States.

Please accept, Excellencies, the assurances of my highest consideration.



Miguel d'Escoto Brockmann

All Permanent Representatives and
Permanent Observers to the United Nations
Doha, New York

Office of the President
63rd Session of the General Assembly

TERMS OF REFERENCE
COMMISSION OF EXPERTS OF THE PRESIDENT OF THE UNITED NATIONS GENERAL ASSEMBLY ON REFORMS OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

Background
The breakdown of the Bretton Woods system in the early 1970s, has been followed by a period of financial market liberalization and deregulation, by a surge of private capital flows and by the increasingly global reach of financial institutions. Even so, no institutions have emerged at the international level to prevent excessive risk taking in cross-border lending and investment, reduce systemic failures or address regulatory rules for creditors and debtors, including financial institutions. In fact, conventional wisdom has maintained by cutting back restrictions on capital movements at the national and international levels. a more stable and more efficient financial system would emerge, of particular benefit to developing countries.

The experience has been rather different. Excessive financial liberalization has created a world of global macroeconomic imbalances and recurrent crises. Until recently, the real damage from those crises was, to a large extent, confined to emerging markets. That has now changed, and in a dramatic way. A financial crisis, originating in the most advanced countries and on a scale not seen since the 1930s, is currently unfolding. Over the past few weeks, several major financial institutions in the United States and Europe have failed and stock markets have plummeted and become highly volatile. Especially in the United States, inter-bank lending has declined sharply. Retail businesses and industrial firms, large and small, find it increasingly difficult to obtain credit as banks have become reluctant to lend, even to longtime customers. The response has been state intervention, including the nationalization of financial assets, on an unprecedented scale.

The crisis has become global. Even emerging markets and less developed countries that have managed their economy well, resisted bad lending practices, did not purchase toxic mortgages, and did not allow their banks to engage in excessive risk taking through derivatives, have become embroiled. Any global solution—short term measures to stabilize the current situation and long term measures to make another recurrence less likely—must pay due attention to impacts on all countries. Without doing so, global economic stability cannot be restored.

Ten years ago, at the time of a series of financial crises in emerging markets, there was much discussion of the necessity of reforms to the global financial architecture. Little—too little, it is now evident—was done. It is imperative that we do not only respond adequately to the current crisis, but also begin making the long term reforms necessary to have a more stable and prosperous global economy.

Composition of the Commission

On 18th October, the President of the General Assembly, Miguel D'Escoto Brockmann, announced his intention to establish a taskforce of experts to review the workings of the global financial system, including major bodies such as the World Bank and the IMF, and to suggest steps to be taken by Member States to secure a more sustainable and just global economic order.

The membership of the Taskforce –now Commission- has been chosen based on the need to include experts with a full understanding of the complex and interrelated issues raised by the workings of the financial system, with a strong grasp of the strengths and weaknesses of existing multilateral institutions, and with a sensitivity to the particular challenges faced by countries from different regions of the world and at different levels of economic and social development.

In addition to the Chair, Professor Joseph Stiglitz (USA), members have been drawn from Japan, Western Europe, Africa, Latin America, South and East Asia.

The rapporteur will be Mr. Jan Kregel (former UNDESA staff; now University of Kansas and the Levy Economics Institute of Bard College).

Scope of the Commission Work

The Commission will seek to identify the broad principles underlying needed institutional reforms required to ensure sustained global economic progress and stability which will be of benefit to all countries, developed and less developed. The Commission will suggest a range of credible and feasible proposals for reforming the international monetary and financial system in the best interest of the international community, identify the merits and limitations of alternatives, and will evaluate in particular those that are at the center of current global discussions.

The Commission will be free to address whatever issues -- of an analytical, institutional or policy nature -- it believes are necessary for advancing the reform of the international financial architecture. A more detailed agenda will be established by the President of the GA.

In its deliberations, the Commission will also bear in mind that in an interdependent world, multilateral rules and regulations in trade, debt and finance will have to be mutually reinforcing if they are to underpin financial stability as well as sustainable and equitable development.

If reforms to the existing architecture are to be credible, they must provide for open and inclusive discussion among the broad range of stakeholders in the international community. The President recognizes that while the discussions of the Commission will need to focus on the specific challenges posed by financial instability, reform of the financial system should not be seen as an isolated endeavour but, where appropriate, must be linked to other challenges facing the multilateral system including climate change, peace and security, poverty reduction and the elimination of hunger. Adjustments to deal with the immediate crisis must not be made at the expense of the poor and the vulnerable, while their needs and interests must be fully considered in any proposals for long-term reform.

Process for Producing the Report

The Commission will hold at least three formal meetings to discuss the issues and to begin drafting the report. At the same time, it will solicit comments and suggestions from a wider body of interested stakeholders including policymakers and government officials, representatives of international agencies, academics and members of civil society. Together, these deliberations and inputs will feed into a final report. The report will be published and distributed to member states, other involved parties and the wider public as part of a larger United Nations General Assembly initiative to achieve the needed reforms. A website will be established to promote the work of the Commission.

Timeline

The first plenary session will be held in the New York City 5-6 January 2009 and the second session in Geneva 9-10 March 2009, for two day long sessions. The third and final meeting will be held at the UN HQ in New York to discuss the draft of the report in the spring. The President of the General Assembly plans to distribute the final report to Member States in April, at which point it will also be launched publicly at press conferences in a number of locations world wide.

Office of the President
63rd Session of the General Assembly

MEMBERS OF THE COMMISSION OF EXPERTS OF THE PRESIDENT OF THE UN GENERAL ASSEMBLY ON REFORMS OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

1. **Mr. Joseph Stiglitz** (USA) (Chairman) Nobel Prize in Economic Sciences (2001). Former Senior Vice President and Chief Economist of the World Bank.

2. **Mr. Jean-Paul Fitoussi** (France) Professor of Economics at the Institut d'Etudes Politiques de Paris since 1982. Currently President of the Scientific Council of the Institut d'Etudes Politiques de Paris and President of the Observatoire Français des Conjunctures Economiques.

3. **Mr. Charles A. E. Goodhart** (UK) Norman Sosnow Professor of Banking and Finance, London School of Economics. Former Chief Advisor to the Bank of England and member of its Monetary Policy Committee.

4. **Mr. Pedro Páez** (Ecuador). Minister of Economic Policy Coordination.

5. **Mr. Roger W. Ferguson, Jr.** (US) Former Member and Vice Chairman of the Board of Governors, Federal Reserve System (1997 to 2006).

6. **Mr. Jomo Kwame Sundaram** (United Nations) Assistant Secretary-General for Economic Development, United Nations Department of Economics and Social Affairs.

7. **Mr. José Antonio Ocampo** (Colombia) Former UN Under-Secretary-General for Economic and Social Affairs and Finance Minister, Colombia. Currently Professor, School of International and Public Affairs, Columbia University.

8. **Mr. Avinash Persaud** (Barbados) Chairman of Intelligence Capital Limited. Member of council, London School of Economics. Founding director of the Global Association of Risk Professionals.

9. **Mr. Yaga Venugopal Reddy** (India) Former Governor of the Reserve Bank of India.

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15. **Mr. Rubens Ricupero** (Brazil) Former Secretary-General of UNTACD. Former Minister of Finance of Brazil.

Rapporteur
Mr. Jan Kregel. Former UNDESA staff; now University of Kansas and the Levy Economics Institute of Bard College.

STATEMENT FROM THE CHAIRMAN OF THE COMMISSION OF EXPERTS OF THE PRESIDENT OF THE UN GENERAL ASSEMBLY ON REFORMS OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM FOR THE LAUNCH OF THE COMMISSION IN DOHA, 29 NOVEMBER 2008

I am sorry that I was not able to join you in Doha. This unprecedented global financial and economic crisis requires an unprecedented global response. It requires a response not just from the G-7, G-8, G-10, or G-20, but from the entire international community, the G-192. This gives especial importance to this initiative of the President of the General Assembly, which has received so much support from around the world. I am particularly pleased at the quality and diversity of the group of experts that he has been able to assemble. This will help ensure that the interests, concerns, and perspectives not only of the richest countries and the rapidly growing emerging markets and those in the financial markets are heard, but also those of the poorest countries and those from all sectors of the economy. In our work, we hope to draw upon the expertise of the best scholars and practitioners from all over the world.

The current financial crisis, which began in the U.S., then spread to Europe, has now become global. Even emerging markets and less developed countries that managed their economy well, resisted the bad lending practices, held high levels of foreign exchange reserves, did not purchase toxic mortgages, and did not allow their banks to engage in excessive risk taking through derivatives are likely to become embroiled and to suffer as a result. *Any global solution—short term measures to stabilize the current situation and long term measures to make another recurrence less likely—must pay due attention to impacts on these countries.* Without doing so, global economic stability cannot be restored and economic growth, as well as poverty reduction worldwide will be threatened.

The current economic crisis should provide an opportunity to reassess global economic arrangements and prevalent economic doctrines. Large changes have occurred in the global economy in recent years, e.g. in the sources of global savings, reserves and GDP, and these are not fully reflected in our global economic institutions and arrangements. As we address the short run crisis, we should seize the opportunity for making deeper reforms that enable the world to enter into the twenty first century with a more equitable and a more stable global financial system, which could usher in an era of enhanced prosperity for all countries.

In the past, the global financial system often worked to the disadvantage of developing countries. Banks in developed countries, for instance, were encouraged to lend short term to developing countries; while this provided greater liquidity to the former, it led to greater instability in the latter. Pro-cyclical monetary and fiscal policies were often foisted on developing countries, while developed countries followed countercyclical policies. *The international community must commit itself to developing the institutions and instruments for increasing the stability and equity of the global financial system.*

Part of the reason for the failure to create a stable and equitable system are long recognized problems in global governance. There is inadequate and in some cases no representation of emerging markets and less developed countries. *There needs to be reform in the governance of the international economic institutions and standard setting bodies, like the Basle Committee on Banking Regulation.*

While discussions among informal groupings of countries will necessarily play an important role in developing a global consensus on key and complex issues, decision making must reside within international institutions with broad political legitimacy, and with adequate representation of both middle income countries and the least developed countries. The only institution that currently has that broad legitimacy today is the UN. Historically, the UN has played a central role, e.g. in convening the "United Nations' Monetary and Financial Conference," at Bretton Woods which established the Bretton Woods Institutions.

This expert group is devoted to helping the U.N. fulfill its historic mission. The Commission will seek to identify the broad principles underlying needed institutional reforms required to ensure sustained global economic progress and stability which will be of benefit to all countries, developed and less developed. The Commission will suggest a range of credible and feasible proposals for reforming the international monetary and financial system in the best interest of the international community, identify the merits and limitations of alternatives, and will evaluate in particular those that are at the center of current global discussions.

This will, of course, be one of several similar efforts going around the world, a global conversation on a topic of immense complexity. This Commission is, however, the only one with its breadth of vision and representation We will, of course, try to learn what we can from these other efforts.

It is my hope that this Commission will help the UN and the leaders of the countries of the world respond to the crisis in as thoughtful and informed way as possible. If we succeed, we will, at the same time create conditions for sustained prosperity for all countries and poverty eradication everywhere for the coming decades.

We look forward to working with all of you in this important endeavor.

Joseph E. Stiglitz
Chairman

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

7 January 2009

Excellencies,

I have the honour of submitting for your review a statement prepared by the Commission of Experts on Reforms of the International Monetary and Financial System following its first meeting in New York City, 4-6 January 2009.

As noted in my communication of 28 November 2008, the Commission of Experts was convened to prepare a set of comprehensive recommendations by March 2009 that would assist the United Nations General Assembly in defining its approach to increasing the stability and equity of the global financial system.

The enclosed statement, containing 11 recommendations for immediate action, reflects the deliberations of the first of three formal meetings of the 18-member Commission.

In the statement, the Commission calls upon all nations to pay careful attention to the potentially harmful impact on the developing countries of the stimulative policies that the developed countries are taking in the face of global economic and financial crisis.

The Commission also draws attention to the need to address asymmetries in the capacities of the developed and developing nations to adopt counter-cyclical policies in the face of deepening global economic and financial crisis.

Finally, to assure that the burden of economic adjustment does not fall disproportionately on the world's most vulnerable populations, the Commission stresses the urgency of identifying or creating facilities for channeling resources to countries that need liquidity to offset the collapse of global demand for emerging countries' goods and services.

The next formal meeting of the Commission will be held in Geneva on 8-10 March 2009.

Please accept, Excellencies, the assurances of my highest consideration.

Miguel d'Escoto Brockmann

All Permanent Representatives and
Permanent Observers to the United Nations
United Nations Headquarters, New York

Office of the President
63rd Session of the General Assembly

MEMBERS OF THE COMMISSION OF EXPERTS OF THE PRESIDENT OF THE UN GENERAL ASSEMBLY ON REFORMS OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

1. **Mr. Joseph Stiglitz** (USA) (Chair) Nobel Prize in Economic Sciences (2001). Former Senior Vice President and Chief Economist of the World Bank.

2. **Mr. Jean-Paul Fitoussi** (France) Professor of Economics at the Institut d'Etudes Politiques de Paris since 1982. Currently President of the Scientific Council of the Institut d'Etudes Politiques de Paris and President of the Observatoire Français des Conjunctures Economiques.

3. **Mr. Charles A. E. Goodhart** (UK) Norman Sosnow Professor of Banking and Finance, London School of Economics. Former Chief Advisor to the Bank of England and member of its Monetary Policy Committee.

4. **Mr. Pedro Páez** (Ecuador). Minister for Economic Coordination.

5. **Mr. Jomo Kwame Sundaram** (United Nations) Assistant Secretary-General for Economic Development, United Nations Department of Economics and Social Affairs.

6. **Mr. José Antonio Ocampo** (Colombia) Former UN Under-Secretary-General for Economic and Social Affairs and Finance Minister, Colombia. Currently Professor, School of International and Public Affairs, Columbia University.

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13. **Ms. Heidemarie Wieczorek-Zeul** (Germany) Federal Minister of Cooperation and Development.

14. **Mr. Yousef Boutros-Ghali**, Egypt. Minister of Finance. Chair of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund.

15. **Mr. Rubens Ricupero** (Brazil) Former Secretary-General of UNTACD. Former Minister of Finance of Brazil.

16. **Mr. Robert Johnson** (USA) Former Chief Economist of the US Senate Banking Committee and former Senior Economist of the U.S. Senate Budget Committee. Former managing director at Soros Fund Management. Member of the Board of Directors of the Economic Policy Institute and the Institute for America's Future.

17. **Mr. Andrei Bougrov** (Russia) Managing Director and member of the Board of Directors of the Interros Company. Former Principal Resident Representative of Russia, Executive Director and member of the Board of Directors of the International Bank for Reconstruction and Development.

18. **Mr. Benno Ndulo** (Tanzania) Governor of the Bank of Tanzania.

Rapporteur

Mr. Jan Kregel. Former UNDESA staff; now University of Kansas and the Levy Economics Institute of Bard College.

The Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System

Recommendations for Immediate Action

The Commission held its first meeting in New York on January 4 through January 6.

The current financial crisis, which began in the United States, then spread to Europe, has now become global. Even emerging markets and less developed countries that managed their economy relatively well, resisted the bad lending practices, held high levels of foreign exchange reserves, did not purchase toxic mortgages, and did not allow their banks to engage in excessive risk taking through derivatives and excessive leverage have become embroiled and are likely to suffer as a result. *Any global solution—short term measures to stabilize the current situation and long term measures to make another recurrence less likely—must pay due attention to the impact on these countries.* Without doing so, global economic stability cannot be restored and economic growth, as well as poverty reduction worldwide will be threatened.

This unprecedented global financial and economic crisis requires an unprecedented global response. It requires a response not just from the G-7, G-8, G-10, or G-20, but from the entire international community, the G-192. This gives especial importance to this initiative of the President of the General Assembly, which has received so much support from around the world.

The Commission began its work, seeking to identify the underlying factors that have contributed to the magnitude of the crisis and its rapid spread around the world and broad principles underlying needed institutional reforms required to ensure sustained global economic progress and stability, which will be of benefit to all countries, developed and less developed.

Reforms and regulations have a goal: the better functioning of the world economic system for mankind's global good. This entails simultaneously pursuing long term objectives, such as sustainable and equitable growth, the responsible use of natural resources, and reduction of greenhouse gas emissions, and more immediate concerns, including addressing the challenges posed by the food and financial crises.

The Commission noted that the failure to act quickly to address the global economic downturn inevitably will increase its depth and duration and the eventual cost of restoring prosperity. With that in mind, it makes the following recommendations for immediate action, which focus particularly on the adverse impact of the global recession on developing countries and on the poor throughout the world.

1. It is imperative that all the developed countries take strong and effective actions to stimulate their economies. In doing so, they should be mindful of the adverse consequences that their monetary and fiscal policy actions may have on other countries, especially developing countries. Additional assistance to developing countries may be required to offset these effects. An effective stimulus policy should be timely, have a large bang for the buck, help address the strains posed by the economic down turn on the poor, and to the extent possible, help address long run problems and prevent instability. Care should be taken to address potential negative impacts on global imbalances.

2. There are large asymmetries in global economic policies—countercyclical policies are pursued by developed countries, while most developing countries pursue pro-cyclical policies. But even symmetric policies can have asymmetric effects: guarantees provided to financial institutions in developed countries cannot be effectively matched by developing countries. Nor can they match in breadth and scale the subsidies being provided to financial and non-financial institutions in their bail-outs. Whether there ever was a level playing field may be debated; that there is no longer one cannot be. Even the knowledge that there may be a rescue if things go badly gives firms in advanced industrial countries a distinct advantage; they can undertake risks that those in poorer countries cannot. This highlights the lack of coherence between existing global macro and financial arrangements, policies, and frameworks and those governing trade.

3. It is imperative that developing countries be provided with funds to enable them to undertake comparable policies, to stimulate their economies, to provide social protection, and to ensure a flow of liquidity to their firms, including maintenance of trade credits. Failure to provide such support can have long term effects. There will be an increase in poverty and malnutrition and educations will be interrupted, with life long effects. The sense of global social solidarity will be impaired, making agreement on key global issues, such as responding to the challenges of climate change, more difficult. Developed countries should resist the temptation to cut back on development assistance. This is a time to expand assistance, probably by an order of magnitude of at least twenty per cent, including for infrastructure projects addressing long term development and environmental problems.

4. In some parts of the world, there are ample sources of liquid funds, and more of these need to be made available to the needy developing countries. However, countries with these funds are not now adequately represented in the multilateral institutions. While this highlights the need for long discussed reforms in their governance, in the short run the creation of a new credit facility, perhaps within the IMF, the World Bank, or regional or sub-regional development banks, should be considered. The new facilities should have their own governance, be more reflective of democratic principles, with stronger representation for developing countries. These new governance arrangements might serve as a model for future reforms of the multilateral institutions.

5. While funds within the International Financial Institutions are limited, it is imperative that more funds be provided, and that they be provided without the usual conditionalities, especially those that force these countries to pursue pro-cyclical policies or to adopt the kinds of monetary and regulatory policies which contributed to the current crisis. Besides the usual arguments against these conditionalities, they contribute to global asymmetries, disadvantaging developing countries relative to the developed, and they undermine incentives for developing countries to take up the funds, contributing to global economic weakness. While we commend the initial initiatives by the IMF, it is questionable whether they are sufficient.

6. Additional funding could be provided by a large issuance of Special Drawing Rights. The Commission, in later meetings, will address alternative modalities by which this may be done and assess longer term reforms in the global reserve system.

7. The Commission noted several regional efforts at cooperative responses to the crisis, including providing needed liquidity, and urged the consideration of their expansion. For instance, extension of liquidity support under the Chiang Mai initiative without an IMF program requirement should be given immediate consideration.

8. The crisis is widely viewed to be the result of the failure of regulatory policies in the United States and some other advanced industrial countries. To make significant and meaningful changes, it may be necessary to draw lessons from countries in the developed and developing world that have avoided instability.

9. The crisis highlights how policies and institutions in developed countries can have global systemically significant effects. Developing countries should have expanded scope for establishing policies and institutions appropriate for their conditions. This includes developing frameworks that help insulate themselves from regulatory and macro-economic failures in systemically significant countries.

10. Members of the Commission noted that while lack of transparency is widely recognized as having contributed to the problems in the financial market, there have been significant lapses in transparency in the manner in which the bail-outs have been conducted. The Commission urged greater transparency on the part of all parties in responding to the crisis.

11. While a successful completion of the Doha trade round would be welcome, certain actions could be implemented immediately, namely the opening of markets in advanced economies to least developed countries' exports.

The Commission will continue its work on reforms in regulatory and macro economic policies and in the international economic institutions and arrangements which will enhance global economic and financial stability and prosperity. Its next plenary meeting will be held in Geneva on March 8-10.

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

17 March 2009

Excellency,

I have the honour to inform you that from 25 to 27 March 2009, the General Assembly will conduct an extraordinary interactive thematic dialogue on the subject of The World Financial and Economic Crisis and Its Impact on Development.

The dialogue is intended to give Member States an overview of the broad range of issues involved as the world works to define a common plan of action for taking stock of the impact of the crisis, evaluating and choosing from among alternative short-term emergency measures, and defining an effective approach to longer-term issues in order to restore dynamism, revive employment, and enhance equity in our world economy.

As indicated, the dialogue will take place over three days, with each day devoted to a different set of topics and issues:

> Day 1, Wednesday, 25 March: will be devoted to a comprehensive review of the scale and scope of the crisis, its mechanisms of transmission, and range of impacts on nations and on society, with a focus on the impact and risks for the poor and vulnerable. For this assessment, we will rely principally upon programs and agencies of the United Nations system, including the analysis of the Department of Social and Economic Affairs (DESA), the United Nations Conference on Trade and Development (UNCTAD), the International Labor Organization (ILO), and the regional commissions.

For our discussions on Days 2 and 3, we will draw upon the analysis and proposals developed by the Commission of Experts that I have convened under the Chairmanship of Professor Joseph Stiglitz. The Commission's preliminary report will be made available no later than Friday, 20 March.

All Permanent Representatives
and Permanent Observers
to the United Nations

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Day 2, Thursday, 26 March
Morning: the Chairman of the Commission of Experts, Professor Joseph Stiglitz, will present the principal recommendations of the commission as well as the analysis and perspective that lie behind them during the morning session.
Afternoon: we will take a deeper look at key macroeconomic policy issues. Again, we will focus particularly on the needs of those who are most vulnerable, especially peoples whose governments do not have the resources or mechanisms to support counter-cyclical policies and for whom access to credit and investment has been severely impaired. We will also assess the impact of policies that have already been adopted to date to restore demand, promote employment, and restore equity and growth.

Day 3: Friday, 27 March: The crisis has revealed the depth of world-wide economic interdependence, and also exposed numerous weaknesses and gaps in the institutional and regulatory framework for managing our integrated global economy. This session will be devoted to examining the intermediate- and longer-term proposals for reducing systemic and individual risk, improving policy response and coordination, and enhancing legitimacy and equity in management of the global economic and financial system.

The interactive thematic dialogue is conceived as a curtain-raiser not only for the extensive preparatory process leading up to the United Nations conference at the highest level to be held in June 2009 but also as a means to provide information and analysis useful for coordination with other on-going processes related to the financial and economic crisis.

In the coming days I will provide additional details on this event. I look forward to your participation, and invite you to involve other representatives of your Government whose participation you deem important.

I hope this process will help Members States to work together to develop a common understanding of the crisis, and to explore alternative proposals for coordinated action and for beginning a process of systemic reform.

Please accept, Excellency, the assurances of my highest consideration.

Miguel d'Escoto Brockmann

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

20 March 2009

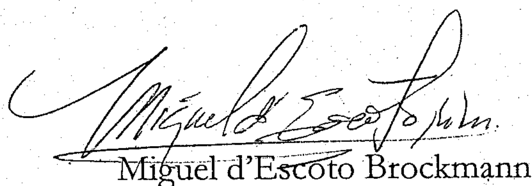
Excellency,

Further to my letter dated 17 March 2009 informing you of the extraordinary interactive dialogue on the subject of The World Financial and Economic Crisis and its Impact on Development, I have the pleasure to transmit for your consideration the draft recommendations of the Commission of Experts of the President of the General Assembly on Reforms of the International Monetary and Financial System.

As mentioned in my previous letter, these recommendations and the analysis that underlies them will figure prominently in the interactive thematic dialogue on "The World Financial and Economic Crisis and its Impact on Development", that will take place from 25 to 27 March 2009 at United Nations Headquarters in New York.

It is my hope that Members of the General Assembly will find these recommendations, and the dialogue next week, useful as they prepare for the United Nations Conference on World Economic and Financial Crisis and Its Impact on Development, which will be convened in little more than two months time in accordance with General Assembly resolution 63/239 of 24 December 2008.

Please accept, Excellency, the assurances of my highest consideration.



Miguel d'Escoto Brockmann

All Permanent Representatives
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Agenda item 48
Follow-up to and implementation of the outcome of the 2002 International Conference on Financing for Development and the preparation of the 2008 Review Conference

Recommendations by the Commission of Experts of the President of the General Assembly on reforms of the international monetary and financial system

Note by the President of the General Assembly

1. The outbreak of the financial crisis in 2008 originated in the advanced developed countries, but has spread quickly to become a world economic crisis that affects all countries, including the emerging economies and less developed countries.

2. To review the workings of the global financial systems and to explore ways and means to secure a more sustainable and just global economic order, I have convened a Commission of Experts, chaired by Professor Joseph Stiglitz, 2001 Nobel laureate Prize winner in Economics, and comprised of a outstanding economists, policy makers, and practitioners drawn from Japan, Western Europe, Africa, Latin America, South and East Asia. These experts were chosen based on their comprehensive understanding of the complex and interrelated issues raised by the workings of the financial system. The Commissioners are also individuals recognized for their strong grasp of the strengths and weaknesses of existing multilateral institutions as well as their sensitivity to the particular challenges facing countries from different regions of the world and at different levels of economic and social development.

3. I now have the pleasure to transmit the preliminary recommendations of the Commission for your consideration. These recommendations and the analysis that underlies them will figure prominently in the interactive thematic dialogue on "The World Financial and Economic Crisis and its Impact on Development", which I will convene from 25 to 27 March 2009 at United Nations Headquarters in New York. It is my hope that Members of the General Assembly will find these recommendations, and the dialogue next week, useful as they prepare for the United Nations Conference on World Economic and Financial Crisis and Its Impact on Development, which will be convened in little more than two months time in accordance with General Assembly resolution 63/239 of 24 December 2008.

THE COMMISSION OF EXPERTS ON REFORMS OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

Recommendations
19 March 2009

I. Preamble

1. The rapid spread of financial crisis from a small number of developed countries to engulf the global economy provides tangible evidence that the international trade and financial system needs to be profoundly reformed to meet the needs and changed conditions of the 21st century. Past economic crises have had a disproportionate adverse impact on the poor, who are least able to bear these costs and that can have consequences long after the crisis is over.

2. While it is important to deal with the structural changes to adapt the international system to prevent future crisis, this cannot be achieved without significant measures to promote recovery from the current crisis whose impact may be even worse than in the past. The International Labour Organization estimates that the rise in unemployment in 2009 compared to 2007 of 30 million could reach more than 50 million if conditions continue to deteriorate. Some 200 million people, mostly in developing economies, could be pushed into poverty if rapid action is not taken to counter the impact of the crisis on developing countries. Even in some advanced industrial countries, millions of households are faced with the threat of losing their homes and access to health care, while economic insecurity and anxiety is increasing among the elderly as they lose their life-time savings in the collapse of asset prices.

3. The welfare of developed and developing countries is mutually interdependent in an increasingly integrated world economy. *Short term measures to stabilize the current situation must ensure the protection of the world's poor, while long term measures to make another recurrence less likely must ensure sustainable financing to strengthen the policy response of developing countries.* Without a truly inclusive response, recognizing the importance of all countries in the reform process, global economic stability cannot be restored, and economic growth, as well as poverty reduction worldwide will be threatened.

4. This inclusive global response will require the participation of the entire international community; it must encompass more than the G-7 or G-8 or G-20, but the representatives of the entire planet, from the G-192. It was to respond to this need that the President of the General Assembly created the present Commission of Experts to address the measures needed to meet the crisis and recommend longer term reforms. Recognising work being undertaken by the G-8 and the G-20, and other

bodies, the Commission sees its own work as complementary, seeking to focus on impacts of the crisis and responses to the crisis on poverty and development.

5. Reform of the International system must have as its goal the better functioning of the world economic system for the global good. This entails simultaneously pursuing long term objectives, such as sustainable and equitable growth, the creation of employment in accordance with the "decent work" concept, the responsible use of natural resources, and reduction of greenhouse gas emissions, and more immediate concerns, including addressing the challenges posed by the food and financial crises. As the world focuses on the exigencies of the moment the long standing commitments to the achievement of the Millennium Development Goals and protecting the world against the threat of climate change must remain the overarching priorities; indeed, appropriately designed global reform should provide an opportunity to accelerate progress toward meeting these goals.

II. Responding to the Global Financial Crisis

6. Sustainable responses to the crisis require identifying the factors underlying the crisis and its rapid spread around the world. Loose monetary policy, inadequate regulation and lax supervision interacted to create financial instability. The results were manifest in the large global imbalances whose disorderly unwinding in the absence of prompt countercyclical measures may aggravate the crisis.

7. Part of the reason for inadequate regulation was an inadequate appreciation of the limits of markets—what economists call "market failures." While such failures arise in many markets, they are particularly important in financial markets and can have disproportionately large consequences as they spill over into "real" economic activity.

8. The conduct of monetary policy can be traced in part to an attempt to offset an insufficiency of global aggregate demand, aggravated by increasing income inequality within most countries. Monetary conditions were also influenced by the accumulation of foreign exchange reserves by some emerging market countries seeking protection from global instability and onerous conditions traditionally attached to assistance from the multilateral financial institutions.

9. The current crisis reflects problems that go beyond the conduct of monetary policy and regulation of the financial sector. It also involves deeper inadequacies in areas such as corporate governance and competition policies. Many of these failings, in turn, have been supported by a flawed understanding of the functioning of markets, which also contributed to the recent drive towards financial deregulation. These views have been the basis for the design of policies advocated by some of the international economic institutions, and for much of the architecture of globalization.

10. More generally, the current crisis has exposed deficiencies in the policies of some national authorities and international institutions based on previously fashionable economic doctrines, which held that unfettered markets are, on their own, quickly self-correcting and efficient. Globalization too was constructed on these flawed hypotheses; and while it has brought benefits to many, it has also enabled defects in one economic system to spread quickly around the world, bringing recessions and impoverization even to developing countries that have developed good regulatory frameworks, created effective monetary institutions, and succeeded in implementing sound fiscal policies.

11. The Principles and Recommendations outlined in this Report seek to address the underlying problems. They focus both on feasible interim steps that can and should be taken immediately, and the deeper medium and longer term reforms that are necessary if we are to make another such crises less likely, and if we are to strengthen the international community's capacity to respond to a crisis, should one occur.

12. In analyzing appropriate national and global responses to the crisis, the Commission noted the following principles:

13. Failure to act quickly to address the global economic downturn inevitably would increase its depth and duration and the eventual cost of creating a more balanced robust recovery.

14. In a globally integrated world, the actions of any one country have effects on others. Too often these *externalities* are not taken into account in national policy decisions. Developed countries in particular need to be aware of the adverse consequences of these externalities, and developing countries need frameworks to help protect themselves from regulatory and macro-economic failures in systemically significant countries.

15. Developing countries should have expanded scope to implement policies and create institutions that will allow them to implement appropriate counter-cyclical policies.

16. Advanced industrial countries should observe their pledges not to undertake *protectionist* actions, and even more importantly insure that stimulus packages and recovery programs do not further distort the economic playing field and further increase global imbalances.

17. Measures to restore domestic financial markets in developed countries through *subsidies* to financial institutions have been accompanied by a sharp reduction in flows of capital to developing countries. It is important to ensure that these measures do not create a new form of financial protectionism. Financial subsidies can be just as detrimental to the efficiency of a free and fair trading system as tariffs. Indeed, they

may be far more inequitable, because rich countries have more resources to support subsidies.

18. Greater transparency on the part of all parties in responding to the crisis is necessary. More generally, democratic principles, including inclusive participation in decision making, should be strengthened and respected.

19. The crisis is, in part, a result of excesses in deregulation of financial markets and in international trade. Restoring the global economy to health will require restoring a balance between the role of the market and the role of the state.

20. In responding to this crisis, it is imperative that actions to improve conditions in the short term do not result in structural changes which increase instability or reduce growth in future.

21. It is essential that governments undertake reforms that address some of the underlying factors that contributed to the current economic crisis if the world is to emerge from the crisis into sustainable, balanced growth. It is not enough simply to return to the status quo *ex ante.*

22. Appropriately designed short run measures may be complementary to long term goals, especially those related to climate change and the environment.

III. Immediate Measures

23. The current crisis must be met with rapid and effective measures, but it must also lay the basis for the long-run reforms that will be necessary if we are to have a more stable and more prosperous global economy and avoid future global crises.

24. Ten immediate measures are essential for global recovery.

1. All developed countries should take strong, coordinated, and effective actions to stimulate their economies.

25. Stimulus should be timely, have large "multipliers," help address the strains posed by the economic downturn on the poor, help address long run problems and prevent instability. While the decision on stimulus is national, it should be judged on its *global impacts;* if each country looks only at the national benefits versus costs, e.g. an increased national debt, the size of the global stimulus will be too small, spending will be distorted, and the global impact will be eviscerated.

26. *National stimulus packages should thus include spending measures to be undertaken in developing countries to offset the impact of the decline in world trade and financial market disintermediation. Industrialised countries should thus dedicate 1.0 per cent*

of their stimulus packages, in addition to traditional official development assistance commitments.

2. **Developing countries need additional funding**

27. More permanent and stable sources of funding for developing countries (See Section IV.10 below) that could be activated quickly and are not subject to inappropriate conditionality are necessary. Indeed, additional funding would be required just to offset the imbalances and inequities created by the massive stimulus and bail-out measures introduced in advanced industrialised countries. Such funding could be provided by an issuance of Special Drawing Rights approved by the IMF Board in September 1997 through the proposed Fourth Amendment of the Articles of Agreement to double cumulative SDR allocations to SDR 42.8 billion and through the issuance of additional SDRs through standard procedures.

28. In addition regional efforts to augment liquidity should be supported. For instance, extension of liquidity support under the Chiang Mai initiative without an IMF program requirement should be given immediate consideration. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighbouring countries.

29. These additional sources of funding should be in addition to traditional official development assistance. Failure to maintain the levels of official assistance will have long-term effects. There will be an increase in poverty and malnutrition and the education of many young people will be interrupted, with life-long effects. The sense of global social solidarity will be impaired, making agreement on key global issues, such as responding to the challenges of climate change, more difficult. Failure to provide such assistance can be counterproductive even in a more narrow sense: it can impair the global recovery.

30. *Developed countries must make a renewed effort to meet the commitments made in the Millennium Declaration, the Monterrey Consensus, the 2005 Global Summit, and the Doha Declaration by 2015.*

3. **Mobilizing Additional Development Funds by the Creation of a New Credit Facility**

31. The creation of a new credit facility is thus a matter of urgency. If such a facility could be created in a timely way, it could be a major vehicle for the disbursement of the requisite additional funding.

32. Given the need for rapid response, the new credit facility might be more quickly established under the umbrella of existing institutions, such as the World Bank, where

efforts are underway to remedy existing inadequacies in governance and lending practices, or in Regional Development Banks where developing countries have more equitable representation.

33. Or alternative institutional arrangements that create competition amongst institutions providing financial assistance might be envisaged. Such competition might not only increase the efficiency of disbursement, but also reduce the application of procyclical conditionality linked to financial support.

34. Whatever form is chosen, the new facility should have governance more reflective of democratic principles, with strong representation of developing countries and those countries contributing to the facility. These new governance arrangements might provide lessons for the reform of existing institutions.

35. Administration of the Facility could be done by staff seconded from existing multilateral financial institutions or central banks. The new facility could draw upon financial contributions from all countries. It could leverage any equity funds contributed by borrowing, including on the market or from those with large reserves or Sovereign Wealth Funds. Its ability to borrow could be enhanced through guarantees provided by governments, especially those of the advanced industrial countries. These alternative arrangements should be seen as a complement to expanded financial support from existing institutions,

4. Developing Countries need more policy space

36. There are asymmetries in global economic policies—countercyclical policies are pursued by developed countries, while most developing countries are encouraged or induced to pursue pro-cyclical policies. While this is partly due to the lack of resources to pursue countercyclical policies, it is also due to misguided policy recommendations from international financial institutions. Conditionality attached to official lending and support for international financial institutions has often required developing countries to adopt the kinds of monetary and regulatory policies which contributed to the current crisis. In addition, these conditionalities contribute to global asymmetries, disadvantage developing countries relative to the developed, and undermine incentives for developing countries to seek support funding, contributing to global economic weakness. While the IMF initiatives to reduce conditionalities are to be commended, they might be insufficient, while in many cases countries are still required to introduce pro-cyclical policies.

5. The lack of coherence between policies governing trade and finance must be rectified.

37. Policy space is circumscribed not only by a lack of resources, but also by international agreements and by the conditionalities that often accompany assistance.

Many bilateral and multilateral trade agreements contain commitments that circumscribe the ability of countries to respond to the current crisis with appropriate regulatory, structural, and macro-economic reforms and rescue packages, and may have exposed them unnecessarily to the contagion from the failures elsewhere in the global economic system. *Developing countries especially need policy frameworks that can help protect them from regulatory and macro-economic failures in systemically significant countries.* Developing countries have had imposed on them not only deregulation policies akin to those that are now recognized as having played a role in the onset of the crisis, but also have faced restrictions on their ability to manage their capital account and financial systems (e.g. as a result of financial and capital market liberalization policies); these policies are now exacting a heavy toll on many developing countries.

6. Crisis response must avoid protectionism

38. Overt protectionism includes tariffs and domestic restrictions on procurement contained in some stimulus packages. Because of complex provisions and coverage of international trade agreements, seemingly "symmetric" provisions (e.g. exceptions of the application of provisions to countries covered by particular WTO or other international agreements) can have markedly asymmetric effects. Subsidies, implicit and explicit, can, as has been noted, be just as distorting to open and fair trade. There may, in some cases, be pressure for banks receiving large amounts of government assistance to focus on lending domestically. While the temptation that gives rise to such measures is understandable, efforts need to be made to finance additional support to developing countries to mitigate the impact of the crisis as well as of both open and hidden subsidies (i.e. state assistance through lending programs and guarantees) in order to avoid further distortions.

7. Opening advanced country markets to least developed countries' exports

39. While a successful completion of the Doha trade round would be welcome, its impact on the crisis and its development dimension are still unclear (see IV.9, below). There are, however, a number of measures that have already been agreed in multilateral trade negotiations which could be implemented rapidly to support developing countries impacted by the crisis. These include implementation of duty-free, quota-free market access for products originated from LDCs. In addition, the agreement reached at the WTO´s Hong Kong Ministerial session in 2005 provided for the elimination of all forms of developed country export subsidies, at the latest by 2013, should be implemented immediately. There is no reason to await a general agreement before implementing these measures. In addition, domestic support for cotton subsidies should be abolished immediately, as they distort prices to the detriment for African countries. More generally, in all trade negotiations, the long recognized principle of special and differential treatment of developing countries should be preserved.

8. Learning from Successful Policies to undertake Regulatory Reforms.

40. The financial crisis is widely viewed to be the result of the failure of regulatory policies in the advanced industrial countries. While full regulatory reforms (discussed more extensively in section IV.6 below) will take time, it is imperative that work on regulatory reform begin now. The collapse in confidence in the financial system is widely recognized as central in the economic crisis; restoration of confidence will be central in the recovery. But it will be hard to restore confidence without changing the incentives and constraints facing the financial sector. *It is imperative that the regulatory reforms be real and substantive, and go beyond the financial sector to address underlying problems in corporate governance and competition policy, and in tax structures, giving preferential treatment to capital gains, that may provide incentives for excessive leverage.* While greater transparency is important, much more is needed than improving the clarity of financial instruments. Even if there had been full disclosure of derivative positions, their complexity was so great as to make an evaluation of the balance sheet position of the financial institutions extraordinarily difficult. Still, there is need for much greater transparency, including forbidding off balance sheet transactions and full expensing of employee stock options.

41. Well regulated economies have to be protected from competition from economies with inadequate or inappropriate regulatory systems. The problems of regulatory arbitrage and tax evasion are closely linked. Tax havens and financial centers in both developed and developing countries *that fail to meet basic standards of transparency, information exchange and regulation should be given strong incentives to reform their practices*, e.g. by restricting transactions between financial institutions in those jurisdictions and those in more highly regulated countries. Institutional arrangements for improving harmonisation and transparency should be strengthened, including the United Nations Committee of Experts on International Cooperation in Tax Matters as proposed in Paragraph 16 of the Doha Declaration. Also other international arrangements and conventions such as United Nations Convention against Corruption should also be strengthened.

9. Coordinating the Domestic and Global Impact of Government Financial Sector Support

42. Government bail-outs have substantial redistributive consequences that must be analysed in assessing their impact on recovery. In addition, because of the urgency of the situation they often fail to observe principles of good governance and especially of democratic transparency. This may lead to the introduction of inappropriate incentives, as well as failure to recognise possible adverse effects on other countries, especially on developing countries that lack equivalent financial resources.

Developed countries should undertake their financial support policies recognising that even symmetric policies can have asymmetric effects because guarantees by developing country governments are likely to be less meaningful than those by developed countries.

43. Failure to recognise these wider domestic and global consequences of financial support measures have often meant that the costs to the government and to developing countries have been higher than necessary. Funds have often been redistributed to those with higher incomes, and have created distorted incentives. Support measures for financial institutions that are implemented by Central Banks risk imposing high costs on the public purse, without adequate parliamentary oversight of appropriations. *Greater transparency on the part of all parties would facilitate a more effective response to the crisis.*

10. Improved coordination of global economic policies

44. There is a need for substantial improvement in the coordination of global economic policy. Global economic integration has outpaced the development of the appropriate political institutions and arrangements for governance of the global economic system. Remedying this lacuna is a matter of urgency, discussed at greater length in section IV.3, but this will not happen overnight.

45. In the short term, there should be an appropriate mechanism within the United Nations System for independent international analysis on questions of global economic policy, including its social and environmental dimensions. Following the successful example of the Intergovernmental Panel on Climate Change (IPCC), a similar panel could be created to offer consultancy to the General Assembly and ECOSOC, but also to other international organizations to enhance their capacity for sound decision-making in these areas. At the same time, such a panel would contribute to foster a constructive dialogue and offer a regular venue for fruitful exchange between policy makers, the academic world and key international organisations. The panel should comprise well respected academics from all over the world, appropriately representing all continents, as well as representatives of international social movements. Being made up of outstanding specialists, the panel should be able to follow, analyse and assess long-term trends, key developments and major dynamics for global change affecting all people around the globe, identify problems in the global economic and financial architecture, and jointly provide options for coherent international action and recommendations for political decision-making processes.

IV. Agenda for Systemic Reforms

46. There is an equally important agenda of deeper systemic reforms to the international system, that should begin now, if we recovery is to be sustainable.

1. A New Global Reserve System

47. The global imbalances which played an important role in this crisis can only be addressed if there is a better way of dealing with international economic risks facing countries than the current system of accumulating international reserves. Indeed, the magnitude of this crisis and the inadequacy of international responses may motivate even further accumulations. Inappropriate responses by some international economic institutions in previous economic crises have contributed to the problem, making reforms of the kind described here all the more essential. To resolve this problem ***a new Global Reserve System***—what may be viewed as a greatly expanded SDR, with regular or cyclically adjusted emissions calibrated to the size of reserve accumulations—could contribute to global stability, economic strength, and global equity. Currently, poor countries are lending to the rich reserve countries at low interest rates. The dangers of a single-country reserve system have long been recognized, as the accumulation of debt undermines confidence and stability. But a two (or three) country reserve system, to which the world seems to be moving, may be equally unstable. The new Global Reserve System is feasible, non-inflationary, and could be easily implemented, including in ways which mitigate the difficulties caused by asymmetric adjustment between surplus and deficit countries.

2. Reforms of the Governance of the International Financial Institutions

48. There is a growing international consensus in support of reform of the governance, accountability, and transparency in the Bretton Woods Institutions and other non-representative institutions that have come to play a role in the global financial system, such as the Bank for International Settlements, its various Committees, and the Financial Stability Forum. These deficiencies have impaired the ability of these institutions to take adequate actions to prevent and respond to the crisis, and have meant that some of the policies and standards that they have adopted or recommended disadvantage developing countries and emerging market economies. Major reforms in the governance of these institutions, including those giving greater voice to developing countries and greater transparency are thus necessary.

49. The reform of the World Bank's governance structure should be completed swiftly. For the second stage of the reform, focussing on the realignment of shares, three criteria could be taken into account: economic weight, contribution to the development mandate of the World Bank (for example, measured in terms of contributions to IDA and trust funds), and the volume of borrowing from the Bank.

50. For the IMF, serious consideration should be given to restoration of the weight of basic votes and the introduction of double or multiple majority voting.

51. Elections of the leaders of the World Bank and the International Monetary Fund should take place under an open democratic process.

3. A Global Economic Coordination Council.

52. A globally representative forum to address areas of concern in the functioning of the global economic system in a comprehensive way must be created. At a level equivalent with the General Assembly and the Security Council, such a Global Economic Council should meet annually at the Heads of State and Government level to assess developments and provide leadership in economic, social and ecologic issues. It would promote development, secure consistency and coherence in the policy goals of the major international organisations and support consensus building among governments on efficient and effective solutions for issues of global economic, governance. Such a Council could also promote accountability of all international economic organizations, identify gaps that need to be filled to ensure the efficient operation of the global economic and financial system, and help set the agenda for global economic and financial reforms. It would be supported intellectually by the work of the International Panel discussed in III.10. Representation would be based on the constituency system, and designed to ensure that all continents and all major economies are represented. At the same time, its size should be guided by the fact that the council must remain small enough for effective discussion and decision making All important global institutions, such as the World Bank, IMF, WTO, ILO and members of the UN Secretariat dealing with economic and social issues would provide supporting information and participate in the Council. It could thus provide a democratically representative alternative to the G-20.

4. Better and more balanced surveillance.

53. The surveillance of economic policies should be especially focused on systemically significant countries, those whose bad performance is most likely to have global consequences. Such surveillance should focus not just on inflation, but on unemployment, financial stability, systemic stability related to the presence of built in stabilizers or destabilizers, and systems of social protection.

5. Reforming Central Bank Policies to promote Development

54. Whereas price stability is desirable in support of growth and financial stability, it is not sufficient. Central Banks should therefore aim to ensure price stability in the context of delivering long-term sustainable growth, while being sensitive to the risks to financial stability, capital flows and exchange rates. Central banks also need to give consideration to financial market and asset price developments. This may entail Central Banks using a wider range of instruments, including prudential instruments. A distinction may need to be made between the roles of Central Banks in maintaining financial stability under normal circumstances and during crisis periods. Central

Bank governance arrangements may need to differ depending on their precise role. In particular, in any actions which may impose serious risks on a country's fiscal position, such as those now being implemented in many countries as part of financial institution resolutions, should be subject to coordination.

6. Financial Market Policies

55. Financial policies, including regulation, have as their objective not only ensuring the safety and soundness of financial institutions and stability of the financial system, but protection of bank depositors, consumers and investors and ensuring financial inclusion - such as access to all banking services including credit, and the provision of financial products which help individuals and families manage the risks they face and gain access to credit at reasonable terms. It is also imperative to make sure that the sector is competitive and innovative.

56. Financial institutions have been allowed to grow to be too big to fail, imposing enormous risk on the global economy. And while there has been innovation, too much of the innovation was aimed at regulatory, tax, and accounting arbitrage, and too little at meeting the real needs of ordinary citizens. Too little was done to help developing countries and ordinary homeowners manage the risks which they face, with consequences that have been repeatedly apparent. Financial regulation must be designed so as to enhance meaningful innovation that improves risk management and capital allocation.

57. The current crisis has made it apparent that there are large gaps and deficiencies in the regulatory structures in place in many systemically significant countries. It is also apparent that while effective regulatory system must be national there must be some global regulatory framework to establish minimum national standards and also govern the global operations of systemical relevant global financial institutions. The Report of the Commission will identify a number of key aspects of regulatory reform, emphasizing the need for deep and pervasive reforms and highlighting the risks of merely cosmetic changes in regulations. The following items are among the key aspects of needed reform.

(a) Financial Product Safety

58. Sustainable recovery will depend on appropriate regulations (across countries, products, and institutions). Regulations should be based on what things are, not what they are called, i.e. insurance products should be regulated the same way, whether called insurance or not. Financial regulators should be mandated to ascertain the safety and appropriate use of various financial instruments and practices, including through the creation of a Financial Products Safety Commission.

59. Core depository institutions should be restricted from undertaking excessively risky activities and tightly regulated. There also needs to be close oversight over all highly levered and all systemically significant institutions. But there should be oversight over all financial institutions. Institutions can quickly change into systemically significant.

(b) Comprehensive Application of Financial Regulation

60. The fact that correlated behavior of a large number of institutions, each of which is not systemically significant, can give rise to systemic vulnerability makes oversight of all institutions necessary. There needs to be tighter regulation of incentives, especially in the core institutions; part of the current problem is a result of distorted incentives which encouraged short sighted and excessively risky behavior. It may be easier to regulate incentives than every manifestation of perverse incentives. There need to be restrictions on leverage, with automatic countercyclical capital adequacy and/or provisioning requirements.

61. Although the activities of private investment funds, equity funds and hedge funds did not trigger the financial crisis, their regulation is not globally uniform, creating the potential for regulatory arbitrage and the potential for gaps in regulation. Funds should be registered in the countries of their operations and provide appropriate regulation to regulatory authorities. In addition, banks must define limits for transactions with hedge funds.

62. There should be no retreat from mark to market accounting for institutions with short-term funding in order to provide full transparency for investors and regulators. Other institutions may be encouraged to supplement mark-to-market accounting with valuations that are more appropriate to the maturity of their liabilities. In addition, steps should be taken to enforce transparency norms and public accountability for all public companies.

(c) Regulation of derivatives trading

63. The large scale use of unregulated, unsupervised OTC derivatives has resulted in undue complexity, opacity, and mis-pricing of these instruments, and facilitated capital avoidance by financial institutions. These practices have weakened our financial system significantly and made resolution of failing firms extremely difficult.

64. Where appropriate steps should be take to develop regulated exchanges for trading standardized contracts of systemically significant derivative contracts, with the associated regulatory restrictions including limits on non-commercial traders. Regulations should insure that derivative instruments are held on balance sheets, valued at independently audited real transaction prices, with appropriate capital provisioning, and clarity of purpose. The use of over the counter contracts by core

institutions should, in general, be discouraged, but whenever used, there should be ample and adequate margin.

(d) Regulation of Credit Rating Agencies

65. Other needed reforms, including for Credit Rating Agencies and systems of information provision are addressed in an Appendix.

(e) Towards global institutional arrangements for governing the global economy: a Global Financial Regulatory Authority; a Global Competition Authority.

66. The Financial Stability Forum was created in the aftermath of the 1997-8 financial crisis in order to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country, and to enhance the institutional framework to support global financial stability. It is now apparent that the reforms that it has proposed, although important, have not been sufficient to avoid major global financial instability. If it is to become the main instrument for the formulation of reforms of the global financial system it must take into consideration the importance of financial stability for the development of the real economy. In addition it must increase the representation of developing countries to adequately reflect the views and conditions in these countries and be made accountable to a democratically representative institution such as the Global Economic Coordination Council proposed above.

67. The development of financial institutions that are too big to fail has played an important role in the development of the crisis and has made the resolution of the crisis both difficult and costly, both for taxpayers and for the global economy. It is imperative not only that is adequate oversight of these large institution but that efforts be made to limit their size and the extent of their interactions, to limit the scope of systemic risk. This will require more effective global cooperation in financial and competition regulation. Movement towards this goal might be enhanced by taking steps to lay the groundwork for a Global Financial Regulatory Authority and a Global Competition Authority. With so many firms operating across borders, it is difficult to rely on national regulatory authorities. There may be large externalities generated by the action (or inaction) of national authorities. A potential, but partial, remedy to this difficulty is the proposal for a College of Supervisors to oversee systemically relevant global financial institutions. This could provide a basis for a more comprehensive Global Authority.

(f) Host Country regulation of foreign subsidiaries

68. In the absence of adequate global coordination, financial sector regulation will need to be based on the host country, not the home country, and may entail requiring the establishment of subsidiaries, rather than relying on branches.

(g) Regulatory institutions

69. While inadequate regulations are partly to blame for the current crisis, in some cases good regulations were not effectively applied and enforced. This highlights the need for reforms in regulatory structures, including reforms that make the possibility of regulatory capture less likely. The weaker is the system of global regulation, the more segmented will financial markets have to be to ensure global stability.

7. Support for Financial Innovations to Enhance Risk Mitigation

70. The absence of global systems of risk bearing and the absence of—and in some cases resistance to—innovations that would facilitate efficient risk bearing, such as GDP indexed bonds and mortgage products which better manage the risks associated with home ownership must be remedied. Governments and the international financial institutions need to explore meaningful innovations that would enhance risk management and distribution and how markets might be encouraged to do a better job. In particular, while there have been some expansion in capital markets in domestic currencies in developing countries, developing countries still bear the brunt of exchange and interest rate fluctuations. IFI lending in (possibly baskets of) local currencies and the provision of exchange and interest rate cover might be important steps in improving international risk markets.

8. Mechanisms for handling Sovereign Debt Restructuring and Cross-border Investment Disputes

71. There is an urgent need for renewed commitment to develop an equitable and generally acceptable Sovereign Debt Restructuring Mechanism, as a well as an improved framework for handling cross border bankruptcies. One way by which this might be done is through the creation of an independent structure, such as an International Bankruptcy Court. The United Nations Commission on International Trade Law provides a model that could be extended to the harmonization of national legislation on cross border disputes dealing with trade in financial services.

72. A number of countries may face difficulties in meeting their external debt commitments as the crisis worsens and debt rescheduling becomes more and more difficult due to an increase in creditors not represented in the Paris Club. The current crisis has already seen a number of bankruptcies of companies that operate across national borders, and their number is likely to increase. The absence of a formal mechanism for dealing with the impact of cross border bankruptcy and insolvency,

especially when related to financial institutions, transmits the adverse economic effects to the global economy.

73. It is especially important to achieve a uniform approach to financial and investment disputes on bankruptcy and insolvency, given the fact that the regulations dealing with these matters included in bilateral free trade agreements often transcend existing multilateral treaties and national legislation.

9. Completion of a Truly Development-Oriented Trade Round

74. There is a need for a true development round, to create an international trade regime which truly promotes growth in the developing countries. It is essential, that in all trade negotiations, the long recognized principle of special and differential treatment of developing countries be preserved.

10. More Stable and Sustainable Development Finance

75. The need for more and more stable sources of finance for development, including for the investments needed to address the long run challenges of responding to climate change, and new institutions for disbursement of funds, is discussed in Section III.4 above.

76. In the absence of better systems of risk mitigation, it is especially important for developing countries to be wary of measures that expose them to greater risk and volatility, such as capital market liberalization. Developing countries should use all the tools at their disposal, price interventions, quantitative restrictions, and prudential regulations, in order to help manage international capital flows.

77. Market-driven international capital flows are of a magnitude and volatility that they can offset any formal mechanism to provide additional finance for development. Thus, an active management of foreign capital inflows will be required to ensure that they are supportive of government counter-cyclical policies. The Articles of Agreement of the International Monetary Fund provided to members the facility of controlling capital inflows and expressly excluded the use of Fund resources to meet imbalances resulting from capital account disequilibrium. The Fund should thus be encouraged to return to its first principles and support countries that attempt to manage external flows in support domestic counter cyclical policy.

78. The international community needs to explore a variety of mechanisms of ***innovative finance,*** including regular emissions of a new global reserves (SDRs), revenues generated from the auction of global natural resources (such as ocean fishing rights and pollution emission permits), and international taxes (such as a carbon tax, which would simultaneously help address problems of global warming, or a financial

services tax, which would simultaneously help stabilize international financial markets.)

79. The receipts could be directed to support the developing countries costs of reducing greenhouse gas emissions in the context of their national policies to promote sustainable development. The effective implementation of national systems of taxation form a crucial part of domestic development finance. Measures must be taken to preserve national autonomy in the selection of the sources and methods of government financing while ensuring that national differences do not create incentives to evade responsibility of contributors to the support of government policies. An efficient method of achieving this result would be the acceptance by all countries of an amendment of Article 26 of the United Nations Model Double Taxation Convention between Developed and Developing Countries to make the exchange of information automatic.

Information on the Commission of Experts is available in: http://www.un.org/ga/president/63/commission/financial_commission.shtml.

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

20 March 2009

Excellency,

With reference to the letter dated 17 March 2009 from the President of the General Assembly, H.E. Miguel d'Escoto Brockmann, please find attached the draft programme of the extraordinary interactive thematic dialogue to be held by the General Assembly from 25 to 27 March 2009, on the subject of "The World Financial and Economic Crisis and Its Impact on Development".

Please accept, Excellency, the assurances of my highest consideration.

Norma Miranda
Ambassador
Chef de Cabinet

All Permanent Representatives
and Permanent Observers
to the United Nations
New York

Interactive Thematic Dialogue

On the Financial and Economic Crisis and its Impact on Development

25 – 27 March 2008
United Nations Headquarters, New York
(Provisional)

Programme

25 March (Analysis of the crisis)

10:00 a.m. Opening statement by the President of the General Assembly

Morning Panel - The crisis: origins, evolution, and systemic aspects
Moderator: H. E. Morten Wetland, Permanent Representative of Norway to the United Nations.

10:20 a.m. 11:20 a.m.
Presentation 1: Mr. Jomo Kwame Sundaram, Assistant Secretary-General. DESA.
Presentation 2: Ms. Jane Stewart, Special Representative to the United Nations. International Labor Organization (ILO).
Presentation 3: Ms. Alicia Barcena, Executive Secretary ECLAC. Regional dimensions of the crisis. Videoconference.

11:20 a.m. – 11:40 p.m.
Comments by:
- Mr. Andrey Denisov, First Deputy Foreign Minister of the Russian Federation.
- Prof. Mario Baldassarri, Senator, Chairman of the Committee on Finance and Treasury of the Italian Senate.

11:40 a.m. – 1 p.m.
Questions and answers and statements by Member States, groups of states, international organizations and other organs of the UN system. Two questions or statements by two representatives of civil society organizations.

Afternoon Panel: UN System Responses to the crisis
Moderator: Mr. Yu Yongding. Director, Institute of World Economics and Politics, Chinese Academy of Social Sciences. Former Member of Monetary Policy Committee, People's Bank of China. Member of the Commission of Experts of the PGA.

3:00 – 4:15 p.m.
Presentation 1: Mr. Ugo Panizza. Chief of the Debt and Financial Analysis Unit, Debt and Development Finance Branch, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development (UNCTAD).
Presentation 2: Mr Selim Jahan, Director, Poverty Group, Bureau for Development Policy, United Nations Development Programme (UNDP).
Presentation 3: Mr. Jeffrey Lewis, Senior Advisor, World Bank.
Presentation 4: Mr. Ranjit Teja, Deputy Director of Strategy Policy and Review Department, International Monetary Fund.

Comments by: Mr. Martin Khor, Executive Director of the South Centre.

4:15 - 6:00 p.m. Questions and answers and statements by Member States and groups of states, international organizations and other organs of the UN system. Two questions or statements by two representatives of civil society organizations.

26 March

Morning Presentation.

Moderator: H.E. In Kook Park, Permanent Representative of the Republic of Korea to the United Nations.

10:00 – 11.00 a.m.

Introduction of the Recommendations. *Professor Joseph Stiglitz* (USA), Chairman of the Commission of Experts accompanied by Members of the Commission.

11.00 a.m.-1.00 p.m. Questions and answers and statements by Member States and groups of states and UN agencies. Two questions or statements by two representatives of civil society organizations.

Afternoon Panel.

Moderator: H.E. Mrs. U. Joy Ogwu, Permanent Representative of Nigeria to the United Nations.

3:00 – 3. 45 p.m.
Panel 1: Reform of International Institutions
Ms. Heidemarie Wieczorek-Zeul (Germany)
Mr. Jomo K.S. (United Nations)
Mr. François Houtart (Belgium)
Mr. Pedro Páez (Ecuador)

3:45 – 4:30 p.m.
Panel 2: Macroeconomic measures in response to the Crisis:
Mr. Jean-Paul Fitoussi, Chair (France)
Mr. Jomo K.S. (United Nations)
Mr. Robert Johnson (USA)
Mr. Yaga Venugopal Reddy (India)

Comments by: Mr. Jon S. Corzine, Governor of the State of New Jersey, USA (To be confirmed)

4:30 – 6:00 p.m.
Questions and answers and statements by Member States and groups and UN agencies. Two questions or statements by two representatives of civil society organizations.

27 March

Morning Panel.
Moderator: H. E. Claude Heller, Permanent Representative of Mexico to the United Nations.

10:00 – 10:30 a.m.
Panel 3: International Financial Architecture:
Mr. Yu Yongding, Chair (China)
Mr. Yaga Venugopal Reddy (India)
Mr. Benno Ndulo (Tanzania)
Ms. Heidemarie Wieczorek-Zeu (Germany)
Ms. Zeti Akhtar Aziz (Malaysia)

10:30 - 11.00 a.m.
Panel 4: Re-Regulating the Financial System
Mr. Robert Johnson, Chair (USA)
Mr. Yaga Venugopal Reddy (India)
Mr. Benno Ndulo (Tanzania)

11:00 p.m. – 12:45 p.m.
Questions and answers and statements by Member States and groups and UN agencies. Two questions or statements by two representatives of civil society organizations.

Closing
12:45 p.m.
Final remarks. *Professor Joseph Stiglitz*, Chairman of the Commission of Experts.

NEW YORK

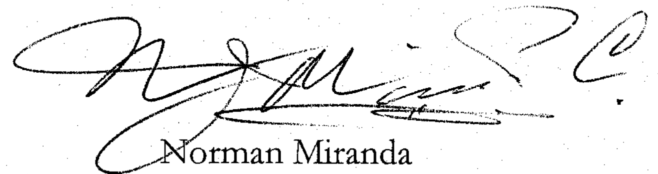
OFFICE OF THE PRESIDENT OF THE GENERAL ASSEMBLY

23 March 2009

Excellency,

I would like to draw your attention to the attached reference paper prepared by the International Labour Organization for the interactive dialogue on The World Financial and Economic Crisis and Its Impact on Development that will be held from 25 to 27 March 2009 at United Nations Headquarters in New York.

Please accept, Excellency, the assurances of my highest consideration.



Norman Miranda
Ambassador
Chef de Cabinet

All Permanent Representatives
and Permanent Observers
to the United Nations

ORGANISATION INTERNATIONALE DU TRAVAIL
BUREAU AUPRÈS DES NATIONS UNIES

ORGANIZACION INTERNACIONAL DEL TRABAJO
OFICINA PARA LAS NACIONES UNIDAS

INTERNATIONAL LABOUR ORGANIZATION
OFFICE FOR THE UNITED NATIONS

Jane Stewart
Special Representative to the United Nations and
Director

24 March 2009

Excellency,

In preparation for the Extraordinary Interactive Thematic Dialogue on The World Financial and Economic Crisis and Its Impact on Development which is to take place from 25 to 27 March 2009, it is my privilege to draw your attention to the attached executive summary of the document entitled: *"The financial and economic crisis: A Decent Work response"*. The complete paper, which can be accessed on the website of the President of the General Assembly, has also been submitted to the ILO's Governing Body Committee on Employment and Social Policy as well as to the High-level Tripartite meeting on the Current Global Financial and Economic Crisis.

This contribution will serve as a background to the discussion on the ILO's analysis of the origins and impacts of the international financial crisis which will be presented on 25 March at the above-mentioned thematic dialogue.

Please accept, Excellency, the assurances of my highest consideration.

Jane Stewart
Special Representative to the United Nations and
Director

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UN GENERAL ASSEMBLY

Extraordinary Interactive Thematic Dialogue on The World Financial and Economic Crisis and Its Impact on Development

AN ILO DISCUSSION PAPER

The financial and economic crisis: A Decent Work response [1]

[1] This paper is also being submitted to the ILO's Governing Body Committee on Employment and Social Policy as document GB.304/ESP/2 and to the High-Level Tripartite meeting on the Current Global Financial and Economic Crisis as document HTM/1.

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Executive Summary

The global crisis is deepening…

1. The world economy has been significantly affected by the financial crisis and prospects are the worst since the Great Depression. Already, the largest developed countries, notably those where the crisis originated, have entered into recession. Spill over to other countries was initially small, but several emerging economies are now being hit hard – assumptions about a "decoupling" of these economies have indeed proved wrong.

2. Developing countries too are facing the effects of the crisis, which will disrupt – and in some cases reverse – the achievement of Millennium Development Goals, including decent work for all. This is of particular concern given that, even in the pre-crisis period, growth patterns in certain regions, notably in Africa, led to only negligible reductions in poverty. Decent living and working conditions still remain out of reach for large numbers of people.

3. Importantly, the crisis is spreading throughout the real economy by means of three mutually-reinforcing transmission channels, namely: the limited availability of credit for working capital, trade finance and viable investments in the real economy (the credit crunch); cautious spending decisions, leading to lower output, employment and prices, in turn affecting confidence among consumers and investors (the vicious cycle of depression); and international trade and investment linkages and remittance flows (the globalization channel).

... and entails a risk of a prolonged labour market recession ...

4. The consequences of the crisis on labour markets have been visible since 2008, especially in the United States where the crisis originated. At the global level, after four years of consecutive declines, the number of unemployed increased in 2008 by 11 million. As the crisis continues to spread and job losses mount, worldwide unemployment could increase by an additional 40 million by the end of this year.

5. The bleak labour market picture affects certain groups disproportionately – notably women, migrant workers and youth. In some countries, the financial sector, construction and automobiles are suffering the most. In general, export-oriented sectors, which in many developing countries are major providers of formal jobs, notably for women, face the prospect of rapidly shrinking world markets. And the impact of the crisis on labour markets will go beyond job losses. In particular, the incidence of informal employment and working poverty will rise, aggravating pre-existing challenges.

6. The biggest risk is of a prolonged labour market recession. Lessons from past financial crises show that the labour market tends to recover only four to five years after the economic recovery (which is not expected before the end of 2009). This is because massive rises in long-term unemployment and greater labour market "informalization" – exacerbated by return migrants and large-scale reverse migration from urban to rural areas – are very difficult to reverse. If these trends take root, the negative effects of the

crisis will be long-lasting, thus yielding significant social hardship and depriving the economy of valuable resources.

... threatening social stability

7. Social hardship will be heightened in developing countries where social protection is often limited. But even in emerging economies and a number of developed countries, most new jobseekers do not receive unemployment benefits. The result is that millions of workers will be left without adequate support.

8. Pension systems are under severe strain as a result of the collapse of capital markets. Private pension funds have recorded substantial losses on their investments. Though the trends are often presented in overly technical language, one thing is clear: pension entitlements for workers who rely on such funds have been cut by over 20 per cent, on average. In some countries, even retirees have been left with the prospect of lower pension benefits. Importantly, well-designed public pension systems have been much less affected than private funds. This has motivated a policy shift in the stance of certain international organizations, which now advocate greater focus on more stable, security-oriented public pension systems. This is a much-welcomed development, though the damage has already been done and will be difficult to repair.

9. Finally, there is concern that the crisis is affecting all groups, while the gains of the pre-crisis expansionary period had been distributed unequally.

10. In short, a social crisis is looming large and can only be averted if adequate action is taken promptly.

Countries have attempted to address the crisis through the adoption of massive financial rescue measures and the announcement of fiscal stimulus packages…

11. Much of the focus to date has been on stabilizing financial markets and attempts to restore credit liquidity. At the same time, to stimulate the economy many countries have announced fiscal rescue packages – cutting taxes and boosting spending – of varying sizes. Several countries have also taken some action to mitigate the labour market and social consequences of the crisis. However, the amount committed for financial rescue measures has been for the most part far in excess of fiscal tools deployed to stimulate demand, output and employment.

...but the plans have not succeeded so far ...

12. It is commendable that countries have reacted so quickly, given the time lag for these packages to reach the real economy. Nevertheless, the impact of the measures has been limited to date. This is because, as evidenced from the over 40 rescue and stimulus plans assessed for the purposes of this paper, the transmission mechanisms through which the crisis is spreading have not been fully addressed. And the measures have often failed to tackle the structural imbalances that lie behind the crisis.

… because the credit system has not been revived…

13. First, rescue measures to banks, though of unprecedented magnitude, have not revived bank credit. To avert the risk of systemic collapse, developed countries have rescued financial institutions through capital injections, credit guarantees and sometimes outright assumption of bad loans. Indeed, protecting banks' solvency and restoring the availability of credit to enterprises and households was rightly regarded as a pre-condition to avoid a total collapse of the financial system, with unpredictable consequences for the real economy. However, access to bank credit remains limited.

... fiscal packages do not focus sufficiently on decent work and are not coordinated, thus failing to boost the economy…

14. Second, fiscal stimulus measures announced by governments are generally on a lower scale than rescue support to banks. In addition, they mostly do not focus sufficiently on employment and social protection. For instance: only a handful of countries have announced labour market initiatives; infrastructure programmes do not adequately take into account the need to reinforce the existing capacity of businesses and skills supply – so that part of the infrastructure spending may result in higher prices, rather than higher production and jobs; and some tax cuts will end in higher savings rather than higher demand, output and jobs. The measures moreover involve only limited social dialogue with employers and unions and lack coordination across countries.

15. Lack of international coordination obviously diminishes the overall effect of the stimulus measures. But it also makes each individual country reluctant to move faster than its trading partners, given the international linkages. As a result, practical implementation of the fiscal packages may be postponed further, aggravating the vicious cycle of depression.

… world markets face the risk of inward-looking solutions, competitive devaluations and wage deflation…

16. Third, world markets are affected by the credit crunch (which dries up trade finance available to enterprises) and face the risk of inward-looking solutions and protectionist responses. The repercussions for developing countries, which rely so heavily on world markets, would be especially acute. This is why the multilateral system should remain vigilant vis-à-vis the mounting pressure to support strategic sectors like automobiles. Likewise, attempts to overcome the crisis through competitive currency devaluations would be counterproductive.

17. Generalized wage deflation to protect individual economies would aggravate the crisis even more than a wave of competitive devaluations. Indeed, wage deflation would deprive the world economy from much-needed demand and would also seriously undermine confidence. Open market policies, which are so crucial to the recovery, would also face a risk of backlash if workers perceive the measures as unfair.

… little attention has been devoted to the development dimension…

18. Fourth, inadequate attention has been given to the development perspective. The social impacts of the crisis in developing countries are exacerbated by the fact that the majority

of workers and small businesses do not have basic social security. It is expected that between 40 and 50 per cent of men and women globally will not be able to earn enough to lift themselves and their families above the two US dollars a day poverty line in 2009.

19. Moreover, many developing countries lack the capacity to undertake massive public investments. Already a number of countries are facing sizeable fiscal and current account deficits on the heels of the food and fuel price crisis of mid-2008. If the gap between countries widens even further as a result of varying capacities to respond to the crisis, global imbalances and inequalities will intensify.

20. Traditional International Monetary Fund (IMF) packages to support countries that undergo balance of payments crises are simply not adapted to the situation. Such packages were based on an approach that assumed countries faced local crises, for which the countries involved themselves had the main responsibility. The current crisis, however, is global and originates in the developed world. A multiplication of traditional rescue packages would further aggravate the decline in world demand and perpetuate the global crisis. This is why a new mechanism, which would coexist with IMF rescue packages, rather than replace it, is needed.

… and the structural causes of the crisis have not been tackled

21. Fifth, the stimulus measures have, so far, not been deployed with a view to ensuring that global growth is more equitable and sustainable in the medium to longer term. Global imbalances, decent work deficits and inequalities have been a significant contributor to the crisis. Likewise, reflecting poorly regulated financial markets, the real economy has been subject to pressure to raise returns in the short run, sometimes to the detriment of workers' incomes and the long-term interests of sustainable enterprises. It is vital to tackle the root causes of the crisis to support the recovery, reduce the risk of another major systemic crisis and promote a sense of fairness. Reverting to the "status quo" is not an option.

What is needed is a global jobs pact

22. Moving ahead with the Decent Work Agenda is crucial to supporting the economic recovery, averting the labour market and social crises and promoting social cohesion on the measures. In the global crisis context, this is best done through a global jobs pact.

23. A *global* approach is needed because the measures, to be effective, need to avoid beggar-thy-neighbour solutions to a crisis which is global in nature. The emphasis on *jobs* comes from evidence provided in this paper that it will not be possible to reactivate the economy in a sustainable manner unless greater emphasis is placed on decent and productive employment for women and men, well-designed social protection and workers' rights. Measures are best implemented through social dialogue in countries, but greater cooperation at the international level can also have mutually-reinforcing benefits – thus the need for a *pact*.

24. The global jobs pact would build on the ILO's Global Employment Agenda and the November 2008 statement by the Officers of the ILO Governing Body. In essence, the

global jobs pact seeks to support economic recovery through decent-work friendly policies, reduce the risk that the crisis spreads further across countries and pave the way for a more sustainable, fairer globalization. This is how.

25. To ***restore credit***, governments could consider:

    - Making financial support, such as government's assumption of toxic assets, conditional on: beneficiary banks providing new credit for viable projects of businesses and individuals; and limitations to managers' pay and dividend policy, so that government support does not miss the target of reactivating credit.
    - Providing credit lines and direct access to government loans to small businesses (important drivers of innovation and employment growth) so they can maintain operations (and seize potential new opportunities) until demand is restored.

26. ***Fiscal stimulus packages would provide a much stronger boost to the economy and jobs, while also proving cheaper than current packages,*** if the following conditions were met:

    - Ensuring that infrastructure, construction and housing projects leverage capacity among existing businesses by: giving small and medium-sized enterprises (SMEs) support to take advantage of new opportunities; ensuring that workers have the skills to respond to new requirements; and promoting the rural and agricultural dimensions of the projects, which are crucial for developing countries as they would help boost domestic economic and job dynamism and attenuate the looming food crisis.
    - Given the lags in launching infrastructure, construction and housing projects, it would be helpful to: provide support to existing jobs in viable firms through shorter working hours, partial unemployment benefits and training; reduce labour taxes on low-wage employment; and enhance social protection through well-designed programmes that support aggregate demand and are consistent with work incentives. This could include conditional cash transfers to enhance access to education and health services, and unconditional transfers in countries where poverty is widespread and administrative capacity is limited. More structural measures are also needed however, so that social protection becomes broad-based.
    - For job losers and new entrants who do not find jobs, the following measures proved useful in earlier crises: putting in place at least minimal unemployment benefits or employment guarantees for those not able to access income support (experience from the Asian crisis shows successful performers overcame the crisis partly through these new, cost-effective schemes); active labour market programmes and training administered through solid, well-resourced public employment services (evidence shows that these services, if well functioning, are crucial at times of crisis and are cost-effective relative to other measures); and specific programmes and approaches to vulnerable groups, notably women who return to the labour market after maternity leave, youth, who could also be encouraged to stay longer in education, and migrant workers.
    - To the extent that specific industrial sectors need support, such support should be: subject to strict social and environmental conditionality; and targeted and coordinated globally, consistent with international trade agreements.

- Enhance fiscal space, administrative capacity and technical support to developing countries in the event of global crises, possibly through the creation of a global jobs fund. Unlike the IMF rescue packages, this fund would be anti-cyclical. The global jobs fund would not be subject to cuts in social spending and wage deflation (which not only depress the domestic economy but also affect neighbouring countries, exerting further downward pressure on world demand). Recipient countries could take advantage of ILO expertise in developing the various dimensions of the global jobs pact. They would engage social partners in the design of the measures. Repayment of the fund's loans, possibly larger in scale than traditional rescue loans, would be made easier because the system is anti-cyclical in nature, and thus supports the global recovery, and is designed to promote domestic economic capacity.

27. ***Avoiding wage deflation through coordinated systems of collective bargaining and protecting workers' rights*** would not only provide adequate support to victims of the crisis, but would also ensure a timely demand stimulus and pave the way for a more sustainable economy. As such, the global jobs pact would also comprise the following measures:

    - Strengthening respect for core workers' rights, as this would be both socially desirable and economically efficient to achieve more balanced income developments.
    - Building the capacity of social partners for dialogue and reach agreements at various levels so that wages for the economy as a whole grow in line with productivity developments (and not below them as was the case over the past two decades).
    - Guaranteeing the purchasing power of minimum wages, so that they act as anchor to all wages.
    - Avoiding wage deflation to support global demand and reduce trade tensions.

Global policy coherence for shared prosperity and development:

28. Now is the time to enhance cooperation among key international organizations. This is key to speed up the recovery. Indeed, inward-looking solutions would be counterproductive. More fundamentally, the crisis is global and multi-faceted, so no organization or country is equipped to address all its dimensions. This is why the ILO has reaffirmed the importance of fostering greater cooperation among national governments, international organizations, and other stakeholders in support of a stronger, cleaner and fairer economy. International partners can increase coherence between financial, trade, social, environmental and development goals. This also implies a reprioritization between these goals, to:

    - ensure that the financial system serves the real economy and social development, through a deep reform of the financial architecture and the implementation of executive compensation packages that are reasonable and geared towards real performance;
    - re-balance the globalization process, as stated in the ILO Declaration on Social Justice for a Fair Globalization (the Social Justice Declaration), and in particular address the decent work gaps, and excessive income inequalities as well as the

growing incidence of informal and non-standard employment that developed during the pre-crisis period;

- pave the way for a green economy, given that future spending will be limited by the need for governments to tighten budgets so as to repay mounting public debt after the economy recovers. Importantly, green technologies tend to be more job-rich than their CO2-intensive counterparts – hence the Green Jobs agenda; and
- ensure that official development aid is not affected by the crisis and establish a new mechanism such as the global jobs fund, to complement existing measures and support adjustment of emerging and developing countries at times of crisis.

29. Debates at the G20 could offer an opportunity to discuss these issues, as well as the global jobs pact. In addition an exchange of good practices could take place at the ILO, so that countries benefit from each other's experiences and take advantage of the expertise developed at the ILO.

30. In sum, responses to the crisis must *not* be piecemeal in nature and rolled out temporarily, only to revert back to "business as usual" as soon as possible. The challenge now is to respond to the current crisis by putting in place measures that pave the way for a better pattern of growth and development.

Introduction

31. What started as a mortgage crisis in the United States in the latter half of 2007 has now developed into a global economic crisis, bringing with it unprecedented labour market and social challenges across advanced, emerging and developing countries.

32. The objective of this paper is to provide evidence-based policy analysis of how ILO members can best mitigate the challenges facing enterprises and workers. The first section of the paper reviews recent developments, discusses the origins of the crisis and how the damaging effects have spread from developed countries to other parts of the world, and from the financial economy to the real economy, employment and society.

33. The second section examines current international and national responses to the crisis, including financial and fiscal policy measures, labour market initiatives and social dialogue. The aim of this section is to assess the breadth and depth of the responses and identify potential gaps.

34. In building upon the lessons learned and measures taken to date, the third section of the paper examines the key ingredients to overcoming the crisis, and the role of the ILO in addressing the challenges.

35. The last section discusses how best to respond to the crisis through measures that support a recovery while meeting the longer-term goal of achieving a more sustainable and equitable pattern of development, as provided in the Social Justice Declaration.

I. Crisis spreads worldwide and entails risk of prolonged social crisis

The largest developed countries, notably those where the crisis originated, have already entered into recession …

36. The global economy is experiencing the worst economic crisis since the Great Depression. What began as a financial crisis when the housing market in the United States turned sour has now expanded into a global meltdown, wiping away trillions of dollars of financial wealth, putting the real economy at grave risk of prolonged recession, and causing significant job losses and widespread social hardship.

37. The IMF predicts that world output will grow at 0.5 per cent this year, the lowest rate since the Second World War (Table 1). In comparison, in 2007 and 2008, world output grew by over 5 per cent and 3.4 per cent, respectively. The European Union (EU), Japan, the United States and other large developed economies have already entered into recession or are on the brink of doing so. The UN's Department for Economic and Social Affairs (UNDESA) has confirmed the IMF's bleak economic prospects for 2009. And private-sector analysts such as the Deutsche Bank paint an even direr scenario, with world output actually falling in 2009.

Table 1. World Economic Outlook*

	IMF		Deutsche Bank	UNDESA
	2008	**2009**	**2009**	**2009**
World output	3.4	0.5	-0.8	1.0
United States	1.1	-1.6	-2.7	-0.9
Euro Area	1.0	-2.0	-3.0	-0.7
Japan	-0.3	-2.6	-7.6	-0.3
Brazil	5.8	1.8	1.2	2.9
China	9.0	6.7	7.0	8.4
India	7.3	5.1	4.8	7.0
Russian Federation	6.2	-0.7	-2.4	4.8
South Africa	:	:	:	2.5
Africa	5.2	3.4	:	4.1
ASEAN-5	5.4	2.7	:	:
Central and Eastern Europe	3.2	-0.4	:	:
Western Hemisphere	4.6	1.1		
Middle East	6.1	3.9	:	:

* IMF and UNDESA forecasts are from January 2009 and Deutsche Bank from 25 February 2009.
Source: IMF, Deutsche Bank and UNDESA.

…and the crisis is now spreading to the rest of the world…

38. Spill over to emerging and developing economies was initially small, but the crisis has now spread worldwide and from financial markets to the real economy through a number of transmission mechanisms (Box 1).

Box 1. **The crisis: causes and transmission mechanisms**

The crisis has been brought about by a combination of inappropriate financial regulations, excessive risk-taking of certain financial intermediaries and inefficient remuneration practices of bank managers and traders. But it is the interaction between these financial factors and global imbalances that lies at the heart of the crisis:

- Since the early 1990s, significant savings-investment imbalances built up. This is partly the result of export-oriented growth strategies in some countries, and insufficient savings in others. Lack of exchange rate adjustments contributed as well.

- Within countries, income inequalities grew significantly since the early 1990s. Stagnating wages and incomes for a majority of workers in some countries spurred demand for credit to sustain consumption possibilities and housing investment decisions. Interestingly, a rise in the share of over-indebted households has been observed in all the countries where income inequalities have increased.

- This was made possible by lightly regulated financial practices that allowed excessive debt accumulation and focused on short-term returns (because of skewed compensation packages) rather than long-term investments in the real economy. When housing markets reached a turning point and interest rates rose, over-leveraged low-income households defaulted on payments and foreclosures rose significantly. As the value of the assets plummeted, banks had to finance foreclosures, and effectively stopped lending to each other, causing liquidity to dry up substantially.[2] In short, financial markets have tended to operate to the detriment of labour market stability and sustainable enterprises.

The crisis then spread to the real economy, and beyond developed countries, through three channels.

First, the crisis spread through the financial system via the process of "securitisation" of "toxic assets". Direct exposure to toxic assets led to some localized bank failures, but more broadly, inter-bank credit was affected and as a result, the volume of new credit available to the real economy declined. Even businesses with a long record of creditworthiness have had credit lines cut and have had difficulty selling their bonds. This abrupt freezing up of the normal credit lines needed for trade, coupled with the inability of companies to raise capital for seemingly profitable business opportunities and investment plans, created the so-called "credit crunch".

Second, over and above the credit crunch, the crisis is gaining its own dynamics in the real economy through the confidence channel. Consumers and investors lack confidence and postpone their spending decisions. This affects firms' prospects and leads to job losses, further aggravating confidence.

Third, the crisis is spreading worldwide through international linkages, so even countries with

[2] This issue is discussed in detail in ILO: *A global policy package to address the global crisis*, Policy Brief, International Institute for Labour Studies (IILS), Geneva, 2008.

relatively healthy financial systems are being affected:

- World trade is estimated to contract by 2.8 per cent in 2009 after growing at an average annual rate of 7.8 per cent for the last three years.[3] This has dire consequences for economies around the world, especially the export-led economies of Asia and Latin America. Moreover, global trade activity is also negatively affected by the scarcity of trade financing.

- Some trade prices, notably for oil and other commodities, declined significantly as a result of the recession. As such, oil and gas producers like Mexico, Middle Eastern countries, the Russian Federation and the Bolivarian Republic of Venezuela face a sudden reduction of export revenues. Likewise, declines in prices of metals such as nickel, lead and zinc have deeply affected countries such as Australia, Brazil and South Africa. Lower commodity prices – though improving the terms of trade for importing countries – have not outweighed the other negative forces at work.

- Foreign direct investment and other private capital flows are affected as well. In particular, private capital flows to emerging economies are expected to fall to $165 billion in 2009. From the high of $929 billion in 2007, this represents an unprecedented drop of 82 per cent.[4] This has implications for development, since one third of growth in emerging countries comes from investment.[5] Reduced flows of capital may have a dramatic effect on countries with large current account deficits and with a limited ability to borrow from abroad.

- It is likely that, for the first time in decades, remittances will fall, impacting the economic security of households around the globe. Remittances represent more than 10 per cent of GDP in over twenty countries, and in some cases as much as 24 per cent.[6] For many countries, remittances are larger than the amount received in Official Development Assistance. The negative impact of falling remittances on the developing world could be in the order of $3 billion per year.[7]

- Although donor countries have committed not to reduce development aid in several international fora, this commitment might eventually come under pressure in view of declining outputs in major industrialised countries.

39. Large emerging economies are being hit hard by the crisis – assumptions of a "decoupling" of these economies have proved wrong. During the second half of 2008, industrial output slowed significantly and even contracted in some large emerging economies (Figure 1).

40. Other emerging and developing countries are also being affected. There is a risk that the development path will be seriously disrupted and in some cases reversed. This could compromise the attainment of the Millennium Development Goals, notably "full and productive employment and decent work for all, including women and young people".

[3] World Trade Organization: *Annual Report*, 2002.
[4] Institute of International Finance: *Capital Flows to Emerging Market Economies*, 27 January 2009.
[5] UNCTAD: *Trade and development report: Commodity prices, capital flows and the financing of investment*, 2008.
[6] World Bank: *Migration and Development Brief*, 29 November 2007.
[7] Under the assumption that remittances fall 2 per cent globally – in line with the estimated decline in Latin America (Inter-American Development Bank: *IADB estimates of 2008 remittance flows to Latin America and the Caribbean*, October 2008).

Decent living and working conditions still remain out of reach for a large number of people.

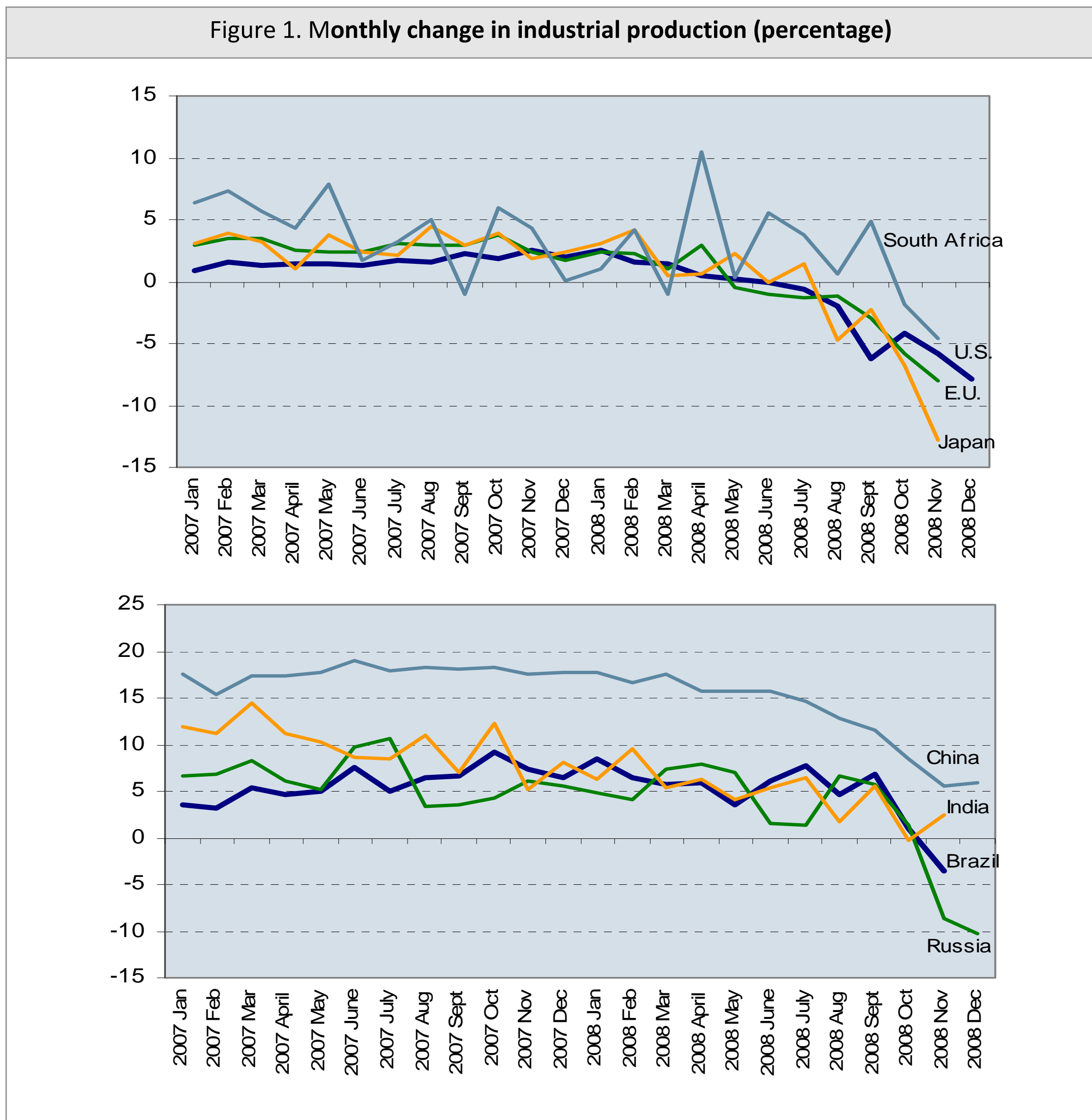

Figure 1. **Monthly change in industrial production (percentage)**

Source: World Bank.

…with severe impacts on certain sectors

41. Certain sectors are being disproportionately affected by the crisis. The effects on financial services and construction – the sectors at the epicentre of the crisis in developed countries – have been immediate and profound.[8] In a second round, those sectors most affected by the credit squeeze and confidence effects, like automobile production, were hit.[9] Export-oriented activities, tourism and commodity sectors are now suffering from

[8] See GB.304/STM/2/2 and V. Escudero: *Effects of the Crisis on the Financial Sector: Trends and Policy Issues*, Discussion Paper, IILS, ILO, forthcoming 2009.

[9] Two-thirds of cars in the world are purchased with credit. However, it is important to note that even before the current crisis, the automotive sector was facing a number of challenges, including decreased demand for relatively high-profit vehicles due to volatile fuel prices and geographical relocation of some operations to areas with low labour costs. See GB.304/STM/2/2.

that rely heavily on a narrow, commodity-based export sector, is dramatic.

Global unemployment rose in 2008 and employment levels have declined significantly in advanced economies…

42. As growth rates declined in 2008, the effects on the labour market started to be felt. After four years of consecutive declines, the global unemployment rate increased to 6 per cent in 2008, up from 5.7 per cent in 2007, and the number of unemployed rose by 11 million.[10] The impact was immediate and particularly severe in the United States, where employment losses started in early 2008 and have continued to mount since. Similar trends are present in Japan (Figure 2). In European countries, job losses have been contained to some extent due to recourse to shorter hours or partial unemployment benefits. However, even there, recent indicators suggest significant increases in unemployment.

Figure 2. **Employment declines in 2008 in the G7 (000s)**

Source: International Institute for Labour Studies (IILS) estimates based on national sources.

…with already visible impacts on emerging and developing countries...

43. In other countries, the job losses stemming from the crisis have only just begun and so the full extent of the impacts on labour markets may not be felt for some time. Nevertheless, there are early and clear indications that the crisis is impacting labour market and social conditions in emerging economies and developing countries:

- Following job losses in factories on the industrialized eastern coast of China, more than 20 million workers have reportedly returned to their residential rural areas.[11]
- During the last quarter of 2008, employment in eight export-oriented sectors in India (mining, textile and textile garments, metals and metal products, automobile, gems and jewellery, construction, transport and information technology) fell by over 3 per cent.[12]

[10] ILO: *Global Employment Trends,* January 2009.
[11] China national statistics, Ministry of Agriculture.

- The South African economy may lose a quarter of a million jobs as a result of the crisis and this is likely to undermine government plans to cut the unemployment rate to 14 percent by 2014.[13]
- Reflecting a sudden deterioration in the economic outlook, Central and Eastern European countries are experiencing a dramatic reversal of earlier, hard-won employment gains.
- Significant job losses have been recorded in developing countries that rely heavily on a narrow export base. For instance, in Africa, employment levels in commodity production and tourism have declined significantly in recent months.

44. In these countries, job losses will exacerbate challenges of employment informality and working poverty. In the absence of income support alternatives, job losers either move back to rural areas or take up informal jobs in the urban economy.[14] This has started to happen, according to an ILO report.[15] For instance, a reversal in rural-to-urban migration flows has been noted in China and, in Africa, workers who had formal jobs in export-oriented sectors have been pushed to the informal economy where they will earn lower wages. As a result, between 40 and 50 per cent of the world's working men and women in 2009 are not expected to earn enough to lift themselves and their families above the $2 a day per person poverty line.[16]

… and disproportionate effects on vulnerable groups such as women, youth and migrant workers

45. Groups that were already in a vulnerable position before the crisis will be disproportionately affected, while temporary and migrant workers are also usually not protected by collective bargaining agreements.[17]

46. The crisis is already having differentiated employment and social impacts from a gender perspective. Many of the job losses to date in advanced economies, especially the United States, have been in male-dominated sectors such as finance and construction.[18] However, in many developing countries, women are often in more precarious employment situations.[19] In particular, the concentration of women in export-oriented enterprises in emerging and developing countries brings a number of acute labour market challenges (Box 2).

[12] C.P. Chandrasekhar; J. Ghosh: "Asian face of the global recession", in *The Hindu Business Line* 10 February 2009.
[13] N. Seria; M. Cohen: "Manuel Cuts South African Growth Forecast to Decade Low of 1.2 per cent", in *Bloomberg.com*, 11 February 2009.
[14] G. Betcherman; R. Inslam (eds.): *East Asian Labour Markets and the Economic Crisis*, World Bank, 2001.
[15] ILO Regional Office for Asia and the Pacific: *The Fallout in Asia: Assessing labour market impacts and national policy responses to the global financial crisis*, prepared for the forum Responding to the Economic Crisis – Coherent Policies for Growth, Employment and Decent Work in Asia and Pacific, Manila, 18-20 February 2009.
[16] ILO: *Global Employment Trends*, January 2009.
[17] The impact on vulnerable groups varies by country and time period under consideration (see for example, ILO: *Global Employment Trends for Women*, March 2008).
[18] Of the 2.9 million jobs losers in the United States in 2008, 2.3 million were male.
[19] ILO: *Global Employment Trends for Women*, March 2008.

Box 2. Impact of the crisis on women's employment[20]

The crisis has already hit major exporting industries dependent on American and European markets, such as labour-intensive sectors of developing countries. This includes clothing, footwear and processed foods, as well as micro-circuits and electronic products. Since women make up the majority of the workforce in these sectors, their labour market position has worsened considerably.

More generally, women are often regarded as a flexible reserve, to be drawn into the labour market in upturns and expelled in downturns.[21] Women are also over-represented among casual and temporary employment, contract labour and home workers. They also tend to earn lower wages than their male counterparts and the crisis is likely to worsen the situation in this regard.

47. Youth are facing considerable difficulties entering the labour market.[22] This comes on top of an already fragile situation for youth in both developed and developing countries. Even during the previous period of economic expansion, most economies fell short of creating enough decent and productive jobs for young people. Between 1997 and 2007, the number of unemployed youth rose by 8 million.[23] Moreover, a lack of decent work opportunities at an early age may permanently compromise the future employment prospects of youth. The relative disadvantage of young workers is even more pronounced in developing countries.[24]

48. As employment losses mount, migrant workers are particularly vulnerable and often among the hardest hit, due in part to their low bargaining position (especially among newly arrived migrant workers). Evidence from past crises reveals that for the most vulnerable migrant workers, especially women and those in irregular status, this often translates into significant job loss. For those able to maintain employment, a serious deterioration in working conditions is often registered.

The prospects are for a continued deterioration in labour market and social conditions…

49. The global number of unemployed persons could rise by 20 million in 2009.[25] If the outlook worsens to the point where increases in unemployment match the magnitude

[20] A. King-Desjardin; J. Owens: *The global economic crisis: impacts and responses from a gender perspective*, ILO, forthcoming 2009.
[21] Studies of economic recessions in several developed countries in North America, Europe and Asia show that women's employment moved pro-cyclically, and significantly more pro-cyclically than men's (J. Rubery (ed): *Women and Recession*, Routledge & Kegan Paul, London, 1988). In addition, women's integration into the workforce in the 1980s was generally associated with their providing forms of labour market flexibility (G. Standing: "Global feminisation through flexible labour," World Development, Vol. 17, No.7, 1989).
[22] For example, in Spain, during the fourth quarter of 2008, employment decreased for most age groups, but the drop, at 10 per cent, was particularly severe for 20-24 year olds.
[23] ILO: *Global Employment Trends for Youth*, October 2008.
[24] *Ibid.*
[25] ILO: *Global Employment Trends*, January 2009. Scenario 2: Projection on the historical relationship between economic growth and unemployment at times of crises in each economy; IMF revised estimates for economic growth, November 2008.

witnessed in the 1990s, then unemployment could rise by 50 million, bringing the global unemployment rate above 7 per cent.[26]

50. Likewise, vulnerable employment, as measured by own-account workers and contributing family workers, is expected to rise by some 25 million (Figure 3, Panel A). The majority of the increase is expected to occur in South Asia and Sub-Saharan Africa.

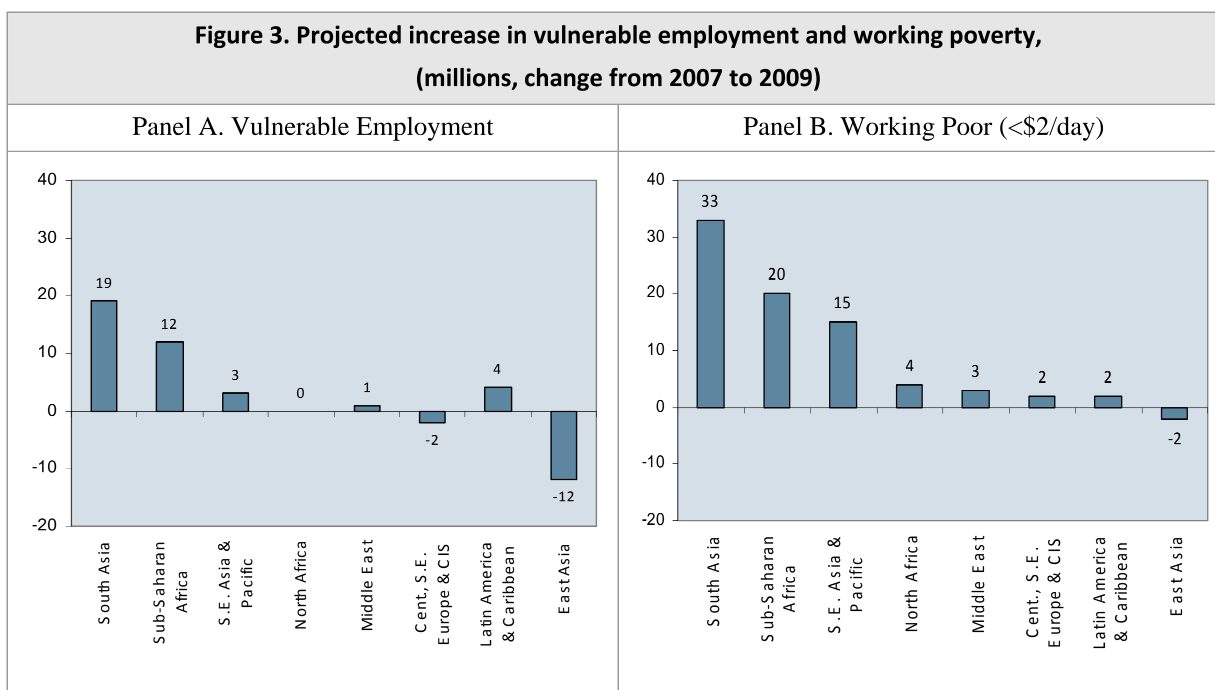

Figure 3. Projected increase in vulnerable employment and working poverty, (millions, change from 2007 to 2009)

Source: ILO: *Global Employment Trends*, 2009.

51. As was the case in previous crises, this could generate substantial downward pressure on informal-economy wages, which before the current crisis were already declining and are substantially lower than for regular workers.[27] This is also likely to lead to a reduction in the number of days worked.[28] This combination of factors will reduce incomes at the household level and erode purchasing power, leading to an increase in the proportion of working poor in most developing economies (Figure 3, Panel B). Based upon a threshold of $2 per day, over 2008 and 2009 the incidence of working poverty is expected to rise across all developing regions. This will add over 75 million people to the working poor, with most of the increase occurring in South Asia and Sub-Saharan Africa.

52. Rising working poverty will compound the effects that the increase in food prices has had on the poor in developing countries (Box 3). And while prices have now fallen, given their recent volatility there is a risk that then when demand for food commodities recovers, the challenges associated with poverty will intensify.

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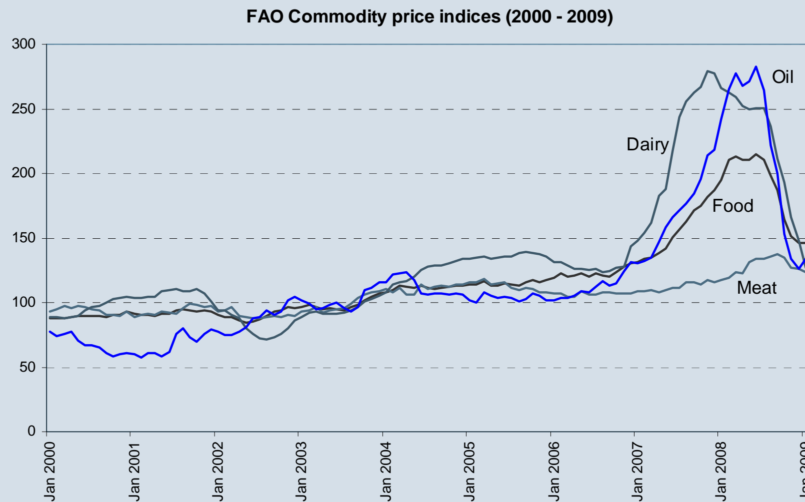
[26] *Ibid.* Scenario 3: Projection on the basis of a simultaneous increase in the unemployment rate in the developed economies and the European Union equal to the largest increase since 1991 and half of the largest increase since 1991 in economies in other regions; IMF revised estimates for economic growth, November 2008.
[27] ILO: *World of Work Report. Income Inequalities in the Age of Financial Globalization*, IILS, Geneva, 2008.
[28] G. Betcherman; R. Inslam (eds.): *Op.cit*.

Box 3. Unstable food prices and impact on the poor

The rise in food prices between 2005 and 2008 is estimated to have increased the share of the population of East Asia, the Middle East, and South Asia living in extreme poverty by more than 1 percentage point. The impact on Africa was relatively lower because food prices increased somewhat less than in other regions. As the poor in developing countries spend 50 percent or more on food, the increase in food prices had a disproportionate impact on them. Since July 2008, prices of all commodities, including food items, have fallen sharply mainly reflecting declining world demand. However, food prices remain well above the levels reached in the 1990s.[29]



Source: Food and Agriculture Organization of the United Nations (FAO), February 2009.

… entailing a risk of prolonged labour market recession

53. Previous crises show that it take much longer to reach pre-crisis employment levels than to restore economic growth – with the impact from banking-related crises often being deeper and more prolonged (Box 4).

Box. 4 Aftermath of banking crises and employment recovery after recessions

Banking crises typically have long-lasting effects on employment.[30] Earlier crises caused, on average, a drop in GDP for approximately two years and increases in unemployment for a much longer period – 4 to 5 years. Furthermore, as growth of government revenues weakens significantly in the year of a crisis and declines in the following years, the real value of government debt tends to surge, rising an average of 86 per cent. Thus, the fiscal consequences of banking crises reach beyond the immediate sector-specific bailout costs.

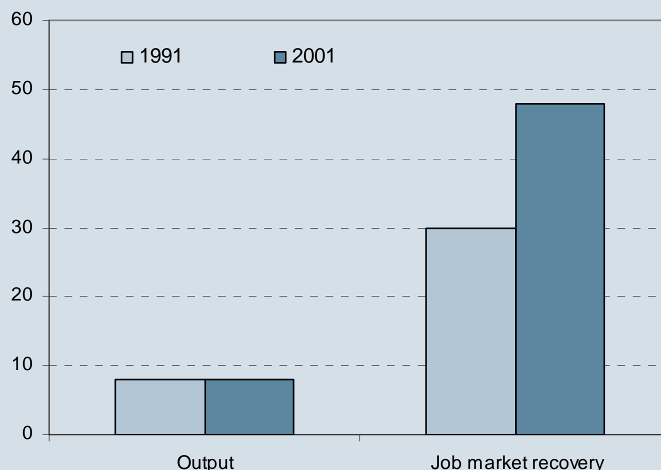
The figure below shows the duration of the last two recessions in the United States (1991 and 2001).

[29] *Ibid.*

[30] See C.M. Reinhart; K.S. Rogoff: *Banking Crises: An Equal Opportunity Menace*, National Bureau of Economic Research (NBER), Working Paper No. 14587, 2008a; and C.M. Reinhart; K.S Rogoff: *The Aftermath of Financial Crises*, paper prepared for presentation at the American Economic Association, 2008b.

Both recessions lasted eight months (according to the National Bureau of Economic Research), but the job market recovery took 30 months in the case of the 1991 recession and 48 months in the 2001 recession. In other words, not only does it take much longer for the job market to recover in response to a recession, but the time it takes for such recovery to materialize seems to have increased in recent years.

Duration of output recovery and job market recovery after the 1991 and 2001 US recessions (in months)



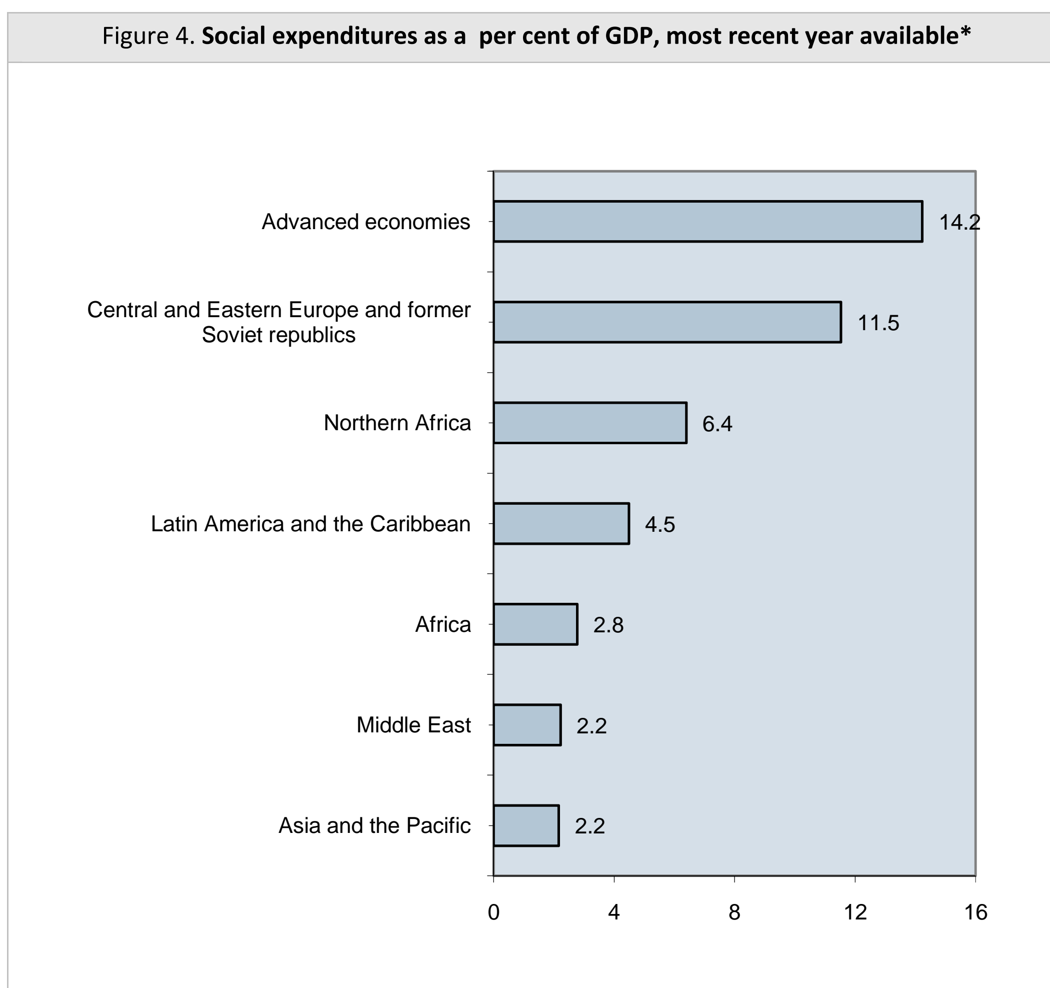
Source: J. Irons, *How long would a job-market recovery take?*, Economic Policy Institute, 7 January 2009.

Depending on social protection coverage, the labour market recession will lead to significant social hardship...

54. Social protection, if well designed, plays a crucial role in alleviating social hardship in the face of the crisis. Yet, the array of benefits and support measures available to individuals varies significantly across countries and regions. Social spending as a share of GDP ranges from as high as 14 per cent in advanced economies to as low as 2 to 3 per cent in Asia, the Middle East and Sub-Saharan Africa (Figure 4). The reality is that in many emerging and developing countries, the majority of workers do not contribute to basic social security coverage, including unemployment benefits.[31] This is due mainly to the fact that most employment is in the informal economy.

[31] It is important to note that in many countries – emerging, developing and developed – unemployed workers often have access to other benefits and support (e.g. social assistance, training, etc.).

Figure 4. **Social expenditures as a per cent of GDP, most recent year available***



* Social expenditures (consolidated central government) are defined as transfers to protect the entire population against certain social risks such as medical services, unemployment compensation, social security pensions, and social assistance benefits. Social security benefits include sickness and invalidity benefits, maternity allowances, children's or family allowances, unemployment benefits, retirement and survivors' pensions, and death benefits. Subsidies, grants, and other social benefits include all unrequited, non repayable transfers on current account to private and public enterprises; grants to foreign governments, international organizations, and other government units; and social security, social assistance benefits, and employer social benefits in cash and in kind.

Source: IMF: Government Financial Statistics, 2007.

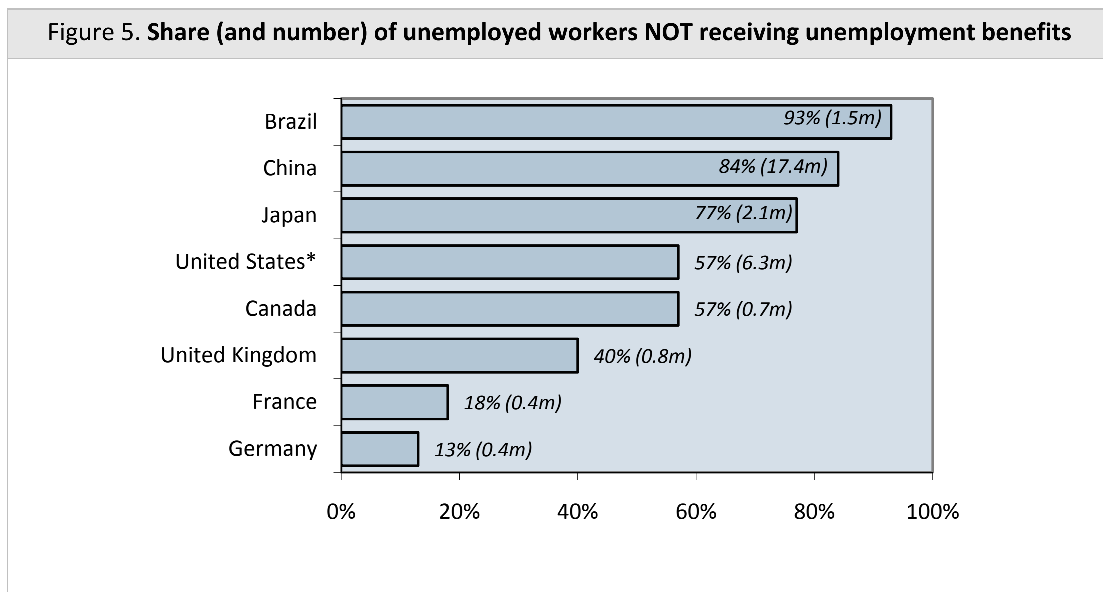
…as millions of workers are left without adequate support…

55. Even where unemployment benefit systems exist in emerging and developing economies, they are often restricted to urban areas. For example, in China, close to 5 million unemployed urban workers (57 per cent) were without unemployment insurance in 2005. Given that over 60 per cent of total employment in China is in rural areas, the share of unemployed workers unable to access unemployment benefits is probably closer to 84 per cent (Figure 5).

56. In many developed countries, job losers are often not eligible for unemployment benefits. In half of the OECD member countries, 50 per cent or more of the unemployed do not receive unemployment benefits (though non-recipients may be entitled to social

assistance benefits).[32] Even in countries like France and the United Kingdom, where coverage is greater, many workers do not receive unemployment benefits (Figure 5).

Figure 5. **Share (and number) of unemployed workers NOT receiving unemployment benefits**



* For the United States, if benefits under the extended unemployment compensation programme authorised by Congress in the summer of 2008 are also included, the rate declines to 42 per cent.

Source: IILS estimates based on national statistics. For Brazil, recipiency rate is taken from Vroman and Brusentsev: *Unemployment Compensation Throughout the World: A Comparative Analysis,* 2005, and applied to the level of unemployment from the December 2008 Labour Force Survey.

57. In Canada, Japan, and the United States, where regulations governing access to such benefits are often much stricter, the share of unemployed workers not receiving benefits can be well over half. As of January 2009, more than 6 million jobless Americans were *not* receiving unemployment insurance. In Japan, about 77 per cent of unemployed persons do not receive unemployment benefits.

58. The absence of unemployment benefit support is made worse by the fact that for many individuals social protection is conditional on being employed. The immediate fall in income resulting from unemployment is thus worsened by the loss in non-cash benefits such as employer-sponsored health. The loss of these benefits can be a particularly severe blow to middle- and low-income households.

…and retirement savings are eroded

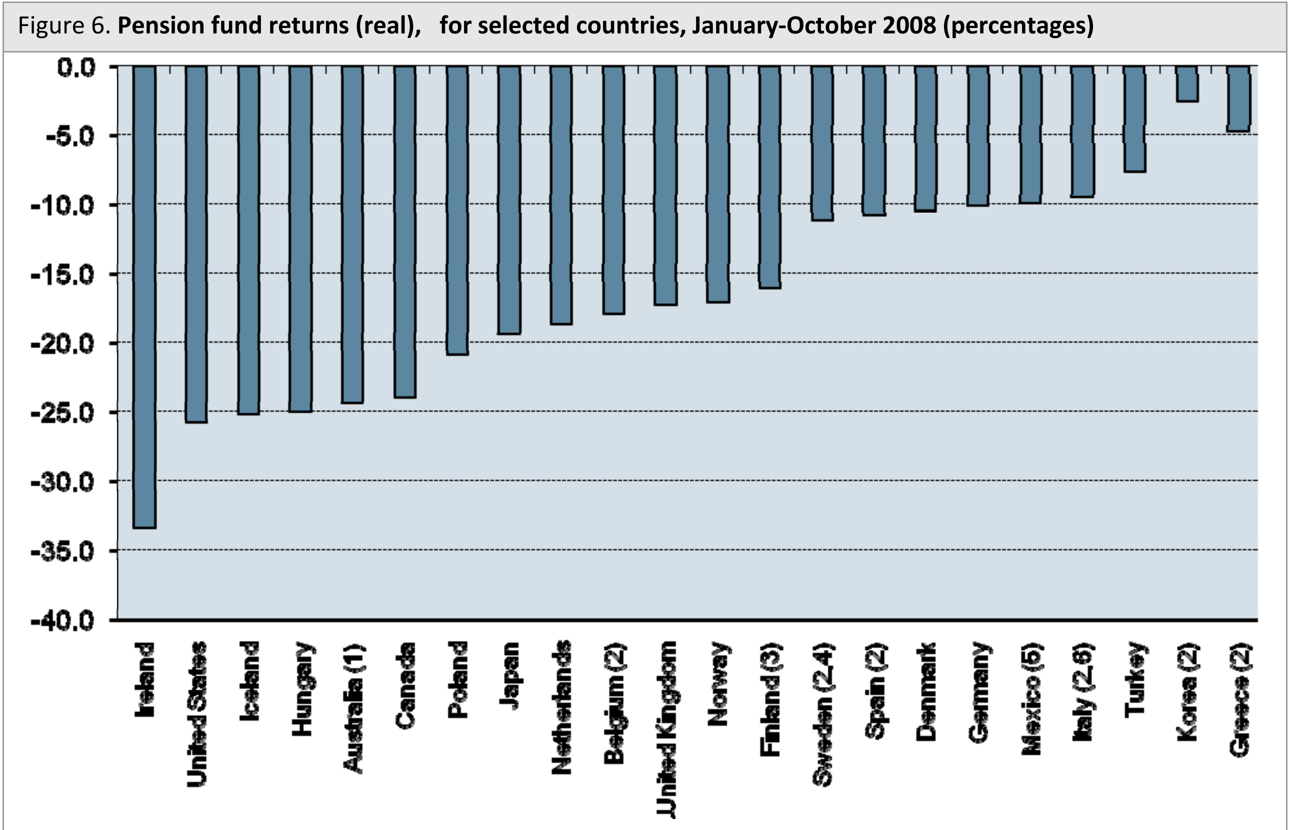
59. An immediate consequence of the collapse of stock markets in 2008 has been the dramatic decline in individual wealth held in pensions.[33] According to the OECD, between January and October of 2008, private pensions registered losses of nearly 20 per

[32] The generosity and replacement rates of unemployment benefits – an important consideration – vary significantly from country to country, and should not be taken as an indication as to the amount of money spent on non-work assistance. OECD: *Employment Outlook,* 2008; C. Stone; R. Greenstein; M. Coven: *Addressing Longstanding Gaps In Unemployment Insurance Coverage*, Center on Budget and Policy Priority, 2007; and OECD Database on Benefits and Wages.

[33] Losses in advanced economies approached 40 per cent in 2008. The MSCI Emerging Market Index (25 emerging country indices) lost more than half its value (54.5 per cent) over the same period – the worst annual performance since the measure was created two decades ago.

cent – representing a value of $4.5 trillion (Figure 6). This has prompted concerns about the adequacy of retirement savings for many individuals.

Figure 6. **Pension fund returns (real), for selected countries, January-October 2008 (percentages)**



(1) Official data up to June 2008 then complemented by OECD estimate up to October.
(2) 2008 data refer to 30 September 2008.
(3) Data refer to statutory earnings-related pension plans
(4) Data refer to occupational pension plans only.
(5) Data refer to the mandatory and voluntary pension systems.
(6) Data refer to new pension funds (contractual and open) instituted after 1993 legislation.

Source: OECD.

60. In World Bank client countries with funded pension systems, losses in pension funds range from 8 per cent to 50 per cent.[34] In Chile, for example, the private pension funds that cover 8.3 million workers lost a total of $25 billion in 2008. Traditional pension systems provided by governments on a pay-as-you-go basis will also be affected by the current downturn, but much less than private pension funds. Interestingly, in view of the pension crisis, the World Bank has shifted its stance on this matter and is now advocating greater focus on government-backed pay-as-you-go systems.[35]

[34] World Bank: *The Financial Crisis and Mandatory Pension Systems in Developing Countries*, 2009.
[35] *Ibid*.

These developments come on the heels of an expansionary period where the gains of growth were unevenly distributed

61. The global economic crisis comes after a sustained period of growth, whose benefits were unevenly shared.[36] During the two decades that preceded the crisis, the incomes of richer groups grew faster than those of middle- and low-income groups.[37] As mentioned in Box 1, growing income inequalities within countries contributed to an increase in the demand for credit, which, in conjunction with poor financial regulation, lies at the heart of the current crisis.

In sum, the risks of prolonged labour market and enduring social crises need to be averted

62. By definition, any financial crisis has serious consequences on the entire real economy, which depends so vitally on financial markets in order to grow and create jobs. But the current financial crisis is deeper than recent ones. It has its origins in developed countries which had been the engine of global demand and trade growth. In addition, given the strong international inter-linkages, it affects most countries. And, against the backdrop of the pre-crisis expansionary period, in which gains were unevenly shared, the economic and social costs of the crisis are noticeably widespread. Perceptions of unfairness are mounting, increasing the risk of social instability.

63. The challenge is to avoid a major labour market and social crisis. Already, job losses have mounted and new entrants like youth have had difficulty finding employment. However, the rise in unemployment has been contained to some extent as firms have attempted to limit the extent of layoffs via recourse to shorter hours and partial unemployment. This could change with a prolonged recession – in such an event, significant increases in unemployment would be unavoidable and, in developing countries, a long-lasting shift to informality and higher working-poverty would occur.

64. A prolonged recession would have deeper effects than just higher unemployment and increased informality and working-poverty. With so many people around the world lacking social protection, social hardship resulting from poor job prospects would intensify. Some developing countries will also need to integrate growing numbers of return migrant workers. And within countries the movement of workers from urban centres where jobs disappear, back to rural areas poses acute challenges as well. Social protection itself is being affected by the crisis, at the time when it is most needed, especially in countries that relied excessively on private pension funds or employer-provided health care.

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[36] ILO: *World of Work Report. Income Inequalities in the Age of Financial Globalization*, IILS, Geneva, 2008.
[37] *Ibid.* and ILO: *Global Wage Report*, Geneva, 2008.

II. International and country responses to the crisis

65. Given the grim economic outlook, and risk of widespread labour market and social consequences, countries around the world have adopted unprecedented measures to address the global economic slowdown. This section provides a brief overview of the outcomes of efforts to coordinate the measures among countries. It also describes rescue efforts undertaken by 40 countries (including the G20).[38] This includes an overview of the labour market initiatives that have been put in place, and the role of social dialogue and tripartite institutions in shaping the discourse to date.

International efforts to coordinate responses to the crisis have been stepped up

66. The global financial market has been unstable since as early as 2007. But 2008, marked by bankruptcies and bailouts of financial institutions (notably AIG, Bears Stearns and Lehman Brothers) placed the financial system in a state of constant turmoil and volatility. Credit markets froze and stock indices tumbled throughout 2008. The first round responses were largely uncoordinated, but the case for more internationally coordinated action has become increasingly clear – as witnessed by several efforts. These include:

   - the G20 commitment at the meeting in Washington in November 2008, which prescribes action to be taken in key determinants of decent work and agrees on the importance of coordinating macro-economic policies and reducing global imbalances;
   - an Economic Recovery Plan approved by the European Council in 2008 (200 billion euros), which aims to boost demand through joint fiscal stimulus action as well as temporary support for the unemployed through cash transfers and extension of unemployment benefits. It also calls for lower taxes and social contributions, and measures targeting small enterprises.[39]

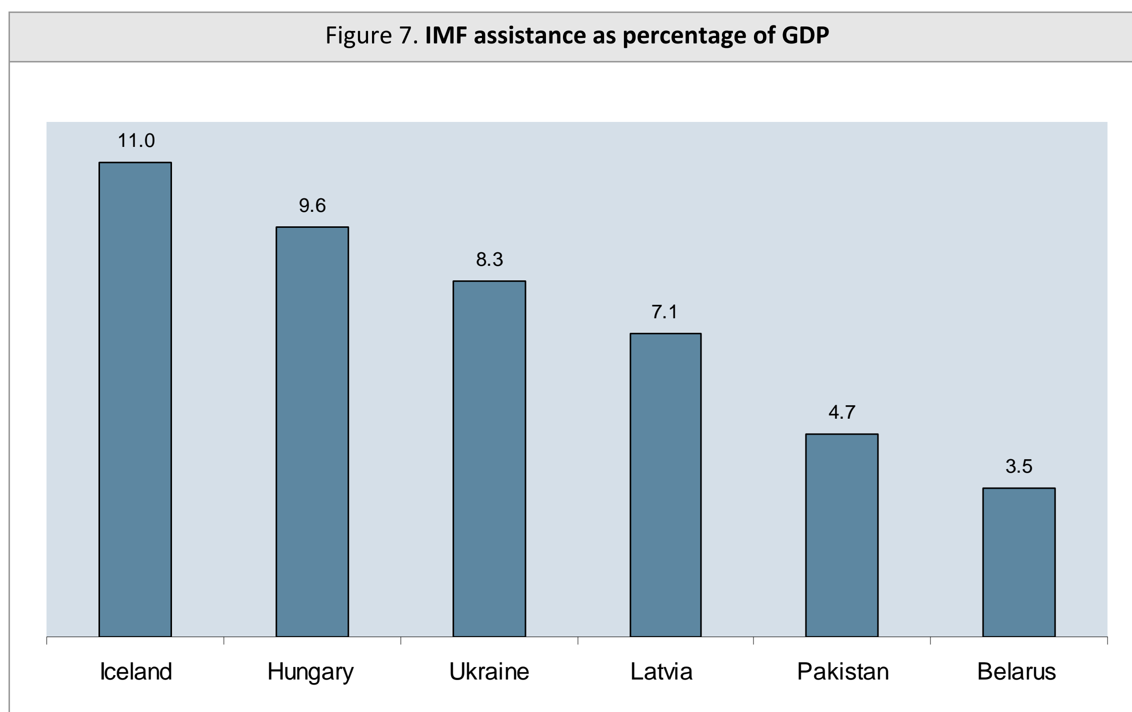
67. Addressing the social dimensions of the crisis is at the core of ILO's mandate. The Social Justice Declaration stresses that "As trade and financial policy both affect employment, it is the ILO's role to evaluate those employment effects to achieve its aim of placing employment at the heart of economic policies".

68. The IMF has provided financial assistance to countries affected by rapidly declining capital inflows, and balance of payments deficits. The policy response by most emerging economies facing such situations has generally involved pro-cyclical fiscal and monetary tightening designed to restore market confidence, combined with IMF interventions to

[38] For a detailed presentation of the measures, see S. Khatiwada: *Stimulus packages to counter the global slowdown*, IILS, ILO, forthcoming 2009.
[39] On 11 and 12 December 2008, the European Council approved a European Economic Recovery Plan, equivalent to about 1,5 per cent of the GDP of the European Union. The plan provides a common framework for the efforts made by Member States and by the institutions of the European Union.

bail out international creditors and investors.[40] Therefore, as part of the crisis resolution tools available for countries, the IMF has offered its fast-track emergency lending facilities. So far, the governments of Belarus, Hungary, Iceland, Latvia, Pakistan and Ukraine have resorted to IMF loans to restore their financial and economic systems (Figure 7). Latvia has a stand-by arrangement whereby IMF credits can be provided to finance a temporary balance of payments deficit. The IMF also has about $200 billion for immediate lending and can draw an additional $50 billion if needed.[41]

Figure 7. **IMF assistance as percentage of GDP**



Source: IMF.

Governments have provided prompt, massive support to rescue the financial system…

69. Government efforts to strengthen bank balance sheets were initially undertaken on a case-by-case basis. For example, the United States and European governments injected capital into individual banks or induced mergers in hopes of reviving the credit market by encouraging banks to lend to one another. But market confidence continued to decline and credit markets remained frozen, highlighting the need for system-wide intervention.

70. The system-wide interventions subsequently put in place by the United States and European governments have involved ensuring bank funding through explicit government guarantees on retail deposits and other bank liabilities, and reducing bank leverage through government purchases of distressed assets or capital injections. Almost all the major economies have increased guarantees of private deposits, put in place inter-bank loan guarantees, banned or restricted short-selling and injected capital into troubled banks by buying equity stakes (Table 2).

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[40] Y. Akyüz: *From liberalization to investment and jobs: Lost in translation*, Policy Integration and Statistics Department, Working Paper No. 74, ILO, Geneva, 2006.

[41] As IMF Managing Director Dominique Strauss-Khan recently pointed out, the IMF may need another $150 billion to help counter the hit to emerging markets and poor countries. Japan has pledged $100 billion while other nations have yet to commit to help.

71. Australia, Canada, Germany, Norway, Spain, Switzerland and the United Kingdom have opted to buy (or insure) toxic assets, while the United States abandoned this plan in favour of direct capital injections. However, under the new administration, the United States is considering getting troubled assets off banks' balance sheets by using at least $500 billion (possibly up to $1 trillion) in private and government money. The three main elements of the new programmes proposed by the United States Treasury Secretary are: injecting government capital into the biggest financial institutions; establishing public-private partnership to buy banks' troubled assets; and starting a credit facility with the Federal Reserve with as much as $1 trillion to promote lending to consumers and businesses.

Table 2. **Crisis resolution instruments for select countries**[1]

	Increased guarantee of private deposits	Guarantees for bank loans or debt	Fund to purchase commercial papers	Purchase mortgage bonds	Ban or restrict short-selling[2]	Capital Injections	Option to purchase toxic assets	Induced Mergers & Acquisitions	IMF's emergency lending
Australia	X	X		X	X		X		
Austria	X	X			X	X			
Belgium	€ 100,000	X			X	X			
Brazil								X	
Canada		X		X	X		X		
China						X		X	
Denmark	X	X		X	X				
Finland	€ 50,000	X			X				
France	€ 70,000	X			X	X			
Germany	X	X			X	X	X		
Greece	€ 100,000	X			X	X			
Hungary	€ 50,000	X				X			$15.7 billion
Iceland	X					X			$2.1 billion
India						X			
Indonesia	2 billion rupiahs								
Ireland	€ 100,000	X				X			
Italy	€ 100,000				X	X			
Japan		X			X				
Korea	X	X				X			
Mexico		X							
Netherlands	€ 100,000	X			X	X			
New Zealand	X	X							
Norway	X	X					X		
Poland	€ 50,000								
Portugal	€ 100,000	X				X			
Russian Federation	X	X			X	X			
Spain	€ 100,000	X		X	X		X		
Sweden	€ 50,000	X		X		X			
Switzerland	X		X			X	X		
Turkey									X
United Kingdom	£50,000	X		X	X	X		X	
United States	$250,000	X	X	X	X	X	X	X	

(1) Most crisis resolution instruments were put in place in October-November, 2008; only the countries that instituted at least one measure are included. An "X" denotes some action taken by a country in the corresponding area.
(2) Ban on short-selling has been lifted for some asset classes in Switzerland and the UK.
Source: IILS based on Bloomberg, Bank for International Settlements and OECD.

…which has been supported by monetary easing and other actions of central banks

72. In addition, central banks around the world have taken action to address the challenges in the global financial market by means of providing liquidity and easing monetary conditions.[42] For example, the United States Federal Reserve Bank and other major central banks, including the European Central Bank, the Bank of England, and the Bank

[42] Quantitative easing involves increasing the base money stock by purchasing government securities and qualitative easing involves purchasing private securities, including possibly illiquid private securities and/or private securities subject to substantial default risk.

of Japan increased assets substantially in order to provide direct lending to banks and dealers through existing and new lending facilities.

73. In addition, aggressive monetary easing has been adopted in light of the rapidly deteriorating economic outlook, including a series of internationally-coordinated interest rate cuts (Table 3). This shift in focus of monetary policy from inflation targeting to supporting economic activity has been supported by a rapid decline in inflation, with some countries now facing deflation pressures. For example, the United States Federal Reserve cut its federal funds rate to a historically low level of between 0 and 0.25 per cent. Even among emerging economies, inflation fears have largely subsided with the rapid decline of commodity prices. However, despite these efforts, global economic activity has continued to decline and with rates at near-zero levels in some cases, further recourse to monetary policy is limited. Governments have thus turned their attention to fiscal rescue packages.

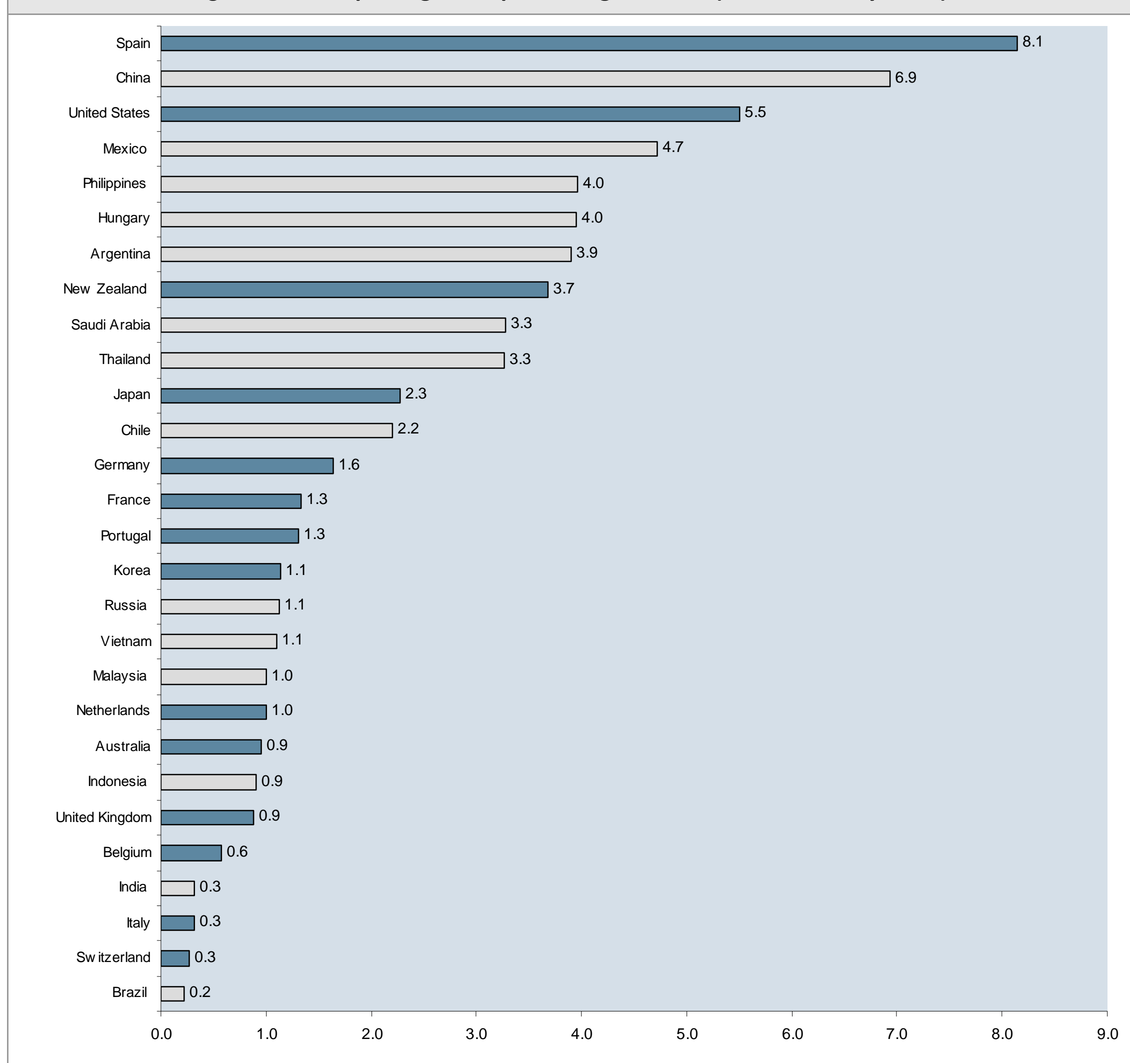
Table 3. **Monetary policy - interest rate changes**			
Australia	Cut to 3.25 per cent, February 2009	**Malaysia**	Cut by 0.75 per cent to 2.5 per cent, January 2009
Austria	Cut (ECB)[1]	**Mexico**	Cut by 1 per cent to 6.75 per cent, January 2009
Belgium	Cut (ECB)	**Netherlands**	Cut (ECB)
Brazil	Cut by 1 per cent to 12.75 per cent, January 2009	**New Zealand**	Cut by 1.5 per cent, December 2008
Canada	Cut by 2.25 per cent over 2008; cut by 0.5 per cent to 1 per cent, January 2009	**Nigeria**	Cut by 0.55 per cent to 9.7 per cent, September 2008
Chile	Cut the overnight lending rate by 1 per cent to 7.5 per cent, January 2009; cut by another 0.25 per cent to 7.25 per cent, January 2009	**Norway**	Cut
China	Cut one year lending rate by 1.89 per cent to 5.58 per cent, December 2008; cut by another 0.27 per cent to 5.31 per cent, December 2008	**Philippines**	Cut by 0.5 per cent to 5 per cent, January 2009
Denmark	Cut by 0.75 per cent to 4.25 per cent, December 2008	**Poland**	Cut
Finland	Cut (ECB)	**Portugal**	Cut (ECB)
France	Cut (ECB)		
Germany	Cut (ECB)	**Saudi Arabia**	Cut main repo rate by 0.5 per cent to 2.5 per cent, December 2008; cut by another 0.5 per cent to 2 per cent, January 2009
Greece	Cut (ECB)	**South Africa**	Cut main repo rate by 0.5 per cent to 11.5 per cent, December 2008
Hungary	Increase by 3 per cent, October 2008 (emergency measure); cut by 0.5 per cent to 10.5 per cent, December 2008; cut by another 0.5 per cent to 10 per cent, December 2008	**Spain**	Cut (ECB)
Iceland	Increase (emergency measure)	**Sweden**	Cut by 1.75 per cent, December 2008
India	Cut repo rate by 1.5 per cent to 7.5 per cent, October 2008; cut by 1 per cent to 6.5 per cent, December 2008; cut by another 1 per cent to 5.5 per cent, January 2009	**Switzerland**	Cut to 0.5 per cent, December 2008
Indonesia	Cut by 0.25 per cent to 9.25 per cent, December 2008; cut by 1.5 per cent to 8.75 per cent, January 2009; cut by 0.5 per cent to 8.25 per cent, February 2009	**Thailand**	Cut to 2 per cent, January 2009
Ireland	Cut (ECB)	**Turkey**	Cut to 13 per cent, January 2009
Italy	Cut (ECB)	**United Kingdom**	Cut by 1 per cent to 2 per cent, December 2008; cut by 0.5 per cent to 1.5 per cent, January 2009; cut by another 0.5 per cent to 1 per cent, February 2009
Japan	Cut by 0.2 per cent to 0.3 per cent, October 2008; cut by another 0.2 per cent to 0.1 per cent, December 2008	**United States**	Cut by 3.25 per cent from January to October 2008; cut to a range of 0.25 to 0 per cent, December 2008
Republic of Korea	Cut by 1 per cent to 3 per cent, December 2008; cut by another 1 per cent to 2 per cent, February 2009	**Vietnam**	Cut by 1.5 per cent to 7 per cent, January 2009

(1) The European Central Bank (ECB) rate stands at 2 per cent as of January 2009.
Source: IILS, based on national sources.

Fiscal stimulus packages have been announced, though with a delay vis-à-vis financial rescue measures…

74. As the G20 Summit in Washington underscored, there is a growing consensus that aggressive fiscal measures – cutting taxes and boosting spending – are required to stimulate domestic demand and avert the worst economic slump since the Great Depression. As a result, countries have announced fiscal rescue packages of varying sizes, with Spain announcing the biggest package as a percentage of GDP, followed by China and the United States (Figure 8).

Figure 8. **Fiscal package as a percentage of GDP (as of February 2009)***



* 2008 GDP from IMF World Economic Outlook. Developed economies are indicated in dark; developing and emerging economies, in gray. Time frame of spending is not clear for most countries and in some cases, package was announced but not the details. For China, Germany and the United Kingdom, the time frame is 2 years, hence the total package was divided by 2.

Source: IILS, based on national sources.

… a degree of uncertainty regarding the precise size and timing of the package…

75. However, there are uncertainties regarding the exact size and timing of the stimulus packages. First, the breakdown of rescue efforts in terms of old spending (already in the pipeline) and new spending is uncertain. Second, the time-horizon in which the stimulus package will be administered is also unclear. For some countries like China, Germany and the United Kingdom, the time frame is two years (2009-10), but for most countries, the time frame of new spending measures has not been decided as yet.[43] Third, most countries have announced fiscal rescue packages different from their financial rescue packages, but there is a tendency to count in financial help to different sectors (like loan guarantees) as part of the package. For the countries examined here, an attempt has been made to disentangle fiscal efforts from financial efforts. And fourth, some countries have

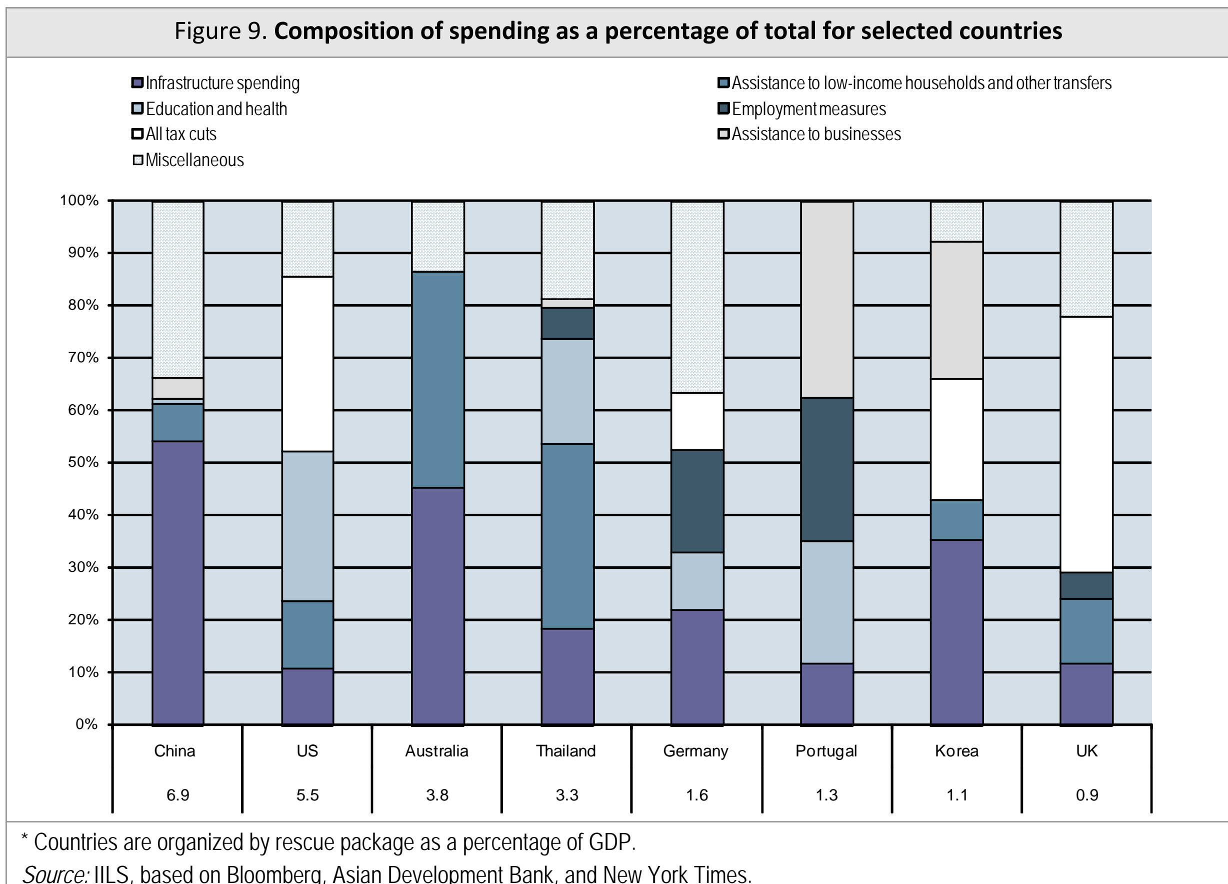
[43] The total rescue package for the China, Germany and the United Kingdom is divided by two before calculating the package as a percentage of GDP.

announced stimulus spending embedded in their annual budgets, which makes it difficult to identify the size of new spending.

... and significant variation in the composition of spending efforts…

76. Across a range of 8 countries with detailed available data, there is significant variation in terms of the emphasis placed on different components of the stimulus package (Figure 9). All, however, have dedicated resources to infrastructure spending, though the share ranges from over half (54 per cent) in China to as low as 11 per cent in the United States. On the other hand, the degree of employment measures and support to low-income households is generally limited. For example, only half the countries have implemented employment measures (notably Germany and Portugal) and only Australia and Thailand dedicate significant resources to low-income households.

Figure 9. **Composition of spending as a percentage of total for selected countries**



* Countries are organized by rescue package as a percentage of GDP.
Source: IILS, based on Bloomberg, Asian Development Bank, and New York Times.

77. A broader analysis of the 40 countries with available data confirms that the composition of rescue packages varies considerably, but almost all the rescue efforts can be divided into three main areas: increase spending on public goods and services, fiscal stimulus aimed at consumers (*e.g.* personal income tax cuts, cash transfers), and fiscal stimulus aimed at firms (*e.g.* corporate tax cuts).

78. In terms of *spending on public goods and services*:

- At least half the countries have announced spending increases in infrastructure and on education and health. The former focus on building and repair of roads, bridges,

railway lines, and rural infrastructure projects with attention given to projects in the pipeline (*e.g.* China, Italy, and the Netherlands). Others like China, Japan, Portugal, and the United States have announced investment in energy efficient projects as part of infrastructure investments. China and Thailand have also announced measures to increase home availability (through public housing projects) for poor households.

- In terms of education and health, China and Saudi Arabia have announced significant increases in education and health spending with some school and hospital constructions as part of rural development programmes for several countries.

79. In terms of *fiscal stimulus aimed at consumers*:

- Germany, New Zealand, Russian Federation, Spain, the United Kingdom, and the United States are some of the many countries that opted for tax cuts aimed at stimulating consumer spending (these tax cuts fall into two categories: income tax cuts and sales tax cuts such as VAT reductions). Others have adopted tax cuts to boost sales in certain sectors, such as automobiles in Brazil, Germany and Turkey.
- Australia, Italy, Mexico and the United States have put in place measures to help home buyers. In some cases, this includes incentives for consumers to purchase energy efficient homes and "greening" existing homes by providing subsidies and tax exemptions.
- Australia, China, France, Indonesia, Italy, Japan, Mexico, Philippines, Spain, and the United States have announced increases in social transfers aimed at poor and low-income households. Social transfers include direct cash transfers, conditional cash transfers, and social welfare programmes.

80. In terms of *fiscal stimulus aimed at firms*:

- Several stimulus packages have placed emphasis on the viability of large firms, especially in the financial and automotive sectors.
- In some cases, measures have been explicitly targeted at SMEs (e.g. Japan, the Republic of Korea, and Mexico). In addition, public investments in infrastructure, construction and housing will also provide new market opportunities for SMEs. Other measures to firms have been specifically targeted to mitigate the impact on employment.

... and varying degrees of direct support for employment and social protection…

81. Some countries have announced explicit measures to help workers and employers as part of their fiscal rescue efforts (see some country examples in Table 4):

- Japan and the United States have put in place extension of unemployment benefits. France and Switzerland have also put in place more generous systems of unemployment benefits for temporarily laid-off workers. Meanwhile, Canada, China, and Turkey are in the process of extending unemployment benefits. Other countries like Korea, Philippines, and Thailand have announced country-specific measures to assist vulnerable workers.
- Some countries are making greater use of in-work benefits in conjunction with reduced working hours to curtail layoffs. For example, in Germany, the government extended the possibility for workers who continue to be employed – but at reduced working hours – to receive income supplements, and companies are reimbursed 100

per cent of their social security contributions on behalf of employees when the down time (i.e. reduced working hours) is used for training.

- To encourage hiring, some countries have announced subsidies and exemptions. For example, the United Kingdom has announced subsidies for employers (up to £2,500) who hire workers who have been unemployed for more than six months, and Japan has announced subsidies for employers who hire temporary workers as regular employees. Other countries that have announced some sort of hiring incentives include Australia, Chile, China, France, Germany, Korea, the Netherlands, and the United States.
- Australia, Canada, Chile, China, France, Germany, Indonesia, Japan, Korea, Portugal, Thailand, the United Kingdom and the United States have announced training programmes for laid-off workers as part of their labour market initiatives. Training programmes include, among others, vocational workshops for laid-off migrant workers, and expanded opportunities for apprentices in trades.
- It is also likely that the new infrastructure projects, discussed briefly above, and increased funding for local governments will result in more public sector jobs. As of February 2009, some 20 countries of the 40 have made such announcements.

82. A few countries have announced *explicit goals for job creation*. These include Chile (100,000), France (80,000 to 110,000), Hungary (20,000), Indonesia (2.6 million), Spain (300,000) and the United States (3.5 million). In France, Spain and the United States, job goals include the creation of green jobs. However, the goals for job creation do not include plans to save existing jobs.

Table 4. **Examples of labour market initiatives in response to the crisis**[1]

	I. Extension of unemployment benefits	II. Activation measures		III. Increase in public sector jobs[3]
		A. Hiring incentives for employers[2]	B. Other activation measures (job-search help, training, measures targeted at disadvantaged group, etc.)	
Argentina				X
Australia		Funds to employers for staff development and training programs	Increase in productivity training places from 57,000 to 113,000	X
Brazil	Increase in minimum wage by 12 per cent as of February 2009, which will affect 45 million workers; expansion of UE benefits from 3 to 5 months to 5 to 7 months			
Canada	X (ongoing discussions but not approved)		$1.5 billion in training fund for laid-off workers	
Chile		X		X
China	X (ongoing discussions at the local and regional level; recommended by the central government)	Reduction in medical and accident insurance premiums; flexible working hours and pay for service sector firms	Nationwide vocational training program for migrant workers returning home after losing jobs	A temporary moratorium on firing in state owned enterprises
France		Employers with less than 10 employees will not pay social taxes for each new employee they hire in 2009.	X	X
Germany	X	Reduction in health insurance contribution	X	
India				X
Indonesia			Job training; voluntary transmigration programs for laid off workers to areas less affected by the crisis	X
Italy				X
Japan	X	Increased subsidies for SME employers; subsidies for employers who hire temporary workers as regular employees	Support for non-regular workers in job-placement	Financial support to local governments that hire job-seekers
Korea	Support vulnerable workers (outside the boundaries of a social safety net) who are put on unpaid temporarily leave	Tax exemption and extension on tax submission periods for employers that maintain their workforce	X	X
Malaysia			Training for retrenched workers; re-training unemployed graduates over the next 2 to 3 years	
Mexico			Increase in seasonal employment programme	
Netherlands		Subsidies for company payrolls		X
Philippines	Increase in conditional cash transfers			
Portugal			€580 million in employment programmes	X
Saudi Arabia				X
Spain				X
Thailand	Cost of living alleviation projects and sustenance allowance		Capacity building for the unemployed	X
Turkey	X (proposed but not approved)			
United Kingdom		Subsidies for employers (up to £2,500) who hire workers that have been unemployed for more than 6 months	X	X
United States	Extension of unemployment benefits; health insurance for those who lost their job; increase in food stamps; increase in social security benefits	X	X	X
Vietnam	New unemployment insurance started in January 2009			X

1. This table includes only the explicitly announced measures. An "X" denotes some action taken by a country.

2. Corporate tax cuts are not counted as an incentive for employers to hire, nor are sectoral subsidies.
3. All the countries with increased spending in infrastructure projects are counted, as they increase public sector employment.
Source: IILS, based on national sources.

…with some efforts to engage social partners

83. In the early stages of the crisis, social partners in many countries had limited involvement in the design and implementation of government anti-crisis measures.[44] More recently, in some cases, social dialogue has been at the heart of governments' plan to address the economic slowdown. These include:

- In Ireland, an agreement was signed between the government and the social partners, following a discussion of the government's recommendations for sustainable economic renewal. The agreement covers issues of pay growth, employment rights of temporary workers, and voluntary arbitration, among others.
- In Pakistan, the tripartite Labour Conference was addressed by the Prime Minister, who announced a new era of consultations with social partners, and modernization of the country's labour law in cooperation with the ILO and the WTO.

84. In some cases, agreements arising from social dialogue initiatives have been embodied into law, such as the decree on partial unemployment benefits in France. Other countries such as Germany have passed a second economic stimulus package following extended consultations with national employers and workers' organizations. In the Russian Federation, the national tripartite commission dealt with the social impact of the crisis several times since October 2008. In some countries, these bipartite or tripartite consultations and negotiations went beyond the scope of narrowly defined labour issues, but also dealt with state budgets and larger economic and policy matters.

In sum, action has been swift, but relatively misaligned

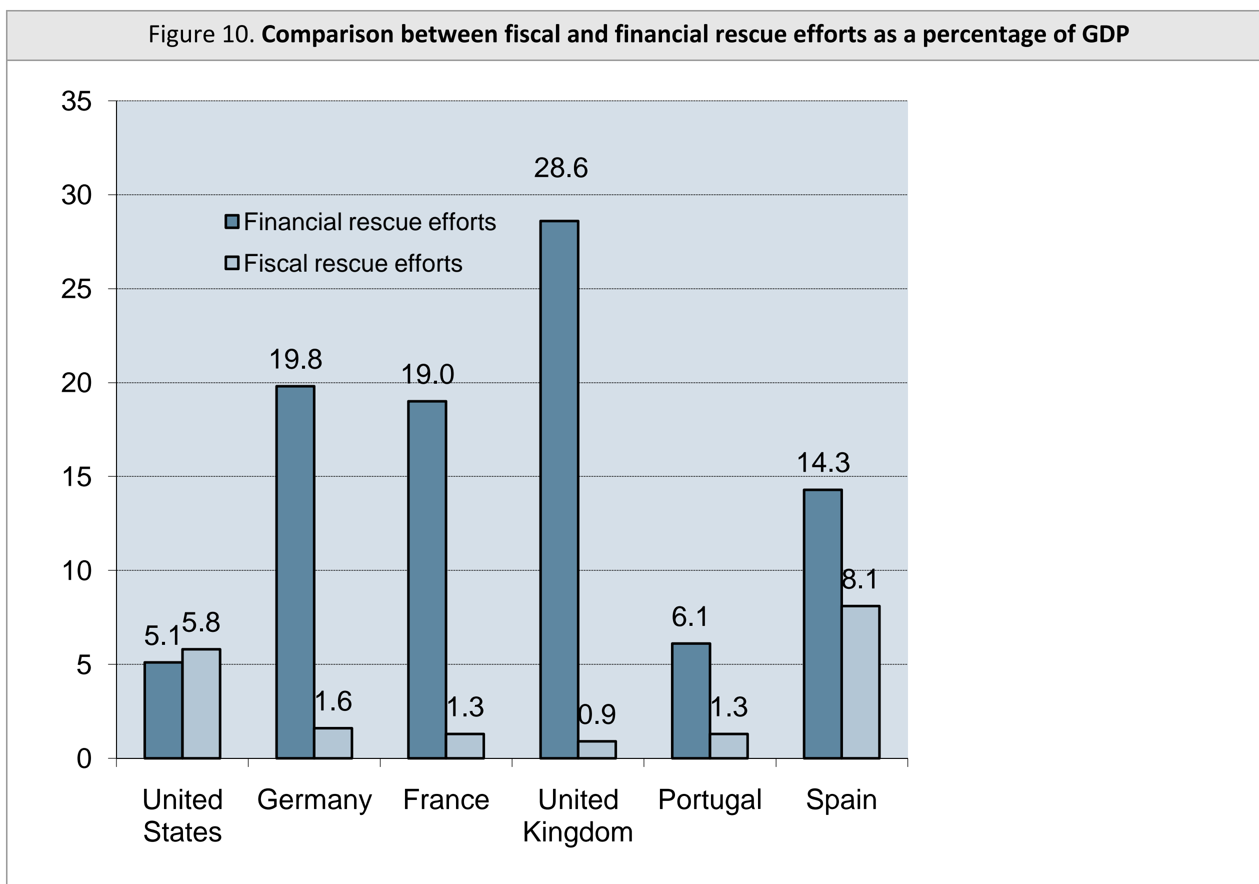
85. There has been considerable emphasis on rescuing the financial sector. As Figure 10 shows, the amount spent on financial rescue efforts far surpasses fiscal rescue efforts for all countries except the United States.[45] Indeed, protecting banks' solvency and restoring the availability of credit to enterprises and households was rightly regarded as a pre-condition to avoid a total collapse of the financial system, with unpredictable consequences for the real economy. Governments have also announced fiscal stimulus measures – an important step in the right direction.

[44] L. Rychly: *Social dialogue on the design and implementation of measures in times of global financial and economic crisis*, ILO, forthcoming 2009.

[45] True, from an accounting point of view, financial rescue packages may not have any impact on the current net debt or budget balance. Measures like capital injection, if treated like a financial transaction, where the government receives in return a financial asset of equal value to the payment, would not affect the budget balance. In fact, the government could theoretically earn income once the markets return to normalcy. Furthermore, buying troubled assets could also prove to be profitable if the government manages to sell them at a higher value. And finally, loan guarantees are not exactly fiscal costs because they might never be exercised or used. Nevertheless, while it is true that comparison between financial and fiscal rescue efforts as a percentage of GDP should not be taken literally, it is very likely that governments will incur costs in rescuing the financial sector which will be far greater than the costs of the fiscal rescue efforts.

86. But there is much debate regarding the desirable content of the packages, their timing, and whether some of the measures should be merely temporary – as championed by the "3 t" approach – or rather, more enduring.[46] The next section addresses these issues.

Figure 10. **Comparison between fiscal and financial rescue efforts as a percentage of GDP**



Source: IILS, based on ILO, OECD & Bloomberg.

[46] According to the "3t" approach, governments should intervene to address the crisis. But interventions should be timely, targeted and – in particular – temporary. The latter means that deviation from market principles should be provisional. Once the economy recovers from the crisis, the state should phase out the measures as quickly as possible.

III. Decent Work as cornerstone of the recovery: A global jobs pact

87. A global jobs pact would be instrumental in overcoming the crisis and paving the way for a more sustainable economy. A *global* approach is needed because the measures, to be effective, need to be coordinated across countries. The emphasis on *jobs* comes from the realization that decent work is central to reactivating the economy in a sustainable manner. This builds on ILO experience with the Global Employment Agenda.[47] Measures are best implemented through social dialogue at the national level, but greater cooperation at the international level can also have mutually reinforcing benefits – thus the need for a *pact*. In this respect, building upon the lessons of the past and avoiding counterproductive measures, such as trade protectionism and generalized wage deflation, will also prove invaluable.

88. More specifically, by putting the Decent Work Agenda at the forefront, a global jobs pact could ensure that stimulus measures more effectively tackle the transmission mechanisms of the crisis, namely the credit crunch, the rapid deterioration in domestic demand conditions and the recession in external markets. A global jobs pact could also address the key factors that nurtured the crisis and lay the foundation for a more sustainable economy.

Reviving the credit system and providing targeted support to sustainable enterprises

89. Experience from previous financial crises suggests that adopting stimulus packages without reviving the credit system may end up raising public debt without stimulating the economy and creating jobs.[48] Furthermore, it has been shown that countries can incur significant fiscal costs because of their failure to tackle problems in the financial system in a timely manner.[49] In light of these lessons, successfully stimulating economic activity will require reactivating credit markets, thus helping businesses to remain viable and be in a position to respond to well-designed fiscal stimulus programmes. A well-functioning financial system is essential for a growing and dynamic private sector. Easier access for SMEs, including cooperatives and start-ups, to financing (such as credit, leasing, venture capital funds or similar or new types of instruments), creates appropriate conditions for a more inclusive process of enterprise development. Financial institutions, particularly

[47] See GB.286/ESP/1(Rev.) and GB.300/ESP/2. Moreover, since 2000, the International Labour Conference has adopted conclusions concerning the following employment themes: decent work and the informal economy (2002); youth employment (2005); the promotion of sustainable enterprises (2007); skills for improved productivity, employment growth and development (2008); and promotion of rural employment for poverty reduction (2008).
[48] The Japanese financial crisis during the 1990s, and the debate about the "lost decade", is a case in point.
[49] C. Reinhart; K. Rogoff: *The Aftermath of Financial Crises*, paper prepared for presentation at the American Economic Association, 2008.

multilateral and international ones, should be encouraged to include decent work in their lending practices.[50]

Re-activating credit to stimulate the real economy …

90. Despite the large-scale financial rescue measures, there are indications that banks are reluctant to lend. In the EU and the United States, lending standards have tightened considerably (Figure 11). As a result, individuals and firms have delayed investment decisions, constraining future economic growth and job creation.[51]

91. One factor is that government conditions for support to banks have thus far been weak. Even in countries where banks receiving government support are required to make credit available to businesses, there are no sanctions or penalties for institutions that fail to comply. Banks continue to undergo the process of "deleveraging", i.e. the amount of capital available to the real economy is restricted by banks' efforts to improve their balance sheets and reduce the burden of "toxic assets".[52]

92. Interestingly, in the United States, state-owned banks have shown greater readiness to lend to businesses and consumers than their private-sector counterparts. This might reflect more limited exposure to risky financial operations among state-owned banks. But the fact that these banks are directly accountable to the government may have contributed as well.[53]

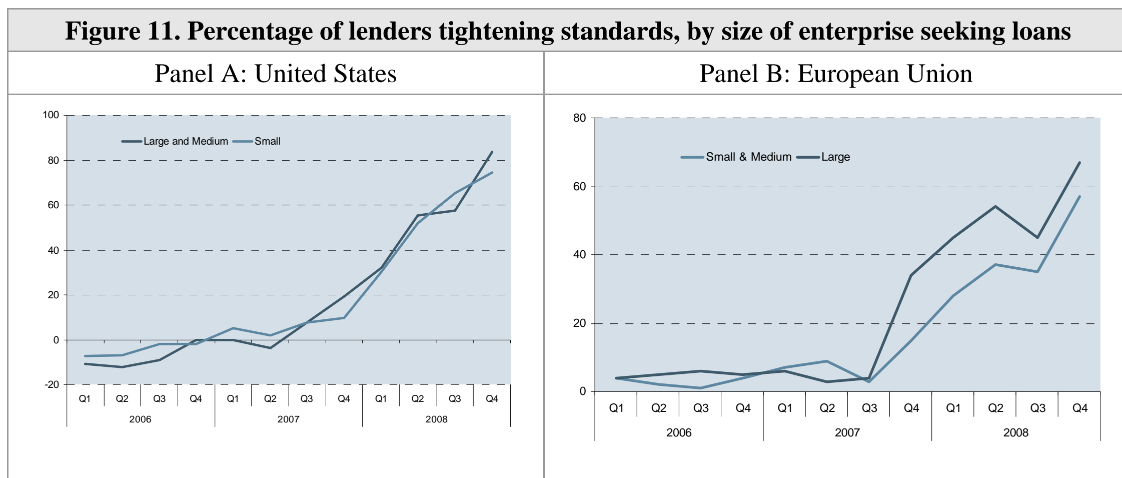


Figure 11. Percentage of lenders tightening standards, by size of enterprise seeking loans

Source: US Federal Reserve; ECB.

…with targeted support to SMEs …

93. Tighter lending standards present particular challenges for SMEs given their reliance on bank credits – they do not have access to capital markets in the same way larger firms

[50] ILO: Conclusions concerning the promotion of sustainable enterprises, International Labour Conference, Geneva, June 2007, para. 11.

[51] A prolonged investment slump would entail lower capital accumulation, thus reducing productivity gains and limiting the scope for improved living standards in the long-run.

[52] As illustrated in Section II, some government efforts have attempted to address this directly by purchasing or insuring toxic assets in the hopes of improving the lending situation.

[53] Cooperative banks have reportedly pursued their regular lending operations as well (see H. Hagen, 2009, forthcoming).

do. This is why restoring credit conditions in general will have especially favourable effects on small businesses. In the meantime, measures such as special credit lines and direct access to government loans could be envisioned for SMEs to assist them in gaining access to capital.

94. This will be key if SMEs, which account for up to 95 per cent of enterprises and are responsible for most existing and new jobs, are to take advantage of new opportunities that arise from the public investments in infrastructure, construction and housing. The ILO's Small Enterprise Development Programme can play a helpful role in this respect (Box 5).

Box 5. ILO's Small Enterprise Development Programme

The ILO's Small Enterprise Development Programme provides policy advice and support to SMEs in clusters and value chains, particularly those with job creation potential, to improve quality and productivity by enhancing good workplace practices and management-labour collaboration.

The programme also aims to maximize SME involvement in public procurement programmes. For instance, the programme has been assisting governments to administer and supervise contracts for local contractors and training local contractors to tender and deliver such contracts. Such activities are helpful complements to infrastructure programmes carried out as part of the response to the crisis.

Another role of the programme is to assist national and local governments in reviewing and improving the regulatory environment for SMEs. This too can be instrumental in times of crisis.

...and viable sectors through social and "green" conditionality, not protectionism

95. As noted in the first section of this paper, the crisis is hitting certain sectors harder than others. Export-oriented sectors are particularly vulnerable to both the credit squeeze, given their reliance on trade finance, and the spectacular fall in world demand and commodity prices.

96. Governments are thus under growing pressure to provide assistance to these sectors. Some countries have already increased import duties on automobile parts or steel. Others have imposed caps on imports of certain products, like chemicals or wood. Yet others have added "buy national" provisions in their fiscal stimulus plans. These types of measures can incite other countries to retaliate, or adopt counterbalance measures. Moreover, history shows that in the long-run protectionist measures are likely to create more substantial employment and income losses.

97. Instead, there are ways to support the long-run viability of industries by, for example, re-orienting them towards greener technologies that would: help stimulate economic activity by facilitating industrial restructuring; support sustainable employment creation; and prepare for the transition to a less CO2-intensive economy. One way to achieve this would be to provide assistance to certain sectors conditional on social and environmental

objectives.[54] The importance of synergies between investments in clean technologies and job creation has been recognized at the international level through the creation of the Green Jobs Initiative. The ILO has an important role to play in this initiative, along with its partners (United Nations Environment Programme, the International Trade Union Confederation and the International Organization of Employers) to ensure that green jobs become a positive driver of development in an environmentally, socially, and economically sustainable future (see also the last section of this paper).[55]

Boosting the economy through employment-oriented, coordinated actions

98. Despite the numerous stimulus packages introduced to date, aggregate demand continues to worsen. As noted above, part of the problem may be that efforts to address the challenges have been insufficient in magnitude. In fact, some of the "new" public spending is a repackaging of previously committed funds. Countries are reluctant to announce bold measures however because they are worried they will "leak" into the economies of their trading partners – a situation that is exacerbated, in some cases, by already deteriorating fiscal positions. This underlines the importance of measures that are coordinated across countries.

Stimulus packages need to be timely and better coordinated…

99. The complexities of the decision-making process may delay the adoption of stimulus packages. However, if unduly delayed, measures may come at a time when the recession is well underway and packages may prove insufficient or ill-adapted to the evolving circumstances. Success in overcoming earlier financial crises in Korea and Sweden is associated with the prompt adoption of a stimulus package. According to a simulation developed for the purpose of this paper, and assuming that credit markets were restored, it would take one year for the United States economy to recover if the "Obama package" was implemented now. And, according to the estimates, it would take almost two years if implementation of the package were delayed by three months.[56]

100. Better coordination of fiscal stimulus packages could also enhance the impact on global demand. There are cross-border externalities to the financial and fiscal rescue packages. Capital injections by the United States authorities would help alleviate the European financial crisis and vice versa. Likewise, a fiscal stimulus put forward by the Chinese government helps its trading partners and vice versa. Coordination is especially important in countries where fiscal space is limited as in the case of many African countries. In the absence of coordination in their response, these countries may be tempted to engage in a process of competitive devaluations or, worse, wage deflation. Coordinated action will also help boost world demand, hence cushioning the effects of a global recession.

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[54] For example, France's plan to support its auto industry includes requirements that funding be used to invest in green technologies and that no layoffs would occur in 2009.

[55] ILO: "Green Jobs Initiative", available at http://www.ilo.org/integration/greenjobs.

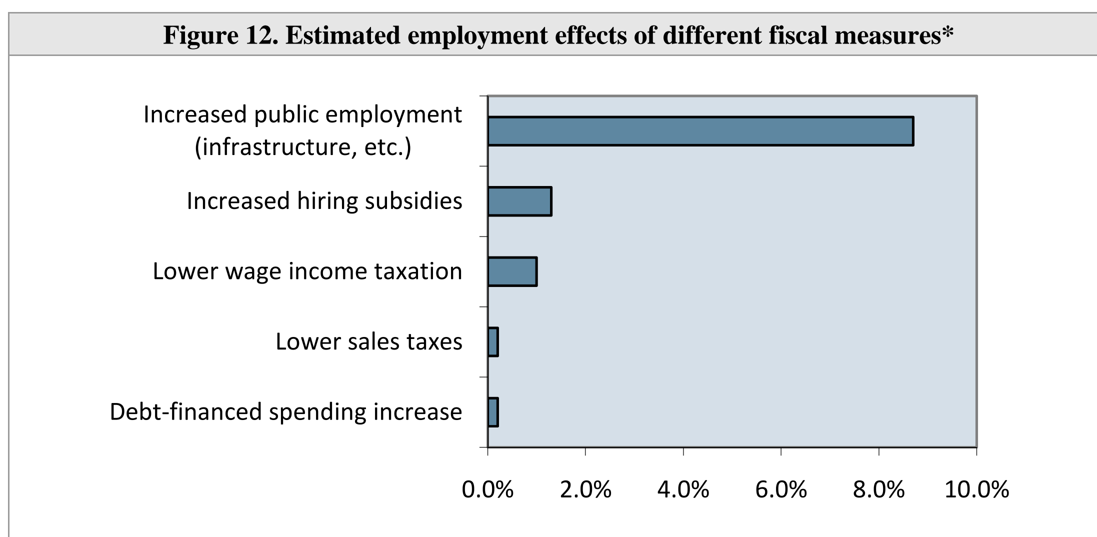
56 E. Ernst; M. Charpe: *Global economic linkages: Labour market implications of macroeconomic and social policies in open economies*, IILS, ILO, forthcoming 2009.

...with a strong focus on employment…

101. One of the lessons of the analysis carried out for this paper is that the greater the employment orientation of the measures, the stronger the stimulus for the real economy. As shown in figure 12, measures that have a direct impact on employment have a stronger effect than relatively untargeted measures (such as VAT cuts, or across-the-board spending increases).

102. In particular, the multiplier effects of investments in employment-intensive areas will be higher than is the case with alternate measures such as tax cuts.[57] At times of crisis, when there is considerable labour market slack, job-rich investment can crowd-in private sector activities and, more fundamentally, unlock development potential and pave the way for higher long-term growth. In this regard, public investments in infrastructure and agricultural development represent a major opportunity to address both employment and development challenges. These can include, among other things, investments in roads and communication, flood control and public buildings for education. To effectively lead to higher employment however, infrastructure projects need to meet existing domestic supply and skills.

Figure 12. Estimated employment effects of different fiscal measures*



* The figure shows the estimated employment effects of different fiscal measures. Each measure represents the equivalent of 5.7 per cent of GDP – the size of the stimulus package recently-adopted in the United States. For instance, it shows that employment would increase by up to 8 per cent in the long-run, if the entire package focused on public employment programmes such as infrastructure spending. Importantly, the estimates assume that new hires have the skills to perform the jobs created by the programmes. They also assume that sufficient domestic supply is available to respond to government incentives.

Source: IILS estimates.

57 A. Spilimbergo; S. Symansky; O. Blanchard; C. Cottarelli: *Fiscal Policy for the Crisis*, IMF Staff Position Note, IMF, 29 December 2008 (SPN/08/01). Stimulus aimed at consumers is potentially uncertain and limited, and direct subsidies to domestic firms have international trade law consequences and could lead to an uneven playing field and even trade wars (*ibid*).

103. Employment guarantees are another employment-intensive measure which, as experience from earlier crises shows, can be especially cost-effective in the face of the crisis – if well-designed and targeted:[58]

- Argentina's *Jefes y Jefas de Hogar Desocupados* programme, introduced during the 2001 crisis, reduced aggregate unemployment by an estimated 2.5 percentage points, increased labour force participation and reduced extreme poverty.59
- Similar pubic works programmes in Indonesia, Republic of Korea and Thailand adopted after the East Asian financial crisis, proved to be relatively successful in employing large numbers of individuals. However, studies suggest that programmes could have been more effective if better designed and monitored.60
- The National Rural Employment Guarantee (NREG) of India provides an important safety net for many rural households. The programme aims to provide additional employment to the underemployed and the unemployed by entitling every rural Indian household to 100 days of work per year. The budget for the NREG in 2006-07 was 0.33 per cent of GDP.61

104. In developed countries where most of the jobs are formal, supporting employment through partial unemployment benefits or subsidies for shorter working hours can prove effective. Such measures are being used extensively in some European countries. (see also Box 10 below for examples of experiences during the Asian financial crisis).

…supported by efforts to promote workers' skills...

105. To be successful, employment-intensive investments need to go hand-in-hand with efforts to promote skills development. In many cases, new skills will be needed in order to match the requirements of new infrastructure spending and programmes designed to support sectoral transition, e.g. towards greener technologies. In this regard, the design of such programmes is fundamental to ensure success due to the time required to adjust training provisions accordingly. Implementing time- and cost-efficient methods to identify current and future skills demands become crucial. The conclusions of the 2008 International Labour Conference discussion on Skills for improved productivity, employment growth and development can help in this regard.

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[58] G. Márquez: *Labor Markets and Income Support: What Did We Learn From the Crises?,* Working Paper No. 425, Inter-American Development Bank, 2000; B. Cook: *Active Labour Market Policies in the Neo-Liberal Era*, Working Paper No. 08-03, Centre of Full Employment and Equity, 2008. Wage levels are very important in ensuring successful employment guarantees and public works. If wages are too high, they will distort the labour market and pull individuals (particularly the non-poor) from employment. High wages will also put pressure on programme funding and likely result in the rationing of jobs. On the other hand, if wages are too low, programmes will not be an effective safety net for participants and may become stigmatizing.

[59] E. Galasso; M. Ravallion: "Social protection in a crisis: Argentina's plan *Jefes y Jefas*", in *The World Bank Economic Review*, Vol. 18, No. 3, 2004, pp. 367-399.

[60] G. Betcherman; R. Islam, *East Asian labor markets and the economic crisis: Impacts, responses and lessons*, World Bank and ILO, 2001.

[61] P. Chakraborty: *Implementation of the National Rural Employment Guarantee Act in India: Spatial Dimensions and Fiscal Implications*, The Levy Economics Institute of Bard College, Working Paper No.505, 2007.

…and help jobseekers through effective public employment services and active labour market programmes

106. Active labour market programmes play an important role in skills development and more broadly in facilitating the adjustment of individuals to changing labour market conditions. Such programmes can take many forms, including: job-search assistance and monitoring, personalized action plans for job seekers, training, and targeted programs for disadvantaged groups. They can also provide much needed income support. If properly designed, they can enhance employability and improve labour market mobility in the short term. They can further facilitate matches between the skills of displaced workers and the skills required in the jobs created by new public investment (e.g. in construction, infrastructure and alternative energy).

107. Some lessons learned to date about enhancing the effectiveness of active labour market programmes include: an obligation on the part of the benefit recipient to undertake an activity and enforcement of this obligation by the programme; making participation in programmes compulsory; targeting increased effectiveness of outcomes, programmes and services (e.g. combining training and job-search assistance); and in-work benefits help facilitate a return to work.[62]

108. During a crisis, special programmes to assist displaced or retrenched workers should be intensified. The ILO *Guide to Worker Displacement: Some tools for reducing the impact on workers, communities and enterprises* demonstrates the wide range of possible responses by enterprises, communities and workers to economic downturns and how to reduce potential job losses. Schemes targeting temporarily laid-off workers can be very efficient, since workers with firm-specific training are often expected to return to work at the same firm (or sector) when the business climate improves. This type of programme could complement the employment-intensive public investments and initiatives to extend, or enhance, unemployment benefit coverage. This may mean allocating additional resources to public employment services. Already, some national employment services have been mobilized to help address the global economic crisis (Box 6).

Box 6. Enhancing public employment services and active labour market programmes

France: *Pôle Emploi*, the newly created agency that merges employment services and unemployment insurance, is increasing the resources available to enhance employment services, facilitate training for jobseekers and support the effort of social partners to coordinate measures to address the financial crisis.
Mexico: the *BÉCATE* programme of the National Employment Service is being expanded to provide various training programmes, including apprenticeships, which include monthly financial support for trainees and counselling on how to start a business.
Philippines: *Public Employment Service Offices* (PESOs) have been mobilized to intensify job placement, emergency employment and livelihood formation services, particularly for workers in commodity and export industries.

[62] See for example, OECD: *Employment Outlook*, Paris, 2005; M. Rosholm; M. Svarer: *Estimating the Threat Effect of Active Labour Market Programs*, Discussion Paper No. 1300, Institute for the Study of Labor, 2004; M. White; R. Riley: *Findings from the Macro Evaluation of the New Deal for Young People*, DWP Research Report No. 166, Centre for Development Studies, University of Leeds, 2002.

Republic of Congo: An anti-crisis strategy has been put in place, monitored by an inter-ministerial committee. It includes a programme to upgrade the skills of both employed and unemployed workers in a way that responds to labour market requirements.

109. Greater use of active labour market programmes could also be foreseen for some developing and emerging countries. A recent study shows that some 12 out of 31 economies in Latin America and the Caribbean are indeed already using active and passive labour market policies in response to current economic circumstances.[63] The cost of new programmes is relatively low. For example, Argentina's spending peaked at about 1 per cent of GDP. Based on this cost level, such programmes could be an appropriate tool if there is political will by policy makers.

Leveraging local partnerships to enhance effectiveness

110. The effectiveness of employment-intensive investments, skills development and active labour market programmes can be improved by leveraging capacity among local partners – the foundation upon which the ILO's employment-intensive investment programme is built (Box 7).

Box 7. The ILO's Employment-intensive Investment Programme

The ILO's Employment-intensive Investment Programme works with governments, employers' and workers' organizations, the private sector and community associations in orienting infrastructure investments towards the creation of higher levels of productive employment, as well as towards the improvement of access to basic goods and services for the poor. Many of the programme's projects rely on labour-based technologies, in order to generate local employment and incomes and develop skills.

Labour-based technologies have several benefits: they are between 10 and 30 per cent less costly than more equipment-intensive options; foreign exchange requirements are reduced by about 50 to 60 per cent; between 2 and 4 times more direct employment opportunities are created for the same investment; indirect employment ranges between 1.5 and 3 times the numbers of direct jobs stemming from the initial investment. Over the last 30 years the programme has played a vital role in over 60 countries in Africa, Asia and Latin America in dealing with job creation and poverty reduction in rural and urban areas. It has also developed methodologies to ensure cost effectiveness of the measures.

Enhancing social protection, especially among low-income groups

111. As earlier sections illustrated, as the crisis unfolds, the risks that individuals around the world are facing are exacerbated by limited access to social security schemes and social safety nets. At the same time, in countries where such schemes do exist, pressures on their finances, e.g. pension systems, are intensifying as countries experience the double burden of declining tax contributions and increasing expenditures due to rising claims.

Well-designed social policies can alleviate the consequences of the crisis in the short run…

112. Supporting workers and their families through well-designed social policies – a core ILO competency – is a key component to averting a social crisis and stimulating the

[63] Economic Commission for Latin America and the Caribbean, 2008.

economy more broadly.[64] Neglecting victims of the crisis, and of the interconnecting food, energy and poverty crises, would be unfair and could undermine support for government rescue plans. Moreover, supporting low-income groups, which typically have a high propensity to consume, would help stimulate aggregate demand and restore confidence.

…by helping low-income and other vulnerable groups while supporting the recovery…

113. One way to provide assistance to individuals is to widen eligibility conditions and increase benefit amounts of existing social security schemes, e.g. by extending the duration or increasing the generosity of unemployment benefits (see Table 4 for examples of countries that have already done this). In the absence of existing schemes, however, it may be necessary to introduce new measures to help low-income and other vulnerable groups.

114. For example, income support measures such as conditional cash transfers could be further strengthened (or introduced) to enhance human capital and access to education and health services, especially for the poor (see Box 8). This is particularly relevant given that in many low-income countries, crises are associated with poorer health and education outcomes for children, while in middle-income countries, they are associated with poorer health outcomes.[65] Investments in children's education and health services also have a long-term systemic impact on poverty levels. Social and care services also provide job opportunities for women who may not be able to take up construction work on infrastructure projects.

Box 8. Conditional cash transfers

Conditional cash transfers provide cash to poor families linked to certain educational and health-related conditions. The most common conditions focus on children's school attendance, health care check-ups and nutrition. Recent studies show that one-third of developing countries have implemented some kind of cash transfer programmes.

Conditional cash transfers have been effective at smoothing recipients' consumption during times of crisis. For example:

- In Nicaragua, during the Central American coffee crisis, they smoothed consumption, protected children's school enrolment, reduced child labour and improved health outcomes.
- Similarly, in Honduras, they allowed families to keep their children in school during the crisis.
- They were also successfully introduced as part of earlier crisis responses in Colombia and Turkey.
- Indonesia's scholarship and school subsidy programme was introduced in 1998 as a part of the government's crisis response.[66]

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[64] See for example E. Lee: *The Asian Financial Crisis: The Challenge for Social Policy,* ILO, 1998.

[65] Children's human capital outcomes are not uniformly affected in a crisis. For instance, during economic or environmental crises, health outcomes suffered in the Philippines and Uganda, while education outcomes were not dramatically affected in Brazil, Indonesia and Uganda (see E. Skoufias: "Economic Crises and Natural Disasters: Coping Strategies and Policy Implications", in *World Development*, Vol. 31, No. 7, 2003, pp. 1087–1102). World Bank: *Lessons from World Bank Research on Financial Crises,* Policy Research Working Paper No. 4779, 2008

[66] For some evaluations of these programmes, see van W. Ginneken: *Managing risk and minimizing vulnerability: The role of social protection in pro-poor growth*, ILO, 2005; S. Handa; B. Davis: "The Experience of Conditional Cash Transfers in Latin America and the Caribbean", in *Development Policy Review*, Vol. 24, No. 5, 2006, pp. 513-536; L. Rawlings; G. Rubio: "Evaluating the impact of conditional cash transfer programs", in *The World Bank*

115. In cases where conditional cash transfers do not exist, establishing a new programme can be a complicated, time-consuming and administratively challenging process, entailing considerable data-collection and monitoring capacity which may be difficult to mobilize in times of crisis. Consequently, in low-income countries where poverty is widespread and administrative capacity limited, unconditional transfers could be considered as a way to enhance universal social protection.

116. A wide range of other tools and targeted intervention programmes could be envisioned to support vulnerable groups such as workers in the informal sector and rural areas, e.g. the labour-intensive public works programmes as undertaken by many governments during crises (Argentina, Indonesia, Republic of Korea and Thailand). As discussed above, employment guarantee programmes of this nature can potentially combat both poverty and unemployment with positive secondary effects on, among other things, health, crime and political stability. Other types of income and employment entitlement programmes, such as those offered by the Self Employed Women's Association in India or the Grameen Bank in Bangladesh, could also help provide much needed social protection to vulnerable groups in times of crises. For programmes targeting informal workers, particular attention to the gender dimension will be crucial.[67]

…and protecting pensions from the volatility of stock markets

117. In order to avoid losing ground both against existing poverty thresholds and the rates of replacement income provided, it is necessary to restore solidarity-based minimum guarantees of pension amounts underwritten by the State, and protect the pension levels of individuals who are close to retirement. In certain countries (such as India), the elderly rely heavily on income from savings, which is likely to be severely curtailed with current interest rate drops. In addition, in countries that rely on annuitization of individual savings accounts, any prolonged suppression of interest rates is likely to lead to serious difficulties because of increased volatility in annuity rates (prices).

118. As a transition measure, a minimum pension based on a reasonable minimum rate of return ought to be financed or guaranteed by the State. Governments could also authorize pension schemes to reduce their levels of capitalization. One possible approach is to allow schemes to go into temporary actuarial deficit. If asset prices rebound in due course, then the ultimate net cost of such guarantees would be only a fraction of the momentary losses of pension assets.

Research Observer, Vol. 20, No. 1, 2005, pp. 29-55; and R. Sparrow: "Protecting Education for the Poor in Times of Crisis: An Evaluation of a Scholarship Programme in Indonesia", in *Oxford bulletin of economics and statistics*, Vol. 69, No. 1, 2007, pp. 99-122.

[67] A. King-Desjardin; *Gender dimensions of globalization*, discussion paper presented at the Oslo Conference on Decent Work: A key to Social Justice for a Fair Globalization, 4 September 2008.

119. The OECD has suggested that governments could play a more active role in managing the risks associated with the payout phase of pensions and annuities. In particular, governments could encourage the development of longevity-hedging products by producing an official longevity index. Other proposals include suggestions for governments to issue longevity bonds that "would set a benchmark for private issuers", while also giving consideration to issuing more long-term and inflation-indexed bonds – a move already taken by a small number of countries, most recently the Danish government, which released a 30-year bond that was primarily bought by domestic pension funds and insurance companies.

But these measures should form the basis of a broad-based social protection for all…

120. While the above measures to protect the most vulnerable are important steps to addressing current challenges, they should form part of a systematic effort to develop a broad-based social security system (covering social assistance, education, health, unemployment benefits, etc.) and an overall poverty reduction strategy.

… which can help mitigate the impacts of future crises…

121. Experience in several European and, more recently, some Asian countries has shown that a system of basic social security can mitigate the impacts of crises by means of automatic stabilizers – measures of support that automatically increase during times of crises or increased household vulnerability.

…and, if consistent with employment goals, support development objectives

122. Moreover, increases in social spending do not impede growth. On the contrary, if social protection is designed in a way that takes into account work incentives, it can boost the quality of growth through its pro-poor elements. For example, countries that have high social spending also tend to have lower levels of poverty and inequality.[68] In other words, social security measures should, and can, be designed in such a way as to go hand in hand with economic policy to increase production, social protection and redistribution while addressing broader social issues such as family, care and poverty.

123. Just as the Great Depression was a defining moment in the United States in creating the Social Security Act (1935) and the financial and economic crises of the 1990s were defining moments in Asian and Latin American social policy innovation, this current crisis should be taken as an opportunity to enact much-needed reforms to social security systems. In this respect the Social Security (Minimum Standards) Convention, 1952 (No. 102) can guide efforts to strengthen social security systems.

Protecting the rights of workers

124. In attempting to address the challenges associated with the crisis, it is crucial to ensure that workers' rights and international labour standards are not compromised in the process. In fact, the observance of fundamental principles and rights at work must be part of the solution to the crisis. Moreover, respect for fundamental principles and rights at

[68] ILO: *World of Work Report 2008.Income Inequalities in the Age of Financial Globalization,* IILS, Geneva, 2008.

work is necessary to maintain social justice and peace, and to avoid political unrest which could create even greater delays in terms of a recovery.

Reduced labour standards would be both unfair and counter-productive…

125. Some argue that labour market rigidity and overly stringent labour standards restrict the capacity of an economy to cope with economic shocks and that labour market flexibility can temper both the depth and duration of unemployment in the current crisis.[69] However, there is considerable evidence drawn from cross-country studies that illustrates that there is no clear relationship between fewer labour regulations and faster economic and employment growth.[70] Efforts that are focused exclusively on speeding up the labour market adjustment process to cope with the global economic crisis run the risk of impairing long-term growth potential.

126. Maintaining labour standards helps support confidence and thus contributes to activating the economy. Moreover such measures would be equitable and enable vulnerable workers to deal with labour market risks, thus enhancing popular support for recovery packages. The different national situations now arising in the context of the crisis highlight the relevance of the ILO's full complement of instruments to protect workers' rights (see Box 9).

Box 9. Relevance of ILO instruments in the crisis context

The ILO has a comprehensive set of instruments to protect workers' rights. The following are examples of the relevance of these instruments in the context of the crisis:

- As pressures on firms mount, the Protection of Wages Convention, 1949 (No. 95) and the Protection of Workers' Claims (Employer's Insolvency) Convention, 1992 (No. 173), along with their associated Recommendations, lay out constructive measures for protecting workers' wages and proceeding fairly in cases of an employer's insolvency. Where lay-offs arise, it is important to ensure that terminations are not discriminatory on any of the grounds provided in the fundamental Conventions. The Termination of Employment Convention, 1982 (No. 158) and Recommendation (No. 166) shed light on how terminations can take place in a balanced manner. The provisions of the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (MNE Declaration) could be particularly useful in managing the effects of the recession along global supply chains. To protect the employment security of workers in atypical employment situations, the Employment Relationship Recommendation, 2006 (No. 198) is salient.
- Instruments concerning migrant workers (the Migration for Employment Convention (Revised), 1949 (No. 97) and the Migrant Workers (Supplementary Provisions) Convention, 1975 (No. 143)) are also highly relevant, given that this group is particularly vulnerable in the context of the downturn in labour markets.
- The Labour Clauses (Public Contracts) Convention, 1949 (No. 94) can help ensure that investments financed by public stimulus packages generate jobs with decent pay and working conditions.
- In the context of enhancing social protection, the eight fundamental Conventions (Forced Labour Convention, 1930 (No. 29); Freedom of Association and Protection of the Right to Organise Convention, 1948 (No. 87); Right to Organise and Collective Bargaining Convention, 1949 (No.

[69] This is under the assumption that in rigid labour markets, relative prices (wages in this case) are sticky, and therefore the brunt of the adjustment process is borne via the depth and duration of unemployment.
[70] J. Berg; D. Kucera: *In defence of labour market institutions. Cultivating justice in the developing world*, ILO, Geneva, 2008; A. Ghose; N. Majid; C. Ernst: *The Global Employment Challenge*, ILO, Geneva, 2008; Baker *et al.: Labour market institutions and unemployment : A critical assessment of the cross-country evidence*, 2005.

98); Abolition of Forced Labour Convention, 1957 (No. 105); Equal Remuneration Convention, 1951 (No. 100); Discrimination (Employment and Occupation) Convention, 1958 (No. 111); Minimum Age Convention, 1973 (No. 138) and Worst Forms of Child Labour Convention, 1999 (No.182)) can guide poverty alleviation efforts and, along with Convention No. 102, efforts to strengthen social security systems. Fundamental Conventions are crucial to ensuring a more balanced distribution of the gains from economic growth and reducing excessive inequalities –a key factor behind the crisis.

- Social dialogue mechanisms and processes, as outlined in the Tripartite Consultation (International Labour Standards) Convention, 1976 (No. 144), and the Tripartite Consultation (Activities of the International Labour Organisation) Recommendation, 1976 (No. 152), as well as in the Consultation (Industrial and National Levels) Recommendation, 1960 (No. 113) and the MNE Declaration, need to be part of the strategy.
- Overall, the Employment Policy Convention, 1964 (No. 122) – based on policies for full, productive, and freely chosen employment – can provide a useful overarching framework for international action.

… and the crisis represents an opportunity to emphasise the role of workers' rights

127. The crisis should be taken as an opportunity to reinforce the value of protecting and respecting workers' rights.[71] Measures should be taken to guarantee impartial and efficient judicial, as well as extra-judicial, proceedings dealing with individual and collective disputes. Labour inspection and administration systems should be reinforced to guarantee implementation of measures taken to combat the crisis and its social consequences and to provide services to employers and workers. Public employment services and labour inspection have a special responsibility in this regard.

128. Better enforcement of workers' rights could help achieve more balanced income developments and thus reduce the risk of future crises.[72] A consistent finding is that countries that have 'labour-friendly' regulations seem to be associated with lower wage inequality – a tangible social benefit – without imposing any significant loss in terms of output and employment.[73] A rights-based approach to the crisis can thus anchor the discussion of policy options, to enhance social justice in the immediate and longer term.

The role of social dialogue and wage determination

Social dialogue plays an essential role in protecting rights and achieving employment objectives …

129. The Declaration of Philadelphia established the ILO's commitment to social dialogue, tripartism and participation. Its central importance has been sustained over the decades. More recently, in 2002, the International Labour Conference adopted a resolution concerning tripartism and social dialogue, recognizing that social dialogue plays an essential role in the achievement of employment objectives and the improvement of social protection. Social dialogue can be instrumental in adopting

[71] L. Rychly: *Social dialogue on the design and implementation of measures in times of global financial and economic crisis*, ILO, forthcoming 2009.
[72] J. Berg; D. Kucera: op.cit.
[73] See for example, R. Freeman: *Doing the Right Thing? Does Fair Share Capitalism Improve Workplace Performance?: Analyzing Effects in Britain*, with Alex Bryson, presented at the Shared Capitalism Research Conference, NBER-Sage Foundation, 6-7 October 2006.

effective, concrete policy responses by helping to improve the design of reforms, and it can help to bolster support for reforms in general.[74]

… social partners can be instrumental in designing and implementing reforms for overcoming the crises...

130. At the 8th European Regional Meeting of the ILO (Lisbon, February 2009) participants emphasized the significance of social dialogue as a key means of developing strategies to counter the recession and secure the commitment of governments, employers and unions for implementation of the strategies.[75] Indeed, examples from past crises can be identified which illustrate how national tripartite consultations have played an important role in overcoming severe economic difficulties. For example, in Singapore measures were introduced to mitigate excessive layoffs, whereas in the Republic of Korea, eventual agreement improved the government's crisis-management capacity, and was instrumental in reaching national consensus (Box 10).[76] In addition, Argentina's post recovery process was based on a social pact bringing all the social partners together.

Box 10. **Lessons from social dialogue in previous crises**

Singapore: To counter the 1997-1998 financial crisis, the government introduced new labour policies. In particular, as a result of a tripartite agreement, employers received financial incentives if they avoided layoffs. Tripartite institutions as well as ad hoc tripartite agreements were very effective in articulating conflicting interests between the three parties, resulting in more effective formulation and implementation of social and economic policies.

Republic of Korea: To respond to the 1997-1998 financial crisis, a Tripartite Commission was created. The Commission had two major objectives: to contribute to economic restructuring and to involve social partners in the revision of Korean labour law, in line with ILO standards. A Social Agreement adopted by social partners in February 1998, accepted layoffs of redundant labour force as an economic reality, but it also significantly enlarged workers' basic rights, substantially expanding freedom of association and the right to bargain collectively, both in the private and public sectors. This "Great Compromise" improved the government's crisis-management capacity, and was instrumental in reaching national consensus and helping the country overcome the credit crunch.

…and finding pro-decent work solutions to immediate and longer-term challenges…

131. At the national level, the existing institutional framework, as well as newly established consultative bodies, should be used to identify and implement appropriate national policies. Where these bodies do not exist, *ad-hoc* high-level meetings should be held to exchange information and to consult or negotiate policy measures. In difficult times, it is of particular importance to build and maintain mutual trust between the State and the social partners and among the social partners themselves. The ILO can play an important role in this context. Social dialogue and collective bargaining are powerful tools to cope with immediate challenges of the crisis, such as preventing social unrest, avoiding damaging industrial actions, reducing income inequalities and maintaining

[74] See L. Rychly: op.cit.
[75] See GB.304/14/4.
[76] For a comprehensive discussion of social dialogue in the post-crisis context, see D. Campbell: "Social Dialogue and Labour Market Adjustment in East Asia after the Crisis", in G. Betcherman, R. Islam, (eds.): *East Asian labor markets and the economic crisis: Impacts, responses and lessons*, World Bank and ILO, 2001.

social cohesion. Through improved governance social dialogue can also pave the way for shared prosperity and stability in the longer term.[77]

… especially as regards wage developments – a particularly contentious issue

132. One point of contention is wage-setting practices. In particular, some advocate wage moderation in an attempt to cut costs and prevent job loss in ailing firms. Others argue for maintaining purchasing power and aggregate demand.

Overall, to sustain the recovery, average real wages should grow in line with productivity and minimum wages should not fall…

133. Paradoxically, both views are probably valid. On the one hand, firms are facing significant financial difficulties and their viability, including that of the employees, may rely on significant cost reductions. Such reductions, which take the form of, among others, wage freezes or cuts – perhaps even in line with productivity declines –can help firms survive and avoid layoffs.[78] In addition, earlier experiences in Asia and Latin America show that lower wages played a strategic role in the response to the crisis. Lower wages, together with currency devaluations, resulted in massive improvements in external competitiveness. The latter, in turn, was instrumental in the recovery of these countries.

134. On the other hand, given the global nature of the current crisis, a generalization of wage restrictions in the name of competitiveness and better profitability would most likely push the world economy into further trouble. This is a real risk. Indeed, excessive wage developments are not the cause of the crisis. In fact, evidence suggests that real wages have tended to grow *below* productivity gains since the early 1990s.[79] On average, pre-crisis profit rates were high by all standards. So, unlike the crisis of the early 1980s, low profitability has not been the main problem for most enterprises. In addition, stagnant median wages and incomes were an enabling factor behind excessive debt accumulation.

135. Altogether, as a response to the crisis as well as from a longer term perspective, it would be economically desirable – as well as fair – if average wages would grow over the medium-term in line with productivity gains, taking into account firms' viability in the short-run. In light of the evidence to date, this may mean that wages may need to rise faster during economic upswings and less rapidly during downswings.

136. In this respect, the role of collective bargaining and social dialogue will be critical to achieving a desirable outcome. Employers and workers need to be encouraged

[77] Countries with coordinated collective bargaining have been shown to have less wage dispersion compared to other countries. T. Aidt; Z. Tzannatos: *Unions and Collective Bargaining: Economic Effects in a Global Environment*, World Bank, Washington, 2002.
[78] Other measures to avoid job loss were discussed throughout the report.
[79] ILO: *Global Wage Report,* November 2008; ILO: *World of Work Report 2008. Income Inequalities in the Age of Financial Globalization,* IILS, Geneva, 2008.

to participate in collectively negotiated wage-setting practices. Governments can help stimulate dialogue and facilitate concerned action to avoid socially undesirable, and potentially inefficient, generalized wage reductions. Moreover, collective bargaining can reduce overall wage inequality and ensures a stronger link between economic growth and average wages.[80]

137. Governments can support this process through minimum wage legislation, adjusted regularly to maintain the purchasing power and avoid sudden adjustments, which are detrimental to job creation. The Minimum Wage Fixing Labour Convention, 1970 (No. 131) provides an important benchmark in this regard.

[80] ILO: *Global Wage Report*, November 2008.

IV. Improving global policy coherence for more balanced growth and development

138. The need for greater global policy coherence has been emphasized many times, and for good reasons. But it is especially important now. Unless greater international coordination is achieved in the responses to the crisis, the world economy will face the prospect of a protracted economic crisis, entailing an even deeper labour market crisis and significant social hardship. Greater coherence is also needed at the global level. No international organization or country has the mandate for, or is equipped to treat, all facets of the crisis and its underlying challenges. This is why the G20 has emerged as a key forum to discuss the crisis.

139. The ILO has therefore committed itself to fostering greater cooperation among national governments, international organizations, and other stakeholders in support of a stronger, cleaner and fairer economy.[81] It is important to build on complementarities between the ILO and the different mandates of other international organizations – particularly the World Bank, the IMF, the WTO, and the United Nations Environment Programme, among others – to enhance coherence between economic, financial, trade, social, environmental and development goals.

Avoiding in-ward looking and protectionist solutions

140. The global crisis will not be solved by protectionist solutions. Rather, such solutions would depress world trade and investment, further aggravating the recession. Historical evidence from the Great Depression shows that attempts to restore economic stability by closing borders to trade are bound to fail and would generate even more substantial income and employment losses in the long-run. The repercussions for developing countries, which rely so heavily on world markets, would be especially acute.

141. The role of the multilateral system is critical and it will be important to remain vigilant vis-à-vis the mounting pressure to support strategic sectors like automobiles. Support should be temporary and tied to social and environmental conditions. To complement this, however, it is of paramount importance to help workers adjust, through a variety of training and re-employment measures as discussed earlier.

142. Likewise, attempts to overcome the crisis through competitive currency devaluations would be counterproductive. Some countries have already had recourse to strong devaluations. In some cases, this may be justified on the basis of economic fundamentals. However, currency devaluations with the aim of improving competitiveness will not help overcome the global crisis and may aggravate trade

[81] See the joint press release by Chancellor Angela Merkel, OECD Secretary General Angel Gurría, WTO Director-General Pascal Lamy, ILO Director-General Juan Somavia, IMF Managing Director Dominique Strauss-Kahn and World Bank President Robert B. Zoellick on the occasion of their meeting on 5 February 2009 in Berlin.

tensions. Here too, an orderly adjustment, through proper international cooperation is clearly desirable.

143. Generalized wage deflation to protect individual economies would aggravate the crisis even more than a wave of competitive devaluations. Indeed, wage deflation would deprive the world economy of much-needed demand and would also seriously affect confidence. Open market policies, which are so crucial to the recovery, would also face a risk of backlash if workers perceive the measures as unfair.

Reforming the financial architecture so that it serves the needs of the real economy…

144. Medium and long-term measures to overhaul the financial regulatory framework are required to move towards a more stable global financial system. Previously widespread practices – such as excessive leveraging, opaque financial instruments and executive compensation schemes – need to cease.[82] In a few cases, limits on executive pay and bonuses have been instituted as a condition for government assistance. But a more profound change is clearly called for.

145. Indeed, despite the coordinated international responses in the short-run, the global financial system is likely to remain marked by volatility until significant structural adjustments are made. Therefore, in all countries, it will be crucial to reinforce prudential regulation to reduce excessive and irresponsible short-term risk-taking on the part of certain financial actors. For instance, lightly regulated markets for financing mechanisms such as private equity, hedge funds and non-bank financing have been held responsible, in part, for sudden herd-like in- and out-flows of funds in certain industries and sectors which may have magnified the effect of the current crisis. A cautious approach to regulation is especially important in countries where financial markets are not sufficiently developed and where supervision mechanisms are weak. The "de Larosière report" provides a rich menu of how to move forward in this regard. [83]

…and takes into account the social impacts of different reform options

146. The regulatory reforms made in the coming months and years must be assessed against their social impacts and implications for employment growth. As the International Labour Conference emphasized in 2007, financial services can indeed be used to promote decent work outcomes, if regulated appropriately.[84] Any new financial system should therefore give incentives for productive investments in sustainable enterprises and decent work, and disincentives to short-term speculation.

147. In this regard, the ILO has an important role in highlighting the social impacts of the reforms to strengthen the inclusiveness of a new financial architecture and help the international community strike the right balance between government regulation and

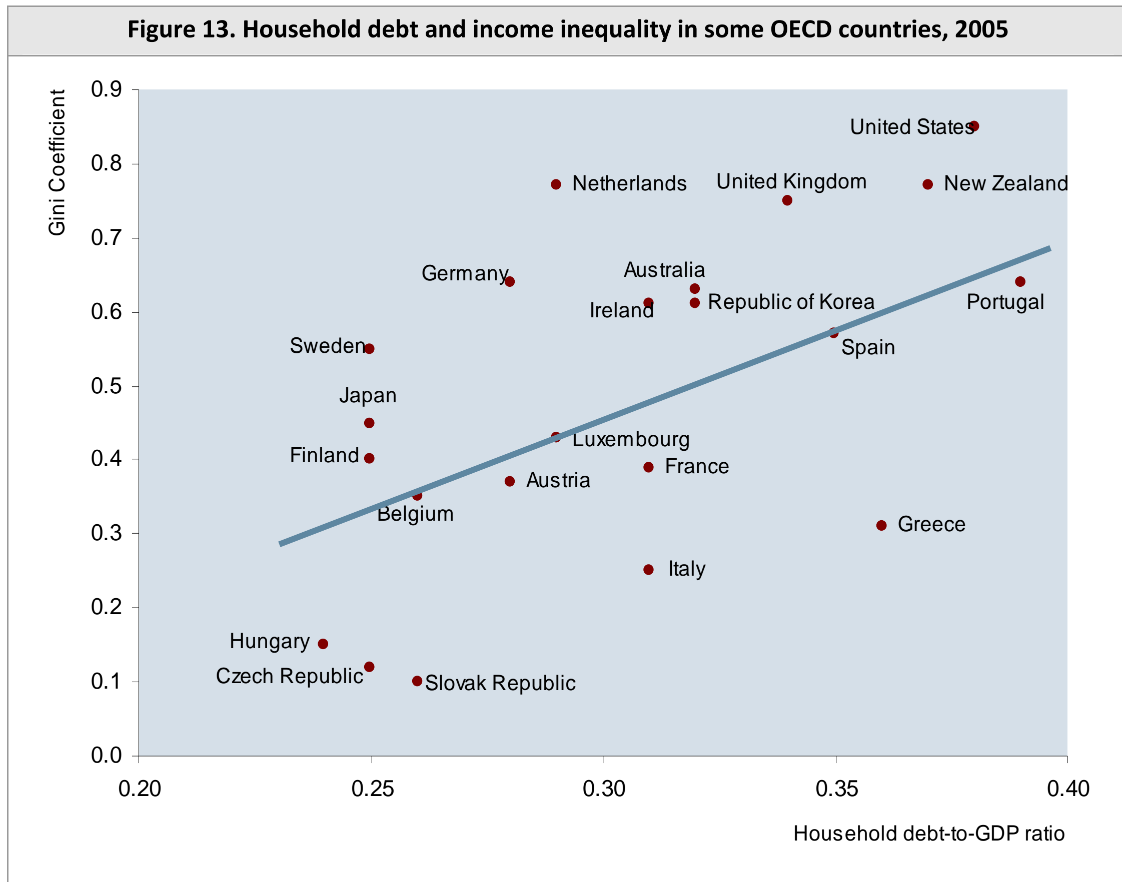
[82] For a recent analysis of executive pay, see F. Ebert, R. Torres, and K. Papadakis: *Executive Pay: trends and policy issues*, International Institute for Labour Studies, Discussion Paper No. 190, ILO, Geneva, 2008.
[83] Available at http://ec.europa.eu/ireland/press_office/news_of_the_day/pdf_files/global_report_-_final.pdf
[84] ILO: *The promotion of sustainable enterprises*, Report VI, International Labour Conference, 96th Session, Geneva, 2007.

corporate self-determination. The ILO's Social Finance Programme, supported by analytical work[85], provides a major benchmark in this respect.

Promoting social sustainability of economic growth…

148. One of the most significant challenges will be to ensure a more equitable distribution of the gains from globalization, as highlighted in the Social Justice Declaration. This is important in and of its own. In addition, as noted in the first section of this paper, excessive inequalities are a key factor behind the financial crisis. Among advanced economies, high income inequalities tend go hand-in-hand with a greater burden of household debt (Figure 13).

Figure 13. Household debt and income inequality in some OECD countries, 2005



Source: Estimates based on OECD data.

149. Moving forward, this means ensuring that tax policies are more progressive than hitherto – which requires international coordination so as to avoid harmful tax competition to attract high-income groups and businesses. Social protection reforms, as discussed in the third section of this paper, can be designed in such a way that they serve both equity and efficiency purposes.[86] Also, countries that have stronger tripartite

[85] See for instance B. Balkenhol: "Access to finance: the place of risk sharing mechanisms", in *Savings and Development* No.1, vol. XXXI, 2007, pp.69 - 90.
[86] ILO: *World of Work Report 2008. Income Inequalities in the Age of Financial Globalization*, International Institute for Labour Studies, Geneva, 2008.

institutions are better placed to ensure that the gains from globalization are distributed in a balanced manner. Finally, rising non-standard and informal employment – which tend to pay less than formal standard jobs – have contributed to rising income inequalities in developed and developing countries alike. More attention is therefore needed to the quality of employment created.

150. Financial globalization too, has reinforced the downward trend in the share of income going to labour and more fundamentally, has intensified economic instability. A new financial architecture, along the lines discussed above, must consider these social consequences in order to produce more stable and equitable employment and economic growth.

…as well as environmental sustainability

151. Globally, increased emphasis has been placed on investing in energy efficient technology for greener and more sustainable growth, and several governments have announced stimulus programmes designed to make progress in that regard (see Box 11). In some cases, the bulk of "greener" jobs created is likely, at least initially, to be in traditional sectors such as construction. Nevertheless, green investments should be viewed as an important step towards revitalizing the economy and generating more environmentally-friendly, decent work. And, in the medium to longer term, such investments can put countries on a path toward greener and more sustainable growth.

Box. 11 Green investments and job creation as a response to the crisis: some examples

***Japan**:* To strengthen growth potential and move to a low-carbon society, the government plans to invest 100 trillion yen in green projects by 2015 which would create more than 2 million jobs in environmental businesses. The “green” initiatives include: accelerating the introduction of energy-saving and new energy technologies; subsidies for the development of the next generation high-speed railway; tax incentives for investments in energy-saving and new-energy facilities and equipment; and greater resources for research and development on cutting-edge environment technologies, including carbon dioxide capture and storage.

Republic of Korea: The government recently announced new investments in the order of $38 billion for a series of “green” initiatives to be rolled out over 2009-2012. This “Green New Deal” provides for nine core projects and 27 subsidiary projects in areas such as the restoration of major rivers, renewable energy, energy conservation, green transportation, clean water, recycling, and carbon reduction. These projects are expected to create as many as 960,000 new green jobs.

United States: The *American Recovery and Reinvestment Act,* signed by the President of the United States on 17 February 2009, includes significant investments in clean energy programmes. $5 billion is allocated for programmes to help low-income households weatherize their homes, which is expected to create about 375,000 jobs. Grants for energy efficiency in residential and commercial buildings amount to over $6 billion. These may create more than a million jobs, particularly in the construction sector, which has been hard hit by the recession.[87] $500 million is allocated to help workers train for “green jobs”, while $11 billion is allocated for “smart grid” investments, $3.4 billion for carbon capture and sequestration demonstration projects, and $2 billion for research into batteries for electric cars.

[87] D.J. Weiss, A. Kougentakis: *Recovery Plan Captures the Energy Opportunity*, Center for American Progress, 13 February 2009.

Addressing the development dimension…

152. Even before the onset of the current financial crisis, significant food, education, health, social and environmental challenges existed for many developing countries. And the crisis is likely to aggravate the situation.

…by building capacity, notably administrative and institutional in developing countries…

153. As outlined in the third section of this paper, the ILO has developed expertise to help promote development through decent-work-friendly policies. The following are important policy elements of the global jobs pact: the implementation of job-rich infrastructure and housing projects, the fight against child labour and in favour of schooling, the build-up of social protection systems as fiscal conditions permit, and the enlargement of the fiscal space through well-designed policies that facilitate transition to the formal economy. In this context it is to be kept in mind that respect for core labour standards is not only a key social goal, but also creates the conditions for balanced economic development, itself conducive to greater prosperity in the long-run.

154. It is crucial to build up administrative and institutional capacity to make these programmes effective and to engage social dialogue as part of the strategy. The recent Mexican anti-crisis reform ("*Acuerdo nacional en favor de la economía familiar y el empleo*") provides an interesting example of what can be done.

… and creating a global jobs fund

155. Some countries are better-positioned than others. For example, those which took steps to better manage their economies and avoid excessive risk-taking and leverage are likely to be impacted less. Others are confronted with an array of challenges including limited fiscal space, a fragile current account, and potential runs on their currency. Indeed, countries inheriting large fiscal and current account deficits will be much more vulnerable, especially if these imbalances are driven by exogenous circumstances (most notably the need to cope with the terms of trade shock unleashed by the food and fuel price crisis of mid-2008).

156. Circumscribing policy options of particular developing countries with a framework of conditionalities by international financial institutions will compound the difficulties faced by such countries (see Box 8).[88]

157. What is needed is a counter-cyclical global mechanism, as advocated by some analysts.[89] For instance, a global jobs fund would provide support to countries facing the global crisis. It would rely on a line of credit separate from that of the traditional IMF package. And it would provide the necessary stabilization credit needed to sustain the

[88] More details on these issues will be provided in a forthcoming ILO publication by Employment Sector specialist.
[89] See for instance UNDESA: *Massive, globally coordinated fiscal stimulus is needed: going from the drawing board to swift action,* Policy Brief No. 11, January 2009. Also, the World Bank has called for the creation of a fund to help vulnerable countries.

external crisis without aggravating social hardship. Indeed the credit would not be subject to the condition that social protection and minimum wages be cut. Instead, it would be used to help revitalize the economy through investments that strengthen development prospects. Importantly, the measures would be adopted as part of national dialogue, so as to improve social cohesion. Involvement of the ILO, side by side with IMF and World Bank, would be crucial. Indeed, as shown in the third section of this paper, ILO has the expertise to design programmes that help create decent work and sustainable enterprises.

158. The President of the UN General Assembly has established the Commission of Experts on Reforms of the International Monetary and Financial System (the so-called Stiglitz Commission) to draw attention to the asymmetries in the capacities of developed and developing nations to respond to the crisis, among a range of other important issues. Through its position in the UN system, the ILO can support the Commission's work by pointing to the employment and social consequences of existing and proposed solutions to crises in developing countries.

Box 12. Macroeconomic stabilization in the wake of financial/economic crisis

Pakistan: In November 2008 Pakistan entered a stand-by arrangement with the IMF for a $7.6 billion adjustment programme to cope with its rising fiscal and current account deficits and price inflation. The adjustment programme calls for a reduction of the fiscal deficit to 4.2 per cent in 2008-09, and to 3.3 per cent during 2009-10, and an interest rate hike of 200 basis points to 15 per cent. These measures would inevitably dampen aggregate demand and the government has already lowered its growth rate forecast from 5.8 per cent achieved in 2007-08 to 4.4 per cent in 2008-09, with official admissions of worsening of unemployment and poverty. They would also run counter to policies advocated in international *fora* to stimulate the global economy. Indeed, the above *pro-cyclical* measures are likely to dampen global demand even further, and exacerbate poverty and unemployment in both Pakistan and its trading partners.

Ukraine: Between 2000 and mid 2008 Ukraine's economy was buoyant, with average annual growth in excess of 7 per cent. The fiscal position of the country was generally sound and the level of public foreign debt was moderate. However, in November 2008 the country signed a standby agreement with the IMF for $16.4 billion. This move came as a result of Ukraine's faltering economy in the second half of 2008 when commodity prices declined sharply, export markets contracted, and a large bank was placed under receivership – events which sparked massive capital outflows, a crisis on the foreign exchange market, significant currency devaluation, a major credit crunch in the real economy, and a massive increase in unemployment.

The recapitalisation of commercial banks is a high priority in the standby agreement with the IMF, but this is an extremely expensive undertaking. It is estimated that bank recapitalisation will cost at least 8 per cent of GDP, including 4.5 per cent of GDP for recapitalisation of foreign-owned banks. Given that a significant proportion of the recapitalisation costs will be borne by the government, at a time when tax revenues are declining dramatically, the government is required to significantly reduce other areas of public expenditure to produce a balanced budget in 2009 (as per IMF provisions).

Much of the fiscal tightening is expected to come through reduced expenditure on public sector wages and benefits, reductions in the overall level of social expenditure, revised indexation arrangements for social transfers, and a postponement of a planned increased in the minimum wage. These reforms imply a significant decline in the real value of pensions and other transfer payments, and a fall in real minimum wages. While it is important to restore the flow of credit to viable enterprises, the costly

recapitalisation of the banks raises concerns, particularly when the opportunity cost is a substantial reduction in public expenditure on social security.

Source: Planning Commission: *Economic Stabilization with a Human Face,* Report of the Panel of Economists, GOP, October 2008; Z.M. Nasir: *National Policy Responses to the Financial and Economic Crisis*, 2009 (mimeo), (Pakistan); R. Kyloh and C. Saget: *A common crisis but contradictory responses: The European experience 2008/09*, (Ukraine), ILO Policy Integration Department, forthcoming 2009.

In sum, a global jobs pact with decent work principles at the fore can pave the way for a more sustainable economy in the longer term

159. It is imperative that responses to the crisis should not just be seen as piecemeal measures to be rolled out temporarily, only to revert back to "business as usual" as soon as possible. The challenge now is to respond to the current crisis through measures, which, as discussed above, pave the way for a better pattern of growth and development. Global coordination efforts currently underway could increase the propensity for multilateralism to tackle development challenges more creatively and effectively in the future.

160. In this way, international partners can contribute to a better global economy and society, which, together with a new financial system, can form the foundation for more sustainable development. In this respect, the ILO has an important role to play within the multilateral system, in cooperation with its partners at the national level, to advance opportunities for women and men around the globe to live and work in conditions of freedom, equity, security and dignity.

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

23 March 2009

Excellency,

On 28 January 2009 I circulated the first draft General Assembly resolution on modalities for the United Nations Conference at the highest level on the World Financial and Economic Crisis and Its Impact on Development. The process of developing that draft included an extensive set of briefings by my staff to Members and groups. Although these were not intended to be consultations, numerous comments and suggestions were received and most were reflected in the first draft resolution.

After consultation with the General Assembly on February 12, I presented a revised draft on 18 February and named a facilitator, the distinguished Permanent Representative of the Republic of Namibia, H.E. Kaire Mbuende to lead the process of consultations among Members to build consensus for the procedural resolution.

By all accounts, the extensive process of consultations, drafting, and negotiations that Ambassador Mbuende has led through last week has helped to bring the Members toward a common understanding of the mandate, scope, and structure of the conference, and has helped to clarify and narrow differences on all other issues. I want to record here the many expressions of deep appreciation I have received from Member states for the outstanding leadership and perseverance of Ambassador Mbuende. Under his stewardship, the confidence of this body concerning the June conference has been palpably strengthened.

The work of preparing the procedural resolution for the June conference is not yet completed. Yet, after receiving Ambassador Mbuende's report on Friday, I am confident that the remaining issues are not the most difficult, and that with continued good will we can close this initial process by the end of the month.

Enclosed herewith is the latest compilation text, with double-bracketed headings indicating the purpose of each numbered paragraph. There are, as it seems to me, five outstanding issues:

All Permanent Representatives
and Permanent Observers
to the United Nations

(1) The Nature of the Outcome of the Conference: It is broadly agreed that the Conference should result in some form of "text" (to choose what I believe is the most neutral word), and that the text should be intergovernmentally agreed. This is in addition to a Conference Report. It is evident that Members also broadly agree that the form of the document should be appropriate to the occasion and intend that the document should be at once relatively brief and concise, and should reflect important decisions that will enable the assembled world leaders to present a common purpose and an agreed plan of action. I share this perspective and believe that we must strive for focus, coherence, and clarity.

The world expects the Conference to provide a sense of direction and a demonstration of leadership. Members must manage the preparatory process jointly so as not to disappoint these expectations.

(2) Participation in the preparatory process and in the Conference by non-Members: There is broad agreement that the preparatory process should be made open to civil society organizations, including the private sector organizations, UN system specialized agencies, including the Bretton Woods institutions, regional development banks, and the WTO under rules adopted for the Monterrey and Doha Financing for Development conference. There is also broad agreement that the heads of the key agencies should be invited to address the Conference in plenary session. Because of the pressure of time, and the expected participation by a large number of countries at the head of states or head of government level, there is concern among many members that the conference should be conducted under the standing rules of the General Assembly. I believe we can find language to accommodate these understandings and concerns.

(3) Preparation of the Information Note: Some Members have expressed concern that the Conference should be prepared by the Secretariat, which has the experience and resources and which can also be held accountable to the Members. Since it has already been agreed twice, in the Doha declaration of 2 December 2008 and GA resolution 63/239, that the conference shall be organized by the President of the General Assembly, it is only natural and highly desirable that the conference should be organized by the secretariat albeit in close collaboration with the President of the General Assembly.

(4) Economic and Social Council inputs: It is broadly agreed that the High-level Meeting of the ECOSOC with the Bretton Woods institutions, the WTO and UNCTAD is a vital opportunity for Members to interact directly with leaders of those institutions, and that the ECOSOC President's report of that meeting would be a valuable input to the conference preparation. Here I find the proposal of the European Union to be a solicitous expression of that shared view.

(5) Preparation of the first draft outcome text: The language of operative paragraph 7 (OP7) has attracted considerable attention in the consultation process. It is evident that at least two major points are held in common. First, all parties have agreed

that the process of preparing the draft should be open, transparent, and inclusive. And second, all parties have agreed that Member states should take the lead in developing the draft. Not stated in the text, but a clear expectation of all parties, is the view that facilitators should be named to lead the negotiating process. On all of these points, I want to clarify, I am in complete agreement. The outstanding issue seems to revolve around who should prepare the first draft. My view is that the manner of the preparation of the first draft of an outcome text is a matter that is normally left to the discretion of the President of the General Assembly. In the present case, it is evident that this process of drafting should be done in close collaboration with the facilitators, and that the initial draft should be jointly agreed between the President of the General Assembly and the facilitators, as has been the process in other sensitive areas, such as Security Council reform.

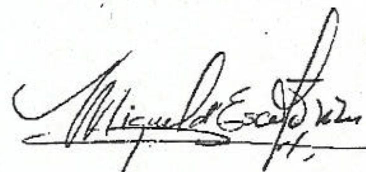
In order to accelerate the negotiating process, and to enable Members to begin the vital work of preparing for the June conference at the highest level, now scarcely more than two months away, I am convening an informal plenary meeting of the General Assembly at the Ambassadorial level tomorrow, Tuesday, 24 March, at 4:00 pm.

It is vitally important now that we finalize our plans to complete the work on the modalities resolution by March 31. In order to accomplish this, I wish to take the views of the Members on the remaining issues.

If we are in substantial agreement with the views I have expressed here, then it should be possible to allow the informal consultation process to continue for one or two more days, with the process completing no later than Thursday night. In the event that it appears we are not in substantial agreement, then it may be necessary to produce a Rev 2 and present that document in an informal consultation on Thursday. In either case, I intend to table a modalities resolution no late than Friday morning March 27, and to convene the General Assembly for its formal consideration on Tuesday afternoon, March 31.

I look forward to meeting with you tomorrow.

Please accept, Excellency, the assurance of my highest consideration.



Miguel d'Escoto Brockmann

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

25 March 2009

Excellency,

I have the honour to refer to General Assembly resolution 63/239 on the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development adopted on 24 December 2008.

I am pleased to announce my decision to appoint the Permanent Representative of the Netherlands, H.E. Frank Majoor and the Permanent Representative of Saint Vincent and the Grenadines, H.E. Camillo Gonsalves as facilitators to complete the negotiations on the resolution on modalities and to facilitate the preparatory process of the Conference.

I take this opportunity to thank the facilitators for kindly accepting this responsibility.

Please accept, Excellency, the assurances of my highest consideration.

Miguel d'Escoto Brockmann

All Permanent Representatives
and Permanent Observers
to the United Nations

2 April 2009

Excellency,

As you are aware from the proceedings of the 78th plenary meeting of the General Assembly, held yesterday, 31 March 2009, action on draft resolution A/63/L.66 on the modalities of the organization of the United Nations conference at the highest level on the world financial and economic crisis and its impact on development has been postponed to a later date to allow time for the review by the Fifth Committee of the programme budget implications of the draft resolution.

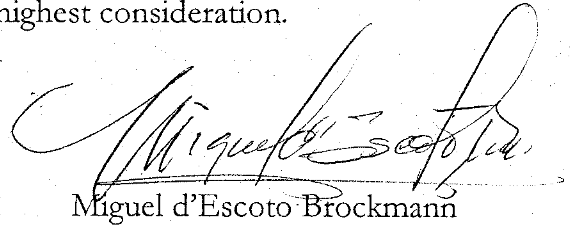
In the mean time, it has been drawn to my attention that the date 1 to 3 June 2009, intended for the convening of the Conference, poses difficulties for a considerable number of countries. There are several high level parallel meetings that will be held during the first few days of June. From 1 to 3 June, the 39th regular session of the Organization of American States at ministerial level will be held in San Pedro, Honduras. On 1 June is the inauguration day for the new government of El Salvador. From 4 to 7 June, European Union Member States will conduct European Parliament elections. In the period 4 to 7 June, the Russian Federation will be hosting the International Economic Forum as well as the World Grain Forum in Saint Petersburg. It is my understanding that these events will affect the schedules of Heads of State and Government of several Member States.

In view of the above and in order that participation at the United Nations conference can be at the highest level for a meaningful outcome, it becomes necessary to find a date that is convenient to Member States. In this connection, I propose to convene the United Nations conference from 9 to 11 June 2009, instead of 1 to 3 June as originally planned. I will be grateful for your understanding and cooperation.

All Permanent Representatives
and Permanent Observers
to the United Nations

In the absence of comments by Member States by noon, Monday, 6 April, we will consider this proposal to be approved. The co-facilitators will then make the necessary arrangements for the change. It is my intention to schedule a plenary meeting on Tuesday, 7 April for the General Assembly to take action on this revised draft resolution. By then, it is expected that the Fifth Committee will have concluded its deliberation on the draft resolution.

Please accept, Excellency, the assurances of my highest consideration.



Miguel d'Escoto Brockmann

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

6 April 2009

Excellency,

Following consultations with the Co-facilitators and Member States on the date of the Conference at the highest level on the World Financial and Economic Crisis and its Impact on Development, I have the honour to inform you that it was decided that the date of the Conference will be from 1 to 3 June, as originally planned.

Please accept, Excellency, the assurances of my highest consideration.

Miguel d'Escoto Brockmann

All Permanent Representatives
and Permanent Observers
to the United Nations

UNITED NATIONS NATIONS UNIES

NEW YORK

OFFICE OF THE PRESIDENT OF THE GENERAL ASSEMBLY

URGENT

21 May 2009

Excellency,

Reference is made to the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development, scheduled to be held from 1 to 3 June 2009 in accordance with General Assembly resolutions 63/239 of 24 December 2008 and 63/277 of 7 April 2009.

You will kindly recall that in the letter of the President of the General Assembly, H.E. Miguel d'Escoto Brockmann of 1 April of this year, he alerted Member States about a number of important meetings taking place in other parts of the world around that time and would be attended by a large number of Heads of State and Government.

In the past few days, many representatives have called upon the President to request a brief deferral to 24 to 26 June 2009 to convene this important Conference, in order to facilitate the participation of their Governments at the highest level. Furthermore, the facilitators have informed the President that the intergovernmental negotiations are proving to be most challenging.

To ensure that the Conference can take full advantage of this historic and unique opportunity for the Member States and the United Nations system as a whole to address the dire and critical financial and economic situation of the world and its impact on development, especially on the developing countries, as well as to forge a common and lasting solution in the form of a meaningful outcome to be adopted by Heads of State and Government, *the President is convening a plenary meeting tomorrow, Friday, 22 May 2009 at 3p.m.* to take action on this proposed postponement.

Please accept, Excellency, the assurances of my highest consideration.

Norman Miranda
Ambassador
Chef de Cabinet

All Permanent Representatives and
Permanent Observers to the United Nations.

THE PRESIDENT
OF THE
GENERAL ASSEMBLY

22 May 2009

Excellency,

It is our common endeavour to ensure the success of the United Nations Conference on the World Financial and Economic Crisis and its Impact on Development. We believe that success will depend on a positive and forward looking outcome document and the active engagement of the political leadership of the Member States at the highest possible level.

With this in view I have carried out extensive consultations with the Permanent Representatives representing all the regional groups and negotiating groups and with the Heads of State and Government of several countries. In the coming days I shall continue to do so.

I have heard the concerns expressed by some Member States. I would like to reiterate that this process will be open, comprehensive, transparent and inclusive and, above all, driven by Member States. I am therefore committed to ensuring that the draft outcome document, at all stages of its evolution, would be negotiated and approved by Member States by consensus consistent with resolution 63/277.

I appeal to all Member States to agree on this document *no later than Monday, 15 June*. I am confident that Member States will demonstrate the necessary political will and good faith towards this end and I will empower the two facilitators to play their role independently in coordination and cooperation with Member States.

On this basis and for the sake of both a good outcome document and high level attendance, I believe there would be consensus on the Conference being rescheduled to 24 to 26 June 2009.

Please accept, Excellency, the assurances of my highest consideration.

Miguel d'Escoto Brockmann

All Permanent Representatives
and Permanent Observers
to the United Nations

DRAFT

A/63/XXX

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19 March 2009

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Sixty-third sessions
Agenda item 48
Follow-up to and implementation of the outcome of the 2002 International Conference on Financing for Development and the preparation of the 2008 Review Conference

Recommendations by the Commission of Experts of the President of the General Assembly on reforms of the international monetary and financial system

Note by the President of the General Assembly

1. The outbreak of the financial crisis in 2008 originated in the advanced developed countries, but has spread quickly to become a world economic crisis that affects all countries, including the emerging economies and less developed countries.

2. To review the workings of the global financial systems and to explore ways and means to secure a more sustainable and just global economic order, I have convened a Commission of Experts, chaired by Professor Joseph Stiglitz, 2001 Nobel laureate Prize winner in Economics, and comprised of a outstanding economists, policy makers, and practitioners drawn from Japan, Western Europe, Africa, Latin America, South and East Asia. These experts were chosen based on their comprehensive understanding of the complex and interrelated issues raised by the workings of the financial system. The Commissioners are also individuals recognized for their strong grasp of the strengths and weaknesses of existing multilateral institutions as well as their sensitivity to the particular challenges facing countries from different regions of the world and at different levels of economic and social development.

3. I now have the pleasure to transmit the preliminary recommendations of the Commission for your consideration. These recommendations and the analysis that underlies them will figure prominently in the interactive thematic dialogue on "The World Financial and Economic Crisis and its Impact on Development", which I will convene from 25 to 27 March 2009 at United Nations Headquarters in New York. It is my hope that Members of the General Assembly will find these recommendations, and the dialogue next week, useful as they prepare for the United Nations Conference on World Economic and Financial Crisis and Its Impact on Development, which will be convened in little more than two months time in accordance with General Assembly resolution 63/239 of 24 December 2008.

THE COMMISSION OF EXPERTS ON REFORMS OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

Recommendations
19 March 2009

I. Preamble

1. The rapid spread of financial crisis from a small number of developed countries to engulf the global economy provides tangible evidence that the international trade and financial system needs to be profoundly reformed to meet the needs and changed conditions of the 21st century. Past economic crises have had a disproportionate adverse impact on the poor, who are least able to bear these costs and that can have consequences long after the crisis is over.

2. While it is important to deal with the structural changes to adapt the international system to prevent future crisis, this cannot be achieved without significant measures to promote recovery from the current crisis whose impact may be even worse than in the past. The International Labour Organization estimates that the rise in unemployment in 2009 compared to 2007 of 30 million could reach more than 50 million if conditions continue to deteriorate. Some 200 million people, mostly in developing economies, could be pushed into poverty if rapid action is not taken to counter the impact of the crisis on developing countries. Even in some advanced industrial countries, millions of households are faced with the threat of losing their homes and access to health care, while economic insecurity and anxiety is increasing among the elderly as they lose their life-time savings in the collapse of asset prices.

3. The welfare of developed and developing countries is mutually interdependent in an increasingly integrated world economy. *Short term measures to stabilize the current situation must ensure the protection of the world's poor, while long term measures to make another recurrence less likely must ensure sustainable financing to strengthen the policy response of developing countries.* Without a truly inclusive response, recognizing the importance of all countries in the reform process, global economic stability cannot be restored, and economic growth, as well as poverty reduction worldwide will be threatened.

4. This inclusive global response will require the participation of the entire international community; it must encompass more than the G-7 or G-8 or G-20, but the representatives of the entire planet, from the G-192. It was to respond to this need that the President of the General Assembly created the present Commission of Experts to address the measures needed to meet the crisis and recommend longer term reforms. Recognising work being undertaken by the G-8 and the G-20, and other

bodies, the Commission sees its own work as complementary, seeking to focus on impacts of the crisis and responses to the crisis on poverty and development.

5. Reform of the International system must have as its goal the better functioning of the world economic system for the global good. This entails simultaneously pursuing long term objectives, such as sustainable and equitable growth, the creation of employment in accordance with the "decent work" concept, the responsible use of natural resources, and reduction of greenhouse gas emissions, and more immediate concerns, including addressing the challenges posed by the food and financial crises. As the world focuses on the exigencies of the moment the long standing commitments to the achievement of the Millennium Development Goals and protecting the world against the threat of climate change must remain the overarching priorities; indeed, appropriately designed global reform should provide an opportunity to accelerate progress toward meeting these goals.

II. Responding to the Global Financial Crisis

6. Sustainable responses to the crisis require identifying the factors underlying the crisis and its rapid spread around the world. Loose monetary policy, inadequate regulation and lax supervision interacted to create financial instability. The results were manifest in the large global imbalances whose disorderly unwinding in the absence of prompt countercyclical measures may aggravate the crisis.

7. Part of the reason for inadequate regulation was an inadequate appreciation of the limits of markets—what economists call "market failures." While such failures arise in many markets, they are particularly important in financial markets and can have disproportionately large consequences as they spill over into "real" economic activity.

8. The conduct of monetary policy can be traced in part to an attempt to offset an insufficiency of global aggregate demand, aggravated by increasing income inequality within most countries. Monetary conditions were also influenced by the accumulation of foreign exchange reserves by some emerging market countries seeking protection from global instability and onerous conditions traditionally attached to assistance from the multilateral financial institutions.

9. The current crisis reflects problems that go beyond the conduct of monetary policy and regulation of the financial sector. It also involves deeper inadequacies in areas such as corporate governance and competition policies. Many of these failings, in turn, have been supported by a flawed understanding of the functioning of markets, which also contributed to the recent drive towards financial deregulation. These views have been the basis for the design of policies advocated by some of the international economic institutions, and for much of the architecture of globalization.

10. More generally, the current crisis has exposed deficiencies in the policies of some national authorities and international institutions based on previously fashionable economic doctrines, which held that unfettered markets are, on their own, quickly self-correcting and efficient. Globalization too was constructed on these flawed hypotheses; and while it has brought benefits to many, it has also enabled defects in one economic system to spread quickly around the world, bringing recessions and impoverization even to developing countries that have developed good regulatory frameworks, created effective monetary institutions, and succeeded in implementing sound fiscal policies.

11. The Principles and Recommendations outlined in this Report seek to address the underlying problems. They focus both on feasible interim steps that can and should be taken immediately, and the deeper medium and longer term reforms that are necessary if we are to make another such crises less likely, and if we are to strengthen the international community's capacity to respond to a crisis, should one occur.

12. In analyzing appropriate national and global responses to the crisis, the Commission noted the following principles:

13. Failure to act quickly to address the global economic downturn inevitably would increase its depth and duration and the eventual cost of creating a more balanced robust recovery.

14. In a globally integrated world, the actions of any one country have effects on others. Too often these *externalities* are not taken into account in national policy decisions. Developed countries in particular need to be aware of the adverse consequences of these externalities, and developing countries need frameworks to help protect themselves from regulatory and macro-economic failures in systemically significant countries.

15. Developing countries should have expanded scope to implement policies and create institutions that will allow them to implement appropriate counter-cyclical policies.

16. Advanced industrial countries should observe their pledges not to undertake *protectionist* actions, and even more importantly insure that stimulus packages and recovery programs do not further distort the economic playing field and further increase global imbalances.

17. Measures to restore domestic financial markets in developed countries through *subsidies* to financial institutions have been accompanied by a sharp reduction in flows of capital to developing countries. It is important to ensure that these measures do not create a new form of financial protectionism. Financial subsidies can be just as detrimental to the efficiency of a free and fair trading system as tariffs. Indeed, they

may be far more inequitable, because rich countries have more resources to support subsidies.

18. Greater transparency on the part of all parties in responding to the crisis is necessary. More generally, democratic principles, including inclusive participation in decision making, should be strengthened and respected.

19. The crisis is, in part, a result of excesses in deregulation of financial markets and in international trade. Restoring the global economy to health will require restoring a balance between the role of the market and the role of the state.

20. In responding to this crisis, it is imperative that actions to improve conditions in the short term do not result in structural changes which increase instability or reduce growth in future.

21. It is essential that governments undertake reforms that address some of the underlying factors that contributed to the current economic crisis if the world is to emerge from the crisis into sustainable, balanced growth. It is not enough simply to return to the status quo *ex ante.*

22. Appropriately designed short run measures may be complementary to long term goals, especially those related to climate change and the environment.

III. Immediate Measures

23. The current crisis must be met with rapid and effective measures, but it must also lay the basis for the long-run reforms that will be necessary if we are to have a more stable and more prosperous global economy and avoid future global crises.

24. Ten immediate measures are essential for global recovery.

1. All developed countries should take strong, coordinated, and effective actions to stimulate their economies.

25. Stimulus should be timely, have large "multipliers," help address the strains posed by the economic downturn on the poor, help address long run problems and prevent instability. While the decision on stimulus is national, it should be judged on its *global impacts;* if each country looks only at the national benefits versus costs, e.g. an increased national debt, the size of the global stimulus will be too small, spending will be distorted, and the global impact will be eviscerated.

26. *National stimulus packages should thus include spending measures to be undertaken in developing countries to offset the impact of the decline in world trade and financial market disintermediation. Industrialised countries should thus dedicate 1.0 per cent*

of their stimulus packages, in addition to traditional official development assistance commitments.

2. **Developing countries need additional funding**

27. More permanent and stable sources of funding for developing countries (See Section IV.10 below) that could be activated quickly and are not subject to inappropriate conditionality are necessary. Indeed, additional funding would be required just to offset the imbalances and inequities created by the massive stimulus and bail-out measures introduced in advanced industrialised countries. Such funding could be provided by an issuance of Special Drawing Rights approved by the IMF Board in September 1997 through the proposed Fourth Amendment of the Articles of Agreement to double cumulative SDR allocations to SDR 42.8 billion and through the issuance of additional SDRs through standard procedures.

28. In addition regional efforts to augment liquidity should be supported. For instance, extension of liquidity support under the Chiang Mai initiative without an IMF program requirement should be given immediate consideration. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighbouring countries.

29. These additional sources of funding should be in addition to traditional official development assistance. Failure to maintain the levels of official assistance will have long-term effects. There will be an increase in poverty and malnutrition and the education of many young people will be interrupted, with life-long effects. The sense of global social solidarity will be impaired, making agreement on key global issues, such as responding to the challenges of climate change, more difficult. Failure to provide such assistance can be counterproductive even in a more narrow sense: it can impair the global recovery.

30. *Developed countries must make a renewed effort to meet the commitments made in the Millennium Declaration, the Monterrey Consensus, the 2005 Global Summit, and the Doha Declaration by 2015.*

3. **Mobilizing Additional Development Funds by the Creation of a New Credit Facility**

31. The creation of a new credit facility is thus a matter of urgency. If such a facility could be created in a timely way, it could be a major vehicle for the disbursement of the requisite additional funding.

32. Given the need for rapid response, the new credit facility might be more quickly established under the umbrella of existing institutions, such as the World Bank, where

efforts are underway to remedy existing inadequacies in governance and lending practices, or in Regional Development Banks where developing countries have more equitable representation.

33. Or alternative institutional arrangements that create competition amongst institutions providing financial assistance might be envisaged. Such competition might not only increase the efficiency of disbursement, but also reduce the application of procyclical conditionality linked to financial support.

34. Whatever form is chosen, the new facility should have governance more reflective of democratic principles, with strong representation of developing countries and those countries contributing to the facility. These new governance arrangements might provide lessons for the reform of existing institutions.

35. Administration of the Facility could be done by staff seconded from existing multilateral financial institutions or central banks. The new facility could draw upon financial contributions from all countries. It could leverage any equity funds contributed by borrowing, including on the market or from those with large reserves or Sovereign Wealth Funds. Its ability to borrow could be enhanced through guarantees provided by governments, especially those of the advanced industrial countries. These alternative arrangements should be seen as a complement to expanded financial support from existing institutions,

4. Developing Countries need more policy space

36. There are asymmetries in global economic policies—countercyclical policies are pursued by developed countries, while most developing countries are encouraged or induced to pursue pro-cyclical policies. While this is partly due to the lack of resources to pursue countercyclical policies, it is also due to misguided policy recommendations from international financial institutions. Conditionality attached to official lending and support for international financial institutions has often required developing countries to adopt the kinds of monetary and regulatory policies which contributed to the current crisis. In addition, these conditionalities contribute to global asymmetries, disadvantage developing countries relative to the developed, and undermine incentives for developing countries to seek support funding, contributing to global economic weakness. While the IMF initiatives to reduce conditionalities are to be commended, they might be insufficient, while in many cases countries are still required to introduce pro-cyclical policies.

5. The lack of coherence between policies governing trade and finance must be rectified.

37. Policy space is circumscribed not only by a lack of resources, but also by international agreements and by the conditionalities that often accompany assistance.

Many bilateral and multilateral trade agreements contain commitments that circumscribe the ability of countries to respond to the current crisis with appropriate regulatory, structural, and macro-economic reforms and rescue packages, and may have exposed them unnecessarily to the contagion from the failures elsewhere in the global economic system. *Developing countries especially need policy frameworks that can help protect them from regulatory and macro-economic failures in systemically significant countries.* Developing countries have had imposed on them not only deregulation policies akin to those that are now recognized as having played a role in the onset of the crisis, but also have faced restrictions on their ability to manage their capital account and financial systems (e.g. as a result of financial and capital market liberalization policies); these policies are now exacting a heavy toll on many developing countries.

6. Crisis response must avoid protectionism

38. Overt protectionism includes tariffs and domestic restrictions on procurement contained in some stimulus packages. Because of complex provisions and coverage of international trade agreements, seemingly "symmetric" provisions (e.g. exceptions of the application of provisions to countries covered by particular WTO or other international agreements) can have markedly asymmetric effects. Subsidies, implicit and explicit, can, as has been noted, be just as distorting to open and fair trade. There may, in some cases, be pressure for banks receiving large amounts of government assistance to focus on lending domestically. While the temptation that gives rise to such measures is understandable, efforts need to be made to finance additional support to developing countries to mitigate the impact of the crisis as well as of both open and hidden subsidies (i.e. state assistance through lending programs and guarantees) in order to avoid further distortions.

7. Opening advanced country markets to least developed countries' exports

39. While a successful completion of the Doha trade round would be welcome, its impact on the crisis and its development dimension are still unclear (see IV.9, below). There are, however, a number of measures that have already been agreed in multilateral trade negotiations which could be implemented rapidly to support developing countries impacted by the crisis. These include implementation of duty-free, quota-free market access for products originated from LDCs. In addition, the agreement reached at the WTO´s Hong Kong Ministerial session in 2005 provided for the elimination of all forms of developed country export subsidies, at the latest by 2013, should be implemented immediately. There is no reason to await a general agreement before implementing these measures. In addition, domestic support for cotton subsidies should be abolished immediately, as they distort prices to the detriment for African countries. More generally, in all trade negotiations, the long recognized principle of special and differential treatment of developing countries should be preserved.

8. Learning from Successful Policies to undertake Regulatory Reforms.

40. The financial crisis is widely viewed to be the result of the failure of regulatory policies in the advanced industrial countries. While full regulatory reforms (discussed more extensively in section IV.6 below) will take time, it is imperative that work on regulatory reform begin now. The collapse in confidence in the financial system is widely recognized as central in the economic crisis; restoration of confidence will be central in the recovery. But it will be hard to restore confidence without changing the incentives and constraints facing the financial sector. *It is imperative that the regulatory reforms be real and substantive, and go beyond the financial sector to address underlying problems in corporate governance and competition policy, and in tax structures, giving preferential treatment to capital gains, that may provide incentives for excessive leverage.* While greater transparency is important, much more is needed than improving the clarity of financial instruments. Even if there had been full disclosure of derivative positions, their complexity was so great as to make an evaluation of the balance sheet position of the financial institutions extraordinarily difficult. Still, there is need for much greater transparency, including forbidding off balance sheet transactions and full expensing of employee stock options.

41. Well regulated economies have to be protected from competition from economies with inadequate or inappropriate regulatory systems. The problems of regulatory arbitrage and tax evasion are closely linked. Tax havens and financial centers in both developed and developing countries *that fail to meet basic standards of transparency, information exchange and regulation should be given strong incentives to reform their practices*, e.g. by restricting transactions between financial institutions in those jurisdictions and those in more highly regulated countries. Institutional arrangements for improving harmonisation and transparency should be strengthened, including the United Nations Committee of Experts on International Cooperation in Tax Matters as proposed in Paragraph 16 of the Doha Declaration. Also other international arrangements and conventions such as United Nations Convention against Corruption should also be strengthened.

9. Coordinating the Domestic and Global Impact of Government Financial Sector Support

42. Government bail-outs have substantial redistributive consequences that must be analysed in assessing their impact on recovery. In addition, because of the urgency of the situation they often fail to observe principles of good governance and especially of democratic transparency. This may lead to the introduction of inappropriate incentives, as well as failure to recognise possible adverse effects on other countries, especially on developing countries that lack equivalent financial resources.

Developed countries should undertake their financial support policies recognising that even symmetric policies can have asymmetric effects because guarantees by developing country governments are likely to be less meaningful than those by developed countries.

43. Failure to recognise these wider domestic and global consequences of financial support measures have often meant that the costs to the government and to developing countries have been higher than necessary. Funds have often been redistributed to those with higher incomes, and have created distorted incentives. Support measures for financial institutions that are implemented by Central Banks risk imposing high costs on the public purse, without adequate parliamentary oversight of appropriations. *Greater transparency on the part of all parties would facilitate a more effective response to the crisis.*

10. Improved coordination of global economic policies

44. There is a need for substantial improvement in the coordination of global economic policy. Global economic integration has outpaced the development of the appropriate political institutions and arrangements for governance of the global economic system. Remedying this lacuna is a matter of urgency, discussed at greater length in section IV.3, but this will not happen overnight.

45. In the short term, there should be an appropriate mechanism within the United Nations System for independent international analysis on questions of global economic policy, including its social and environmental dimensions. Following the successful example of the Intergovernmental Panel on Climate Change (IPCC), a similar panel could be created to offer consultancy to the General Assembly and ECOSOC, but also to other international organizations to enhance their capacity for sound decision-making in these areas. At the same time, such a panel would contribute to foster a constructive dialogue and offer a regular venue for fruitful exchange between policy makers, the academic world and key international organisations. The panel should comprise well respected academics from all over the world, appropriately representing all continents, as well as representatives of international social movements. Being made up of outstanding specialists, the panel should be able to follow, analyse and assess long-term trends, key developments and major dynamics for global change affecting all people around the globe, identify problems in the global economic and financial architecture, and jointly provide options for coherent international action and recommendations for political decision-making processes.

IV. Agenda for Systemic Reforms

46. There is an equally important agenda of deeper systemic reforms to the international system, that should begin now, if we recovery is to be sustainable.

1. A New Global Reserve System

47. The global imbalances which played an important role in this crisis can only be addressed if there is a better way of dealing with international economic risks facing countries than the current system of accumulating international reserves. Indeed, the magnitude of this crisis and the inadequacy of international responses may motivate even further accumulations. Inappropriate responses by some international economic institutions in previous economic crises have contributed to the problem, making reforms of the kind described here all the more essential. To resolve this problem ***a new Global Reserve System***—what may be viewed as a greatly expanded SDR, with regular or cyclically adjusted emissions calibrated to the size of reserve accumulations—could contribute to global stability, economic strength, and global equity. Currently, poor countries are lending to the rich reserve countries at low interest rates. The dangers of a single-country reserve system have long been recognized, as the accumulation of debt undermines confidence and stability. But a two (or three) country reserve system, to which the world seems to be moving, may be equally unstable. The new Global Reserve System is feasible, non-inflationary, and could be easily implemented, including in ways which mitigate the difficulties caused by asymmetric adjustment between surplus and deficit countries.

2. Reforms of the Governance of the International Financial Institutions

48. There is a growing international consensus in support of reform of the governance, accountability, and transparency in the Bretton Woods Institutions and other non-representative institutions that have come to play a role in the global financial system, such as the Bank for International Settlements, its various Committees, and the Financial Stability Forum. These deficiencies have impaired the ability of these institutions to take adequate actions to prevent and respond to the crisis, and have meant that some of the policies and standards that they have adopted or recommended disadvantage developing countries and emerging market economies. Major reforms in the governance of these institutions, including those giving greater voice to developing countries and greater transparency are thus necessary.

49. The reform of the World Bank's governance structure should be completed swiftly. For the second stage of the reform, focussing on the realignment of shares, three criteria could be taken into account: economic weight, contribution to the development mandate of the World Bank (for example, measured in terms of contributions to IDA and trust funds), and the volume of borrowing from the Bank.

50. For the IMF, serious consideration should be given to restoration of the weight of basic votes and the introduction of double or multiple majority voting.

51. Elections of the leaders of the World Bank and the International Monetary Fund should take place under an open democratic process.

3. A Global Economic Coordination Council.

52. A globally representative forum to address areas of concern in the functioning of the global economic system in a comprehensive way must be created. At a level equivalent with the General Assembly and the Security Council, such a Global Economic Council should meet annually at the Heads of State and Government level to assess developments and provide leadership in economic, social and ecologic issues. It would promote development, secure consistency and coherence in the policy goals of the major international organisations and support consensus building among governments on efficient and effective solutions for issues of global economic, governance. Such a Council could also promote accountability of all international economic organizations, identify gaps that need to be filled to ensure the efficient operation of the global economic and financial system, and help set the agenda for global economic and financial reforms. It would be supported intellectually by the work of the International Panel discussed in III.10. Representation would be based on the constituency system, and designed to ensure that all continents and all major economies are represented. At the same time, its size should be guided by the fact that the council must remain small enough for effective discussion and decision making All important global institutions, such as the World Bank, IMF, WTO, ILO and members of the UN Secretariat dealing with economic and social issues would provide supporting information and participate in the Council. It could thus provide a democratically representative alternative to the G-20.

4. Better and more balanced surveillance.

53. The surveillance of economic policies should be especially focused on systemically significant countries, those whose bad performance is most likely to have global consequences. Such surveillance should focus not just on inflation, but on unemployment, financial stability, systemic stability related to the presence of built in stabilizers or destabilizers, and systems of social protection.

5. Reforming Central Bank Policies to promote Development

54. Whereas price stability is desirable in support of growth and financial stability, it is not sufficient. Central Banks should therefore aim to ensure price stability in the context of delivering long-term sustainable growth, while being sensitive to the risks to financial stability, capital flows and exchange rates. Central banks also need to give consideration to financial market and asset price developments. This may entail Central Banks using a wider range of instruments, including prudential instruments. A distinction may need to be made between the roles of Central Banks in maintaining financial stability under normal circumstances and during crisis periods. Central

Bank governance arrangements may need to differ depending on their precise role. In particular, in any actions which may impose serious risks on a country's fiscal position, such as those now being implemented in many countries as part of financial institution resolutions, should be subject to coordination.

6. Financial Market Policies

55. Financial policies, including regulation, have as their objective not only ensuring the safety and soundness of financial institutions and stability of the financial system, but protection of bank depositors, consumers and investors and ensuring financial inclusion - such as access to all banking services including credit, and the provision of financial products which help individuals and families manage the risks they face and gain access to credit at reasonable terms. It is also imperative to make sure that the sector is competitive and innovative.

56. Financial institutions have been allowed to grow to be too big to fail, imposing enormous risk on the global economy. And while there has been innovation, too much of the innovation was aimed at regulatory, tax, and accounting arbitrage, and too little at meeting the real needs of ordinary citizens. Too little was done to help developing countries and ordinary homeowners manage the risks which they face, with consequences that have been repeatedly apparent. Financial regulation must be designed so as to enhance meaningful innovation that improves risk management and capital allocation.

57. The current crisis has made it apparent that there are large gaps and deficiencies in the regulatory structures in place in many systemically significant countries. It is also apparent that while effective regulatory system must be national there must be some global regulatory framework to establish minimum national standards and also govern the global operations of systemical relevant global financial institutions. The Report of the Commission will identify a number of key aspects of regulatory reform, emphasizing the need for deep and pervasive reforms and highlighting the risks of merely cosmetic changes in regulations. The following items are among the key aspects of needed reform.

(a) Financial Product Safety

58. Sustainable recovery will depend on appropriate regulations (across countries, products, and institutions). Regulations should be based on what things are, not what they are called, i.e. insurance products should be regulated the same way, whether called insurance or not. Financial regulators should be mandated to ascertain the safety and appropriate use of various financial instruments and practices, including through the creation of a Financial Products Safety Commission.

59. Core depository institutions should be restricted from undertaking excessively risky activities and tightly regulated. There also needs to be close oversight over all highly levered and all systemically significant institutions. But there should be oversight over all financial institutions. Institutions can quickly change into systemically significant.

(b) Comprehensive Application of Financial Regulation

60. The fact that correlated behavior of a large number of institutions, each of which is not systemically significant, can give rise to systemic vulnerability makes oversight of all institutions necessary. There needs to be tighter regulation of incentives, especially in the core institutions; part of the current problem is a result of distorted incentives which encouraged short sighted and excessively risky behavior. It may be easier to regulate incentives than every manifestation of perverse incentives. There need to be restrictions on leverage, with automatic countercyclical capital adequacy and/or provisioning requirements.

61. Although the activities of private investment funds, equity funds and hedge funds did not trigger the financial crisis, their regulation is not globally uniform, creating the potential for regulatory arbitrage and the potential for gaps in regulation. Funds should be registered in the countries of their operations and provide appropriate regulation to regulatory authorities. In addition, banks must define limits for transactions with hedge funds.

62. There should be no retreat from mark to market accounting for institutions with short-term funding in order to provide full transparency for investors and regulators. Other institutions may be encouraged to supplement mark-to-market accounting with valuations that are more appropriate to the maturity of their liabilities. In addition, steps should be taken to enforce transparency norms and public accountability for all public companies.

(c) Regulation of derivatives trading

63. The large scale use of unregulated, unsupervised OTC derivatives has resulted in undue complexity, opacity, and mis-pricing of these instruments, and facilitated capital avoidance by financial institutions. These practices have weakened our financial system significantly and made resolution of failing firms extremely difficult.

64. Where appropriate steps should be take to develop regulated exchanges for trading standardized contracts of systemically significant derivative contracts, with the associated regulatory restrictions including limits on non-commercial traders. Regulations should insure that derivative instruments are held on balance sheets, valued at independently audited real transaction prices, with appropriate capital provisioning, and clarity of purpose. The use of over the counter contracts by core

institutions should, in general, be discouraged, but whenever used, there should be ample and adequate margin.

(d) Regulation of Credit Rating Agencies

65. Other needed reforms, including for Credit Rating Agencies and systems of information provision are addressed in an Appendix.

(e) Towards global institutional arrangements for governing the global economy: a Global Financial Regulatory Authority; a Global Competition Authority.

66. The Financial Stability Forum was created in the aftermath of the 1997-8 financial crisis in order to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country, and to enhance the institutional framework to support global financial stability. It is now apparent that the reforms that it has proposed, although important, have not been sufficient to avoid major global financial instability. If it is to become the main instrument for the formulation of reforms of the global financial system it must take into consideration the importance of financial stability for the development of the real economy. In addition it must increase the representation of developing countries to adequately reflect the views and conditions in these countries and be made accountable to a democratically representative institution such as the Global Economic Coordination Council proposed above.

67. The development of financial institutions that are too big to fail has played an important role in the development of the crisis and has made the resolution of the crisis both difficult and costly, both for taxpayers and for the global economy. It is imperative not only that is adequate oversight of these large institution but that efforts be made to limit their size and the extent of their interactions, to limit the scope of systemic risk. This will require more effective global cooperation in financial and competition regulation. Movement towards this goal might be enhanced by taking steps to lay the groundwork for a Global Financial Regulatory Authority and a Global Competition Authority. With so many firms operating across borders, it is difficult to rely on national regulatory authorities. There may be large externalities generated by the action (or inaction) of national authorities. A potential, but partial, remedy to this difficulty is the proposal for a College of Supervisors to oversee systemically relevant global financial institutions. This could provide a basis for a more comprehensive Global Authority.

(f) Host Country regulation of foreign subsidiaries

68. In the absence of adequate global coordination, financial sector regulation will need to be based on the host country, not the home country, and may entail requiring the establishment of subsidiaries, rather than relying on branches.

(*g*) *Regulatory institutions*

69. While inadequate regulations are partly to blame for the current crisis, in some cases good regulations were not effectively applied and enforced. This highlights the need for reforms in regulatory structures, including reforms that make the possibility of regulatory capture less likely. The weaker is the system of global regulation, the more segmented will financial markets have to be to ensure global stability.

7. Support for Financial Innovations to Enhance Risk Mitigation

70. The absence of global systems of risk bearing and the absence of—and in some cases resistance to—innovations that would facilitate efficient risk bearing, such as GDP indexed bonds and mortgage products which better manage the risks associated with home ownership must be remedied. Governments and the international financial institutions need to explore meaningful innovations that would enhance risk management and distribution and how markets might be encouraged to do a better job. In particular, while there have been some expansion in capital markets in domestic currencies in developing countries, developing countries still bear the brunt of exchange and interest rate fluctuations. IFI lending in (possibly baskets of) local currencies and the provision of exchange and interest rate cover might be important steps in improving international risk markets.

8. Mechanisms for handling Sovereign Debt Restructuring and Cross-border Investment Disputes

71. There is an urgent need for renewed commitment to develop an equitable and generally acceptable Sovereign Debt Restructuring Mechanism, as a well as an improved framework for handling cross border bankruptcies. One way by which this might be done is through the creation of an independent structure, such as an International Bankruptcy Court. The United Nations Commission on International Trade Law provides a model that could be extended to the harmonization of national legislation on cross border disputes dealing with trade in financial services.

72. A number of countries may face difficulties in meeting their external debt commitments as the crisis worsens and debt rescheduling becomes more and more difficult due to an increase in creditors not represented in the Paris Club. The current crisis has already seen a number of bankruptcies of companies that operate across national borders, and their number is likely to increase. The absence of a formal mechanism for dealing with the impact of cross border bankruptcy and insolvency,

especially when related to financial institutions, transmits the adverse economic effects to the global economy.

73. It is especially important to achieve a uniform approach to financial and investment disputes on bankruptcy and insolvency, given the fact that the regulations dealing with these matters included in bilateral free trade agreements often transcend existing multilateral treaties and national legislation.

9. Completion of a Truly Development-Oriented Trade Round

74. There is a need for a true development round, to create an international trade regime which truly promotes growth in the developing countries. It is essential, that in all trade negotiations, the long recognized principle of special and differential treatment of developing countries be preserved.

10. More Stable and Sustainable Development Finance

75. The need for more and more stable sources of finance for development, including for the investments needed to address the long run challenges of responding to climate change, and new institutions for disbursement of funds, is discussed in Section III.4 above.

76. In the absence of better systems of risk mitigation, it is especially important for developing countries to be wary of measures that expose them to greater risk and volatility, such as capital market liberalization. Developing countries should use all the tools at their disposal, price interventions, quantitative restrictions, and prudential regulations, in order to help manage international capital flows.

77. Market-driven international capital flows are of a magnitude and volatility that they can offset any formal mechanism to provide additional finance for development. Thus, an active management of foreign capital inflows will be required to ensure that they are supportive of government counter-cyclical policies. The Articles of Agreement of the International Monetary Fund provided to members the facility of controlling capital inflows and expressly excluded the use of Fund resources to meet imbalances resulting from capital account disequilibrium. The Fund should thus be encouraged to return to its first principles and support countries that attempt to manage external flows in support domestic counter cyclical policy.

78. The international community needs to explore a variety of mechanisms of ***innovative finance,*** including regular emissions of a new global reserves (SDRs), revenues generated from the auction of global natural resources (such as ocean fishing rights and pollution emission permits), and international taxes (such as a carbon tax, which would simultaneously help address problems of global warming, or a financial

services tax, which would simultaneously help stabilize international financial markets.)

79. The receipts could be directed to support the developing countries costs of reducing greenhouse gas emissions in the context of their national policies to promote sustainable development. The effective implementation of national systems of taxation form a crucial part of domestic development finance. Measures must be taken to preserve national autonomy in the selection of the sources and methods of government financing while ensuring that national differences do not create incentives to evade responsibility of contributors to the support of government policies. An efficient method of achieving this result would be the acceptance by all countries of an amendment of Article 26 of the United Nations Model Double Taxation Convention between Developed and Developing Countries to make the exchange of information automatic.

Information on the Commission of Experts is available in: http://www.un.org/ga/president/63/commission/financial_commission.shtml.

UNITED NATIONS CONFERENCE ON THE WORLD FINANCIAL AND ECONOMIC CRISIS AND ITS IMPACT ON DEVELOPMENT

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Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System

(This interim draft is being published as a reference document for the preparations for the UN Conference on the World Financial and Economic Crisis and its Impact on Development, which will take place in New York on 24-26 June 2009. The final report of the Commission will be published after the Conference in order to reflect upon comments, concepts and proposals made by Leaders and other high-level conference participants, as well as leading representatives of participating UN agencies, social movements, civil society, and the private sector.)

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Chapter 1: Introduction

The Crisis: Its Origins, Impacts, and the Need for a Global Response

1. The current financial crisis, which began in the United States, then spread to Europe, has now become global. The rapid spread of the financial crisis from a small number of developed countries to engulf the global economy provides tangible evidence that the international trade and financial system needs to be profoundly reformed to meet the needs and changed conditions of the 21st century. The crisis has exposed fundamental problems, not only in national regulatory systems affecting finance, competition, and corporate governance, but also in the international institutions and arrangements created to ensure financial and economic stability. These institutions have proven unable to prevent the crisis and been slow to design and implement adequate responses. Indeed, some policies recommended by these institutions have facilitated the contagion of the crisis around the world.

2. The crisis emanated from the centre and reached the farthest limits of the periphery. Developing countries, and especially the poor in these countries, are among the hardest hit victims of a crisis they had no role in making. Even emerging market economies and least developed countries that have improved their economic management suffer declining output and employment. Indeed, those countries that have had the best performance in the recent past, and that have been most successful in integrating into the global economy, have been among the most badly affected.

3. Past economic crises have had a disproportionate impact on the living standards of the world's poor. Those who are least able to bear these costs will bear consequences long after the crisis is over. Infants who suffer from malnutrition will be stunted for life. Children who drop out of school are not likely to return, and they will never live up to their potential. Future growth and employment prospects may be impaired if small firms are forced into bankruptcy. Economic policies must be particularly sensitive to these hysteresis effects.

4. It is important to recognize that what began as a crisis in the financial sector has now become an economic crisis. But, it is not only an economic crisis, it is also a social crisis. According to the International Labour Organization, some 200 million workers, mostly in developing economies, will be pushed into poverty if rapid action is not taken to counter the impact of the crisis. Even in some advanced industrial countries, millions of households are faced with the threat of losing their homes, their jobs and access to health care. Economic insecurity and anxiety is increasing among the elderly as their life savings disappear with the collapse of asset prices. The ILO estimates that unemployment in 2009 could increase by some 30 million compared to 2007, and reach more than 50 million if conditions continue to deteriorate.

5. While the crisis began in the financial markets of advanced industrial countries, and then spread to the real economy, in many developing countries the initial impact of the crisis has been felt in the real sector, but is now spreading through the financial system. Developing countries are being affected through falling export demand and prices, accompanied by reversals of capital flows and reductions in remittances. While developed countries have the

fiscal flexibility to respond, to stimulate their economies, to shore up failing financial institutions, to provide credit, and to strengthen social protections, most developing countries have tighter budget constraints, and resources directed towards offsetting the impact of the crisis must be diverted from development purposes. Money spent to extend social protection may be at the expense of future growth.

6. While it is important to introduce structural changes to adapt the international system to prevent future crises, this cannot be achieved without significant immediate measures to promote recovery from the current crisis. To the extent possible, these measures should promote, or at least be consonant with, the needed long-run structural changes.

7. The welfare of developed and developing countries is mutually interdependent in an increasingly integrated world economy. Short-term measures to stabilize the current situation must ensure the protection of the poorest in the least developed countries, many of whom are in sub-Saharan Africa and will bear a heavy burden of adjustment. Long term measures to make another recurrence less likely must ensure sustainable financing to strengthen the policy response of developing countries. Without a truly inclusive response, recognizing the importance of all countries in the reform process, global economic stability cannot be restored, and economic growth, as well as poverty reduction worldwide will be threatened.

8. At the same time, the international community cannot focus exclusively on immediate measures to stimulate the economy if it wishes to achieve a quick robust recovery. This crisis is, in part, a crisis in confidence, and confidence cannot be restored unless steps are taken to begin the more fundamental reforms required, for instance through improved regulation of the financial system.

9. Any solution –short term measures to stabilize the current situation and long term measures to make another recurrence less likely– must be global, and must pay due attention to impacts on all countries and all groups within society.

10. Any inclusive global response will require the participation of the entire international community. To respond to this need, the President of the General Assembly created the present Commission of Experts to identify measures needed to meet the crisis and to recommend longer term reforms, giving explicit attention to the needs of developing countries. Recognizing work undertaken by the G-7/8 and G-20, and others, the Commission sees its own work as complementary, seeking to focus on impacts and responses to the crisis on poverty and development.

11. Reform of the international system must have as its goal the improved functioning of the world's economic system in support of the global good. This entails simultaneously pursuing long-term objectives, such as sustainable and equitable growth, the creation of employment in accordance with the "decent work" concept, the responsible use of natural resources, reduction of greenhouse gas emissions, and more immediate concerns, including addressing the challenges posed by the food and financial crises. As the world focuses on the exigencies of the moment, long standing commitments to the achievement of the Millennium Development Goals and protecting the world against the threat of climate change must remain overarching priorities; indeed, both the immediate steps taken in response to the crisis and the longer-term global reforms should provide an opportunity to accelerate

progress toward meeting these goals. While the world will eventually recover from the global economic crisis, the resolution of other challenges, including that posed by global warming, and those posed by the potential shortage of food and water, will require additional measures. The conjunction of huge unmet global needs, including responding to the challenges of global warming and the eradication of poverty, in a world with excess capacity and mass unemployment, is unacceptable.

12. Ten years ago, at the time of the Asian financial crisis, there was much discussion of the necessity for rapid reform of the global financial architecture if the world were to avoid the occurrence of another major crisis. Little – too little, it is now evident – was done. It is imperative to provide an adequate immediate response to the current crisis, but also to begin the long run reforms that will be necessary to have a more stable, prosperous and balanced global economy. The aim must be to avoid future global crises.

13. Both developed and developing countries must recognize that globalization must meet the needs of all citizens of the world. While it promised to help stabilize global financial markets and reduce the scale of domestic economic fluctuations, it failed to do so. Rather it served to facilitate contagion from one country to another. A failure in one economy is now leading to a global recession or depression. And unless something is done, and is done quickly, those in developing countries are likely to be among those who suffer most.

14. This report presents an analytical framework for understanding what has gone wrong and possible remedies. It presents both broad perspectives on policies and specific recommendations. This introductory Chapter provides an overview of some of the key issues and policy frameworks and perspectives. As noted, the crisis is both a financial crisis and an economic crisis. It has both macro- and micro- aspects. It began as a failure in the financial sector, but the problems in that sector were in part a result of underlying macro-economic problems, such as growing global imbalances and growing income inequalities within and between countries. The fact that existing global institutions did little to prevent the crisis, and the delays in developing adequate responses to the crisis, suggest that there are important institutional problems that the international community needs to address. The frequent crises that have accompanied globalization, with problems in one country quickly spilling over creating problems in others, suggests the need for reform of the international financial system to meet the needs of an increasingly interdependent world economy. The fact that a major impact of these crises has been on the poor and the developing countries makes it clear that there are inadequacies in global market and non-market mechanisms for managing financial risks.

15. The current economic crisis should provide an opportunity to reassess global economic arrangements and prevalent economic doctrines. Large changes have occurred in the global economy in recent years, e.g. in the sources of global savings, foreign exchange reserves and GDP, and these are not fully reflected in our global economic institutions and arrangements. In trying to resolve the problems of the short run crisis it is important to seize the opportunity to make deeper reforms that enable the world to enter the twenty-first century with a more equitable and stable global financial system, one which could usher in an era of enhanced prosperity for all countries.

The Institutional Response to the Crisis

16. There have been unprecedented efforts to address the crisis. The stimulus measures introduced by many countries around the world will dampen the impact of the crisis. However, it must be recognised that there can be no return to the *status quo ante*. It is essential that governments undertake reforms that address the underlying factors that contributed to the current economic crisis if the world is to emerge from the crisis into sustainable, balanced growth. In this respect failure to act quickly to address the global economic downturn and more fundamental problems would increase the depth and duration of the crisis, making it more difficult and more costly to create a more balanced robust recovery.

17. Most of these longer-term reforms are not just luxuries, to be undertaken at leisure once the recovery is assured; they are essential to the recovery itself. Moreover, there is substantial risk that unless work on these more fundamental reforms is undertaken now, momentum for reform will be lost with the recovery. There are strong political forces at play and those who have benefited from existing arrangements will resist fundamental reforms. But allowing these interests to prevail would ensure the recurrence of crisis. This is one of the lessons to be learned from the Asian financial crisis of 1997-1998.

18. The urgent need to respond to the crisis has been highlighted by the meetings of the Heads of Government of the Group of Twenty in November in Washington and in April in London. These have led to commitments to undertake large fiscal expenditure packages, to introduce significant regulatory reforms, and to provide some increased assistance to developing countries. These are important initiatives, but more important is the recognition that the global nature of the crisis means that it cannot be resolved by a small group of advanced industrialized countries, but must be addressed in a more inclusive framework. Nonetheless, the actions proposed and the processes by which decisions are made and implemented are not ideal.

19. First, and most importantly, the decisions concerning the necessary reforms in global institutional arrangements must be made not by a self-selected group (whether the G-7, G-8, G-10, G-20, or G-24), but should be taken by all the countries of the world, working in concert. This inclusive global response will require the participation of the entire international community; it must encompass representatives of the entire planet, from the G-192.

20. While proposals from smaller groups will necessarily play an important role in developing a global consensus on key and complex issues, decision-making must reside within international institutions with broad political legitimacy, and with adequate representation of both middle-income countries and the least developed countries. The only institution that has that broad legitimacy today is the United Nations.

21. Better representation and democratic legitimacy would not require the presence of all countries in all deliberations. Working committees, selected by mechanisms that ensure democratic selection, could be limited to a size that would ensure effective decision making. The fact that all existing democracies have been able to achieve satisfactory solutions to these problems suggests that they are not irresolvable.

Policy Responses to the Crisis

22. Sustainable responses to the crisis require identifying the factors underlying the crisis and the reasons for its rapid spread around the world. There have been policy failures at both the micro- and macro-economic levels. Loose monetary policy, inadequate regulation and lax supervision interacted to create financial instability. "Reforms" over the past quarter century have exposed countries to greater instability and reduced the impact of "automatic" stabilizers. In some countries, social protection has been weakened, with the result that the adverse consequences of major crises, such as the one the world is now facing, have been especially hard on the poor.

23. At the global level, some international institutions continue to recommend policies, such as financial sector deregulation and capital market liberalisation that are now recognized as having contributed to the creation and rapid diffusion of the crisis. The inadequate responses to the last global crisis in 1997-1998 led to a change in policy frameworks that brought increasing levels of reserves, and contributed to the large global imbalances whose disorderly unwinding was widely feared as an additional source of financial instability.

24. Part of the reason financial regulation was so ineffective lies in inadequate appreciation of the limits of the market mechanism –the prevalence of what economists call "market failures." While such failures arise in many markets, they are particularly important in financial markets and can have disproportionately large consequences as they spill over into "real" economic activity.

25. The conduct of monetary policy in the United States both prior to and after the crisis can be viewed in part as an attempt to offset an insufficiency of global aggregate demand, aggravated by increasing income inequality in most countries.

26. In many countries, the focus of monetary policy was on price stability, rather than other factors that might contribute to long-term growth and stability, because it was believed that low inflation was a necessary and (an almost) sufficient condition for economic prosperity. It should now be clear that monetary authorities should recognize the consequences of their policy decisions on the stability of financial institutions.

27. The current crisis reflects problems that go beyond the conduct of monetary policy and regulation of the financial sector; it has exposed a flawed understanding of the functioning of markets. The belief that unfettered markets are, on their own, quickly self-correcting and efficient led national authorities and international institutions to support measures to deregulate financial markets.

28. This suggests that it is necessary to review the policies currently advocated by international institutions, such as the International Monetary Fund, the World Bank, the regional development banks, and the World Trade Organisation, and in their support of developing countries' response to the crisis.

A Global Crisis Needs a Global Response

29. The current crisis may be considered a manifestation of economic externalities at two levels. First, the failure of financial markets affected an externality on the real sector. Secondly, in a globally integrated world, the actions of any one country have effects on others. Too often these externalities are not taken into account in national policy decisions. Developed countries in particular need to be aware of the consequences of these externalities, and developing countries need frameworks to help protect them from regulatory and macro-economic failures in the major industrialised countries. Ironically, much of the effort to coordinate international economic policy has focused on putting constraints on countries whose behaviour is not systemically significant, while doing little about countries whose policies can have systemically significant consequences.

30. Similarly, the importance of externalities is often ignored in the design of countries' policies in response to crisis. Presently, there is a risk that countries may undertake insufficient expansionary measures because some of the benefits of their policies (such as deficit financed expenditures) accrue to those outside the country. As a result, without global cooperation, countries may spend less than the optimal amount on stimulus packages, as they balance the benefits of the stimulus with the cost of extra debt burdens, and/or try to distort their stimulus packages so that more of the benefits accrue domestically. The net result is that the overall global stimulus impact will be sub-optimal: all may suffer.

31. The introduction of protectionist policies to improve conditions at the expense of trading partners is an example of the negative impact of externalities on recovery from the crisis. Such beggar-thy-neighbour policies contributed to the depth of the Great Depression. Countries attempted to augment the domestic impact of expenditure policies through competitive devaluations or restraints on trade such as quotas and tariffs. Such moves proved to be counterproductive. In the current situation, explicit moves in this direction, at least of the magnitude and transparency of those that occurred in the Great Depression, may be unlikely. Nonetheless, more subtle versions of such protectionism are already occurring. It is a matter of concern that although the G-20 resolved not to engage in protectionist measures in their meeting in November, by April, nearly all had broken that pledge. Particularly disturbing are protectionist measures directed against developing countries.

32. It has long been recognized that subsidies can be just as disturbing to a free and fair trading system as tariffs. In some ways they are far more inequitable because rich countries have greater resources to support them. Measures designed to offset the impact of subsidies in developed countries reduce the availability of already scarce development funds. In the current crisis, developed countries have provided unprecedented subsidies, primarily in the form of financial support for domestic financial and non-financial enterprises. Developing countries cannot match these subsidies in breadth and scale. Even the knowledge that there may be a rescue if things go badly gives firms in advanced industrial countries a distinct advantage that allows them to undertake risks that firms in poorer countries cannot. This highlights the lack of coherence between existing global macro and financial arrangements, policies, and frameworks and those governing trade. Whether there ever was a level playing field may be debated; that there is no longer one cannot be.

33. Other measures taken in response to the crisis are implicitly protectionist. International banks that have received support from their home governments may be encouraged to reduce their lending in developing countries to ensure that domestic lending increases. Or

banks which have received large amounts of public money may do so even without explicit governmental oversight because of worries about adverse political reactions. Such financial market protection exacerbates long-standing asymmetries in the functioning of global financial markets.

34. Unless actions are taken to curb financial market and other forms of implicit and explicit protection, and to provide developing countries with compensatory payments to offset the distorting effects of bail-outs and guarantees and funds with which to engage in expansionary fiscal policies, there is a risk that the global imbalances which contributed to the crisis will increase.

35. A lack of resources is a major impediment to the introduction of strong stimulus packages in developing countries. A substantial increase in resources available to developing countries, not just to undertake stimulus measures, but to cope with the negative impact of the crisis, will be necessary. Funding to shore up their banking systems, provide credit, including trade credit, and strengthen social protection should be provided and developing countries should have expanded scope to implement policies that will allow appropriate counter-cyclical policies and to design other structural policies consonant with their needs, objectives, and situation.

Reforming the international institutions

36. It is apparent that the conditionalities that were often imposed by international financial institutions in their support of developing countries were counterproductive. The demand that countries implement short-run pro-cyclical policies exacerbated downturns, while long-run structural policies exposed countries to greater risk and undermined social protection. It is important to design reforms that prevent, or at least reduce the likelihood, of such counterproductive policies in the future. Part of the answer is to be found in the reform of the governance structures of the international institutions.

Some Basic Principles

37. In addressing the crisis, several other basic principles–besides, for instance, acting with all due speed, paying attention to externalities, and avoiding protectionism, should guide the responses of the international community.

Restoring balance between the market and government

38. The crisis is, in part, a result of excessive deregulation of financial markets. Restoring the global economy to health will require restoring a balance between the role of the market and the role of the state. Both the global economic crisis and the global climate crisis are associated with massive externalities which can only be addressed by appropriate collective action at the national and the global level.

Greater transparency and accountability

39. Greater transparency on the part of all parties in responding to the crisis is necessary. More generally, democratic principles, including inclusive participation in decision making, should be strengthened and respected. Regrettably, in responding to the crisis, many governments have undertaken non-transparent actions and relied heavily on Central Banks, with only limited direct democratic accountability. Some Central Banks with only limited direct accountability have introduced without parliamentary/Congressional approval measures in support of financial institutions that have exposed taxpayers to massive risks.

Short run actions consistent with long run visions

40. In taking policy actions it is imperative that they do not exacerbate the current crisis through their impact on other countries or result in structural changes which increase future instability or reduce future growth. For example, in some countries the response to the crisis created by excessive risk undertaken by financial institutions that were too big to fail has resulted in bank consolidation which increases such risks in the future.

Assessing distributive impacts

41. Any economic policy, including those responding to crises, has large distributive consequences, both within and between countries, and policy makers need to be attentive to those consequences. As noted, previous financial and economic crises have had particularly adverse effects on poverty, but the strategies employed to address the crisis have sometimes resulted in exacerbating income and wealth inequalities. Bank bail-outs and restructurings have played a particularly important role in these adverse redistributions of income and wealth. For example the unprecedented lowering of interest rates may have been the correct macro-economic response to the crisis, but it has produced a sharp reduction in the income of retirees who did not gamble on risky securities and invested prudently in government securities. In the East Asia crisis, high interest rates were imposed as a condition for international assistance. Small businesses which found themselves unable to bear the burden of debt were forced into bankruptcy.

Avoiding an increase in global imbalances and asymmetries

42. There are large inequalities in the global economy and large asymmetries in the global economic framework. It is important that the measures introduced to respond to this crisis seek to reduce, not exacerbate, these inequalities and asymmetries. For instance, countercyclical policies are pursued by developed countries, while most developing countries pursue pro-cyclical policies. As noted, this is a result of both the availability of resources to engage in countercyclical policies, and restrictions on "policy space," resulting from conditions imposed on countries seeking assistance from international institutions. But even symmetric policies can have asymmetric effects: guarantees provided to financial institutions in developed countries cannot be effectively matched by developing countries.

Distribution and Incidence of Risk

43. All economic policies involve risks and uncertainties, but under different economic policies, different groups may bear the brunt of this risk. An aggressive stimulus policy may, for instance, increase the risk of inflation from over-stimulation, and those with long-term

investments with fixed nominal returns (such as bondholders) may suffer. A weak stimulus may lead to the risk of prolonged unemployment, with workers suffering.

Irreversibilities (hysteresis effects)

44. Policies need to be sensitive to non-linearities and problems of irreversibilities. Some policy mistakes are easy to correct, others are not. It may be easier to damp down demand in an economy which faces a risk of overheating than to resuscitate a dying economy. Reversing policies that have lead to the bankruptcy of a firm cannot bring it back to life. These simple maxims of risk management need to be borne in mind in designing responses to the crisis.

Intellectual diversity

45. While much of the support for globalization and the changes in economic policy (e.g. in deregulation) over the past quarter century may have been driven by particular interests, it was also premised on economic doctrines whose theoretical foundations and empirical bases were, at best, questionable. Modern economic theory has brought into question many of the ideas underlying market fundamentalism, including the notion that unregulated markets would lead to efficient outcomes, or that markets were self-regulating and stable. The current economic crisis has raised further questions concerning these doctrines, and has highlighted the relevance of alternative theories and ideas. Any approach to addressing the current economic crisis and preventing future episodes must be robust, in the sense that the conclusions and policy prescriptions cannot rely on economic doctrines in which there is, or should be, limited confidence. Some international institutions have advocated notions of competitive pluralism, encouraging the creation of a marketplace of ideas, while others have tried to enforce a single-minded adherence to a particular ideology that the crisis has been shown to be inadequate. Strengthening diversity of ideas may contribute both to global stability, and to a strengthening of democracy.

46. The crisis also highlights that the standard policy nostrums that countries should have sound macroeconomic fundamentals, strong governance, including transparency, and good institutions, may be less than helpful. Countries that held themselves out as models of best practice have been shown to have had deeply flawed macro-policies and institutions, and to have suffered from major shortfalls in transparency.

Impact on developing countries

47. The crisis is likely to extract a particularly high toll on developing countries for four reasons.

48. First, the citizens of these countries have fewer resources with which to cope with a crisis of this magnitude.

49. Secondly, they already suffer from a lack of automatic stabilizers due to the embryonic nature of their fiscal and social protection systems.

50. Third, "markets" impose constraints on their ability to pursue countercyclical fiscal and monetary policies. Many countries are forced, for instance, to pursue pro-cyclical fiscal policies because in a downturn, tax revenues decline, and they cannot find adequate financing for existing, let alone, expanded, government expenditures. In this crisis especially, many firms and countries will face credit constraints and higher borrowing costs because capital flows to developing countries are likely to be markedly lower and risk premia have increased substantially. To retain foreign investors, countries may be tempted to raise interest rates, with the obvious adverse effects on the real economy. But as in the East Asian and global financial crises, such interest rate increases may not have the desired consequences and reduce economic growth as the economy slows, confidence erodes and capital is repatriated. Thus, the risk-adjusted interest rate may even fall as the nominal interest rate is increased.

51. Fourth, these ever-present threats have been exacerbated by financial market integration. Countries that have fully opened their capital accounts, have engaged in financial market liberalization, and relied on private finance from international capital markets are among those most likely to be most adversely affected. Many countries have come to rely on foreign banks, some from countries that were poorly regulated and that followed inappropriate macro-economic policies and now find their capital badly impaired. These institutions are now repatriating capital, with obvious adverse effects on developing countries. The difficulty is compounded by the fact that many developing countries have entered into free trade agreements (FTA), bilateral investment treaties (BIT) and World Trade Organization (WTO) commitments which enshrine the policies of market fundamentalism noted above and limit their ability to regulate financial institutions and instruments or manage capital flows.

52. In the past, those developing countries that have accessed IMF financing have been constrained by international financial institutions to adopt restrictive policies in times of slow growth or even recession. Such pro-cyclical policies are counterproductive, since one of the purposes of assistance should be to enable developing and emerging markets to stabilize their economies. But in the current global crisis it is not just the developing countries which are forced to adopt such policies that suffer; the entire global economy suffers. Effective international response requires all countries to engage in expansionary policies—*including developing countries.* The purpose of IMF assistance is, in part, to enable the developing countries to participate in this global effort. Even without these artificially imposed constraints, the natural market constraints referred to earlier may impede developing countries, even those receiving assistance, from having as strong countercyclical policies as would be desirable.

53. The legacy of past imposition of pro-cyclical policies may itself exert a depressing effect on developing countries today unless there are strong and clear signals of a marked change in the policy regime. These countries may have to pay higher risk premia in the current crisis as market participants know that they are likely to face a deeper and longer downturn than they would have had if they had been allowed to pursue more countercyclical policies. Unfortunately, the signals are mixed: constraints on implementing countercyclical policies have become apparent in the current crisis in the conditions attached to IMF programmes in several countries.

54. More broadly, developing country dependence on IMF financing has not only constricted policy space for countercyclical policy, concern about future imposition of these constraints has contributed to the building of reserves and global imbalances. Unless the policy regime is changed, incentives for further build-up of reserves could increase, impairing the ability of the global economy to emerge quickly from the global economic crisis.

55. If appropriate measures from the international community are not taken quickly, developing countries may in fact be hurt rather than helped by the responses of developed countries to the crisis. Global imbalances may be increased. In the short and medium term, it is necessary that developing countries undertake a variety of countercyclical policies, including social protection measures, infrastructure development, and credit guarantees, and it is imperative that developed countries provide them with appropriate assistance and policy space to do this. Such measures may also ensure fair global competition.

56. The major focus of this Report is on short term measures and the longer term reforms of the international financial and system that support the developing countries and their aspirations for development. As noted above, developing countries will bear the greatest costs of the crisis, but do not have the resources necessary to deal with its negative impacts. Measures are needed very quickly to avoid further deepening of the crisis in emerging and developing countries, including for restoring and expanding social protection, and reducing the pro-cyclical features of the economic policy. Delay will mean that the eventual cost of dealing with the problem will be higher and the length and depth of the downturn will be greater, with more innocent victims losing their jobs, with more small —and even large— businesses forced into bankruptcy, with public finances increasingly put into jeopardy. The consequences of our failures now may be felt for decades to come.

57. The Report presents its analysis and recommendations in the following four Chapters. Chapter 2 deals with the Macro issues and perspectives lying behind the crisis and the measures that need to be taken to overcome it. Chapter 3 deals with the causes of instability in the financial system in particular and in the impact on the overall economic system as well as those measures that should be taken to ensure financial stability at the level of individual financial institutions and at the systemic level. In Chapter 4 the Report assesses the adequacy of existing international institutions, and how they should be reformed and new institutions that could be created to make the system more stable and to better serve the needs of developing countries. Finally, Chapter 5 deals with International Financial Innovations, those measures that might be introduced to what is called the international financial architecture to meet the needs of the globalised world of the twenty-first century.

Chapter 2: Macro-Issues and Perspectives

1. While the current economic crisis is global in its causes and ramifications, the responses to the crisis have been decided and implemented at the national level. Little attention has been given to the global externalities and the spillovers that arise out of uncoordinated national policy decisions. The challenge raised by the crisis is to design a framework and roadmap for a coordinated, global response that recognizes the differing constraints facing individual countries and in particular the most vulnerable developing countries.

2. Coordination is essential to the success of the different actions currently being implemented by governments in response to the crisis because the impact of individual policies will depend on actions undertaken by other countries. It is important that national governments recognize that their policies will be more effective in protecting their citizens from the crisis if they are internationally coordinated.

3. Coordination failure can lead to growing global imbalances and an increase in exchange rate and asset price volatility, and these will impair a return to robust growth. The protectionist measures introduced in response to the crisis will impede the speed of global recovery

4. National policies introduced in response to the crisis may have unintended and unforeseen protectionist effects. While some measures designed to protect the well being of domestic populations, such as guarantees and bail-outs, may not be intended to provide trade protection, they may nonetheless create advantages restricted to domestic firms. It is thus important to design measures that protect domestic residents without increasing trade protection. It is necessary to find ways to provide social protection without creating trade protection. One of the major lessons of the Great Depression was that protection may be counterproductive. In current conditions the effects of protection may be even worse because of the increased global integration of trade and production.

5. Developing and emerging countries are more exposed to these adverse effects. A globally “balanced” response to the crisis will thus require coordination of national recovery programmes and a substantial increase of assistance for developing countries through increased official assistance and the creation of new credit facilities.

6. The objectives of national and international policy should be a quick recovery and protection of the vulnerable most likely to be adversely affected, and doing so in ways that promote equitable, democratic, environmentally and socially sustainable development. It should, at the same time, facilitate the necessary restructuring of national economies and the global economic system.

The Sources of the Crisis

7. There are many “failures” behind the current financial crisis. Chapter 3 of this Report analyses regulatory failures in developed country financial systems and management of risk. But “macro-economic” failures were part of all other failures. It is important to understand

these interrelationships in order to design policies that will allow the global economy to emerge from the crisis with robust growth and to make a recurrence of the crisis less likely.

8. The sub-prime crisis, which led to a wider crisis in credit markets, was partly engendered by an "excess" supply of liquidity and the failure of the Central Bank in the United States and some other advanced industrial countries to act to restrain liquidity and dampen the speculative increases in housing prices. While lax financial regulation may have contributed to the particular *form* taken by the crisis, the magnitude of the excess liquidity, and other associated factors, made further difficulties inevitable.

9. While problems initially appeared in the financial sector, the origins of the problem are deeper, and cannot be addressed *simply* by repairing the "plumbing" of the financial sector. For example, inadequacies in competition policy and corporate governance discussed in Chapter 3 were of major significance.

10. Focusing attention on the failures of public policy should not, however, detract attention from underlying market failures. Financial markets mismanaged risk and misallocated capital. Had markets done what they should have the availability of capital at low cost could have led to large increases in productivity, rather than further impoverishing lower income Americans.

11. This crisis has much in common with several other financial and economic crises, including the Great Depression. This suggests that economic policies have not fully taken into account the lessons of those crises. Part of the reason for this lies in economic doctrines that became fashionable in some quarters during the last three decades.

12. As the international community frames an immediate response to the crisis, it would be a mistake to forget this broader context. The present Chapter thus focuses on macro-economics—both the underlying macro-economic problems and the necessary macro-economic responses, trying to identify policy responses that may even make recurrence of the crisis more likely.

Role of economic doctrines

13. Part of the explanation of the current crisis may be found in the underlying economic fundamentals. Another is in the economic theories that motivated the financial and economic policies which produced the crisis. A more detailed discussion of the impact of these economic doctrines on regulatory policy is found in Chapter 3. These same economic doctrines --the belief that economic agents are rational, that governments are inherently less informed and less motivated by sound economic principles, and therefore their interventions are likely to distort market allocations, and that markets are efficient and stable, with a strong ability to absorb shocks-- also affected macro-economic policies.

14. One of the most important lessons of the Great Depression was that markets are not self-correcting and that government intervention is required at the macroeconomic level to ensure recovery and a return to full employment. In the aftermath of the Great Depression, governments introduced policies that provided automatic stabilizers for aggregate demand and implemented discretionary policy frameworks to reduce economic instability. But as the

Great Depression and earlier panics and crises faded from memory, confidence in the self-stabilising nature of the market returned.

15. The fact that the world recovered so quickly from financial crises such as the East Asian crisis of 1997 and the global liquidity crisis of 1998 induced false confidence in the self-correcting nature of market processes. The historical role of government intervention in recovery and stability was forgotten.

Changes in the global economy

16. The level of international economic interdependence may also have contributed both to an increase in economic vulnerability of the global economic system to external shock or to insufficiency in aggregate demand.

17. In some countries, the weakening of social protection and the reduction in the progressivity of income tax systems weakened the automatic stabilizers. In others it led to a structural decline in domestic consumption levels, and thus to a decline in the multiplier. Too often in national policy discourse, and even in some theoretical discussion, globalization was used as a pretext for competitive reductions in social protection, creating a global race to the bottom.

18. Constraints imposed in the European Union by the Stability and Growth Pact, and concerns in other countries about the size of fiscal deficits and national indebtedness may impair the use of countercyclical fiscal policies to respond effectively to shocks, including the extra-ordinary shock that the world faces today.

19. However, in the absence of loose monetary policy and lax regulation that characterised the period before the crisis it is likely that there would have been an insufficiency of aggregate demand in the United States caused by growing inequality in income and wealth distribution. The expansion in lending associated with new risk management practices, deregulation, and accommodating monetary policy offset this tendency by allowing consumption to grow more rapidly than incomes through increasing household indebtedness. In the presence of policies in many developing countries to encourage external trade surpluses as a defence against international financial volatility, this led to ever increasing global imbalances.

Growing inequality as a source of the crisis

20. Although economic globalization has supported rapid growth, it has also produced increased volatility in incomes and increasing income inequality. It has not only been associated with increasing inequality of income within developing countries, but also between developing countries and between developed and developing countries. Inequality has also increased within developed countries. When combined with changes in financial markets, this growth in inequality has had important consequences for the evolution and resolution of the crisis.

21. It is now recognized that in most advanced industrial countries, median wages stagnated during the last quarter century, while income inequalities surged in favour of the upper

quintiles of the income distribution. In effect, money was transferred from those who would have spent to meet basic needs to those who had far more than they could easily spend. This created a tendency toward reduced levels of aggregate effective demand.

22. There were many forces contributing to this growth in inequality, including asymmetric globalization, especially the greater liberalization of capital movements than movements of labour, —the weakening of labour unions, deficiencies in corporate governance, and a breakdown of social conventions which resulted in greater disparity in compensation between top executives and average workers. Finally, it was believed that increased incentives would increase saving, labour supply, and investment and thus growth. These problems were exacerbated by the reduction of progressivity in tax structures in some countries. In most OECD countries the highest tax bracket rate has been reduced by more than 10 percentage points on average.

23. The negative impact on rising income inequality on aggregate demand was largely offset by increased indebtedness of households, especially in the United States and some other developed countries such as the United Kingdom. But the high level of indebtedness was not sustainable.

24. It is possible to argue that the increase in public debt in some OECD countries was partly the consequence of the evolution of the distribution of income. In advanced countries such as in the European Union social protection systems compensated for stagnating income in a context of high unemployment, but were accompanied by increasing public deficits and public debt.

25. In countries such as the United States where social protection is much weaker, increased household borrowing may have delayed a decline in living standards and consumption in tandem with the decline in real wages.

26. The 2001 and 2003 tax cuts in the United States provided little stimulus to the economy, but had a negative impact on the deficits and government debt and placed a greater burden on monetary policy to sustain employment.

27. The Iraq War and other events which helped set off an increase in the price of oil had a further depressing effect on countries which import energy, including the U.S. The magnitude of the increase in energy prices was exacerbated by financial speculation. This change in the price of energy, accompanied by governments' attempts to develop alternative bio energy sources contributed to higher food prices. The sharp increase in energy prices thus directly and indirectly brought further reductions in purchasing power within many countries. The transfer of income from those who suffered from these price increases to those who benefited weakened global aggregate demand and contributed to the global imbalances which played an important role in the crisis.

28. While the negative impact of income inequality and energy, commodity and food inflation was thus temporarily offset by mounting private and public debt, it should have been clear that this was not sustainable. But those responsible for macro-economic management, including monetary authorities, in part blinded by certain economic doctrines, failed to recognize this and take appropriate actions.

29. Policy responses designed to ensure a robust recovery from this crisis must also address the problem of how growing income and wealth inequality might be reversed. Should the trend towards reducing the progressivity of the fiscal system be reversed? Should some harmonization of businesses taxation throughout the world be advocated? Should changes in inequality inside each country become public knowledge through a yearly parliamentary debate?

30. One thing seems to be certain: fiscal competition of the type which dominated the golden years of globalization is not sustainable. This is for at least two reasons. The first is its contribution to the rise in inequality through regressive redistribution of income; the second is the rise of inequality that results from the reduced capacity of the State to provide public goods to the population.

Global imbalances and imbalances in global aggregate demand

31. Part of the reason that the United States was able to sustain an expanding external deficit was the decision of many emerging countries to respond to the financial crises in the 1990s by adopting policies to strengthen their external balances. The resulting increase in foreign exchange reserves, along with the increasing reserves accruing to oil producing countries from the rise in oil prices, were invested in official dollar assets and provided the financial counterpart to the rising US external deficits.

32. The apparently unending increase in what came to be known as global imbalances raised concerns that they were unsustainable and that their disorderly reversal might generate a global financial disruption or exchange rate crisis. But those responsible for global macro-management did not take appropriate action, highlighting deficiencies both in the arrangements for macro-economic management and in the economic doctrines that govern economic policy.

33. There were several reasons why many emerging markets chose to adopt the policies to strengthen their external accounts that led to an accumulation of foreign reserves amounting to $4.5 trillion in October 2008. The first was to ensure a defence against external instability due to volatile external financial flows. Countries with insufficient reserves had paid high economic and political costs in the East Asia and global liquidity crises of the end of the previous decade. The loss of economic sovereignty associated with the imposition of pro-cyclical macroeconomic conditionality as part of IMF support programmes has also been a source of particular concern to many countries. In addition, some countries had adopted exchange rate stabilisation as part of their policies to ensure external balance and stability, and built up substantial reserves as a result of attempts to prevent exchange rate appreciation, with its adverse effects on economic development (as discussed further in Chapter 5).

34. Moreover, many emerging market economies, especially those deriving export incomes from the sale of primary commodities, benefited from rising prices due to rising global growth that accompanied the credit expansion before the crisis. Speculative activity by financial institutions also supported rising prices. But, this beneficial trend in prices was also accompanied by increased volatility and many countries reacted by increasing their

prudential reserves. These reserves have provided a useful cushion as prices have declined after the outbreak of the crisis.

35. The collapse of the US mortgage market and the accompanying decline in house prices has produced a sharp increase in household saving and a decline in investment in the US. Other countries also had real estate bubbles, and these bubbles also collapsed, with similar consequences. These difficulties in the real estate sector precipitated problems in financial markets, discussed more extensively in the next Chapter. The problems of bad lending were aggravated by high leverage and other risky behaviour, as well as by a lack of transparency. The resulting collapse of credit reinforced the underlying weakening of aggregate consumption, leading to a rapid decline in global aggregate demand. Declines in final demand and increasing cost and decreasing availability of credit led to inventory adjustments which accelerated the downward movement in global GDP. But it is important to note that while the inventory adjustments may have aggravated the crisis, they are not part of the underlying cause; and thus, even when these inventory adjustments are completed, there will be no automatic economic recovery.

36. Indeed, unless there is a coordinated policy response to this crisis that supports global demand it is possible that the problem of global imbalances may be exacerbated. With countries facing the threat of high volatility in export earnings and global financial flows, it is rational for countries to increase precautionary savings to act as insurance against future potential calamities. While it is rational for individual countries to "insure" against another crisis through the build-up of external surpluses and foreign reserves, doing so weakens aggregate demand. The absence of alternative ways of obtaining "insurance" may not only impair a robust recovery, but also lead, in the long run, to further instability. The implication is that a reform of the Global Reserve Currency System and other forms of risk mitigation is imperative. Proposals for how this may be done are made in Chapter 5.

37. It is possible that when many countries simultaneously attempt to build up reserves the global economy will suffer from generalised insufficiency of aggregate demand—a global version of the well-known paradox of thrift.

38. It is important that the international community not only address the issue of risk mitigation, but also the underlying sources of volatility. Commodity price speculation, as already noted, probably contributed to the magnitude of price volatility. Reforms in the global financial system, in particular capital market liberalization, have facilitated international contagion and thereby increased the risk of volatility originating from abroad.

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Instability and built in de-stabilizers

39. Another major source of concern is the instability of the economic system, and the way in which it responds to shocks. As noted above, economic systems may have become more unstable as a result of weakening of both public and private automatic stabilizers through the reductions in the progressivity of tax structures, weakening of safety nets, greater wage flexibility, and the movement from defined benefit to defined contribution schemes. New bank regulations, including mark to market accounting, may actually have resulted in built in destabilizers.

40. An important part of the response to the crisis should therefore be the strengthening of the automatic stabilizers, and more broadly the adoption of policies that not only reduce the shocks to which economies are exposed, but that dampen the responses. Chapter 3 discusses one important reform: countercyclical capital adequacy and provisioning standards.

41. Unmanaged flexible exchange rate regimes may, in particular, expose developing countries to high levels of volatility, especially when combined with certain monetary policies. Countries that raised their interest rate in response to high food and energy prices saw large appreciations of their currency; and this has now been followed by large depreciations. Such volatility exacts a heavy toll on developing countries.

International Responses: Fiscal Policy

The need for and the nature of a globally coordinated response

42. This crisis is different from the financial crisis of 1997-1998. Then the affected countries used exchange rate adjustments and other policies to export their way out of the crisis. In a global crisis affecting all countries this solution is not possible. It is thus imperative that all countries take strong, coordinated, actions to stimulate their economies.

43. There will be some temptation for countries, especially those with small, open economies, to avoid taking action and benefiting from the expansion that will result from stimulus policies introduced in other countries. As countries balance the trade-off of the benefits of expansion against the costs of increased debt-financed government spending, the risk is that they will undertake insufficient action (when viewed from a global perspective) and, as result, that the global stimulus will be deficient. If all countries think in this way, the global downturn will be more prolonged. Rapid recovery depends on there being no free riders.

44. Moreover, countries will look for those forms of expenditure which have the largest domestic multipliers. What is at stake is illustrated by the fact that national expenditure multipliers are generally believed to be around 1.5, due to leakages of demand abroad through increased imports. But from a global perspective there can be no such leakages (though multipliers will still be limited by savings), so that multipliers for a coordinated global expansion are in reality much larger.

45. The implication is that a global crisis requires a global stimulus—it is much like a global public good. The level of the global stimulus that is desirable is greater than the level that would be implemented by each country thinking only of itself. Moreover, if every country attempts to maximize the domestic impact of its stimulus policies the domestic and the global effectiveness of the policies measured in the expansionary impact per dollar spent will be reduced.

46. Similarly, there will be a temptation in many countries to maximize the domestic impact of their stimulus policy expenditures by introducing protectionist measures that limit leakages of demand into imports from foreign countries. Such measures are more likely to be introduced if countries perceive that others are free riding on their efforts. While these measures may be introduced with the best of intentions, to maximize social protection, they

may not respect equal treatment trade principles, and when imitated by others, are likely to be counterproductive. The fact that so many countries have already introduced such protectionist measures should be viewed as a cause of concern. But even measures that are not designed to have protectionist effects may do so, as noted below. These protectionist measures, both when they are the intentional and when they are unintentional, can be particularly harmful to developing countries.

47. There would be additional benefits from a globally coordinated fiscal response if significant proportions of those expenditures are directed at addressing global problems.

The need for stronger social protection

48. Social protection is not only an instrument of social justice, but also a major tool of economic stabilization. Well designed social protection systems make the economy more resilient to shocks by increasing the size of automatic stabilizers. Social protection systems have two components. The first is insurance against risks. It enables smoothing of disposable income, while the enhanced security is of value in its own right. The second component is progressive redistribution, to avoid exclusion and to prevent individuals from being trapped in poverty. Social mobility, ("giving to my children better opportunities than I had") is one of the engines of growth and prosperity. But social mobility is all the more likely when "counters are reset", at least partially, at each generation. One of the roles of social systems is a transfer of resources that helps reduce inequalities of initial conditions for new generation.

49. Besides its role as "insurance" against income and consumption fluctuations, especially for poorer households, social spending has a more direct impact. Increasing the supply of public goods would free part of the income that is now saved for precautionary purposes, and make it available for spending, including investment in both physical and human capital. In other words, social spending could "crowd in" private expenditure and raise the economy's current and future growth rate alike while decreasing its volatility.

Monetary Policy and Restructuring Financial Markets

50. It is equally important that monetary policy be coordinated across countries. In the absence of coordination there may be large, costly, and destabilizing exchange rate movements. But it may be difficult to achieve the necessary level of coordination, given different circumstances and different views of the role and objectives of monetary policy. Conventional monetary policy measures to combat the crisis appear to have been exhausted in several major countries. Interest rates in the U.S. and some other countries cannot go much lower. This is one of the reasons why most of the burden of the economic policy response to the crisis must now fall on the shoulders of fiscal policy.

51. Monetary policy operates by increasing the availability of money and credit and easing the terms at which credit is available. Much of credit availability is mediated through the banking and financial system. Providing more liquidity to financial institutions may not, however, lead to more lending. A kind of liquidity trap can arise in circumstances such as those the world is facing today. Banks with large risks to their balance sheets, which have seen large erosions in their net worth, and facing prospects of high default rates on existing

risky loans, are not disposed to increase lending. There may, of course, be overreaction: an episode of excess risk taking may be followed by an episode of excessive precaution. If that is the case, governments may need to take a more active role in absorbing some of the risk of lending. Chapter 5 discusses some of the ways in which this may be done.

52. It is thus probable that traditional monetary policy by itself will have only limited effects in resuscitating the global economy; a reduction in interest rates will have an insufficient impact on aggregate demand unless there is an expectation of increased levels of activity and profits.

53. Monetary policy has traditionally focused on the overnight interest rate at which banks borrow from each other or from the Central Bank at the discount window. The spread between the policy interest rate and the interest rate at which firms or households can borrow in the medium and long term is an endogenous variable, which may actually increase as the policy rate falls. This may be because of changed inflationary expectations, or because other changes in the economy result in heightened risk perceptions for lenders. It is possible for monetary authorities to influence longer-term interest rates for government securities and for private sector liabilities by opening the discount window to them or by buying them outright through open market purchases. However, this would require the Central Bank to assume risks that are beyond those that Central Banks have assumed in normal times through its lender of last resort function. It is important that when Central Banks assume such risks they estimate the future actuarial cost carefully and to the extent possible their existence and cost should be in the public domain.

54. When policy intervention involves the purchase of the liabilities of particular private sector issuers this may be equivalent to an implicit subsidy on the financing costs for that sector. If it is restricted to very large firms it may place small and medium sized firms at a disadvantage.

55. In the interests of transparency and accountability, since the costs of these actions may have an impact on resource allocation as well as on the balance sheet and the receipts of the national treasury, it is desirable that these decisions be ratified by parliament.

56. At the same time it needs to be recognized that traditional prudential policies may also have significant impacts on credit availability and the terms at which it is available. There is a fundamental difference between prudential policies affecting a single bank and those that affect an entire banking system. The introduction of prudential regulations in response to financial difficulties has in the past produced excessive credit contraction. While getting the balance right is extraordinarily difficult, Central Bankers need to be attentive to the macro-economic consequences of prudential policies. If a policy of forbearance is adopted, it must be accompanied by increased supervision in order to offset the possibility of moral hazard leading to excessive risk taking and fraudulent behaviour.

57. In some economies monetary policies, both conventional and unconventional, are actively being used in order to prevent a deepening of the financial crisis and its harmful impacts on the employment and income. Part of this is a response to the fact that capital markets have proved inefficient and these policies are a direct response to such inefficiencies. Nevertheless, as a result of the actions of Central Banks, there is a concern

among some observers about high rates of inflation in the short to medium term. While trade-offs between preventing downturns and causing inflation will differ from country to country, at the current juncture there is a need for a global coordination of expansionary policy. In the future, if and when the immediate and severe crisis appears mitigated, governments and Central Banks will have to make the difficult decision on whether and how to retract liquidity. This will certainly depend on the particular context of the country, and will require a careful balancing of the risks of a return to recession versus accelerating inflation.

Bail-outs

58. Bail-outs of financial and non-financial institutions have become a distinguishing feature of the macroeconomic policy responses to this crisis. They have changed the expectations of the future development of global financial markets. The efficiency of the bail-outs will affect the pace of recovery, the level of the national debt, and the ability of a country to pursue a broader range of objectives. One of the important goals of the bail-outs should be to facilitate a restructuring of the financial sector in ways which enhance economic stability and growth. Bailout decisions must be made with future design of financial structure in mind. The financial system of the future must avoid the structural flaws revealed in the recent crisis. In many countries, the financial system had grown too large; it had ceased to be a means to an end, but an end in itself.

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59. The primary concern in this Report is the impact of these policies on developing countries and the impact of badly structured bail-outs in diverting capital resources from developing countries, impeding their long-term growth prospects. For developing countries especially the new global financial system should provide better risk management than in the past, and provide a more stable source of funding, including funding for small and medium sized enterprises. In the past, the global financial system has exacerbated economic fluctuations in many developing countries by providing funds in a pro-cyclical manner. It also diverted funds away from lending to small and medium sized enterprises and forced developing countries to bear a large fraction of the risks they face, including those associated with exchange rate and interest rate fluctuations.

60. In assessing the policies introduced in response to the crisis a distinction needs to be made among the various impacts on the economy. The primary focus of any bail-out is to restore credit flows to the real economy and contribute to macroeconomic recovery. However, there are distributional impacts of a bail-out and its design will affect in different ways all stakeholders -shareholders, bondholders, workers, firms and households seeking credit- and other claimants to a bank's resources. There is a concern that in some countries there has been excessive focus on saving bankers and bank shareholders; and greater focus on saving financial institutions than on the re-establishment of credit flows.

61. One result is that the bail-outs have been more costly than they might otherwise have been, another that the bail-outs have been viewed to be very unfair; a third that there has been a massive redistribution of wealth from ordinary taxpayers to those bailed out. A bailout can be accomplished by forcing unsecured debt holders to restructure their assets, diminishing debt and converting the residual into equity. Alternatively, taxpayers can finance a bailout. The latter approach, by subsidizing bondholders who did not have explicit

guarantees, may serve to reinvigorate moral hazard in the future. In addition, the distributional impact of a taxpayer bailout may reduce growth in the future in order preserve wealth that was created in the past. Also, because resources are scarce, and the national debt is larger than it otherwise would have been, there will be less to spend, e.g. on a stimulus package or social protection. The perception that the bail-outs have been unfair may impede future actions to resuscitate the financial system or to undertake other actions necessary to address the crisis. The fact that the bail-outs have, in many cases, been slow to restart lending is of particular concern because if this continues, prospects of a robust recovery are diminished.

62. Finally, the perception that the bail-outs have been unfair may be corrosive to the reputation of the government and impede its capacity to inspire future actions to resuscitate the financial system or to undertake other actions necessary to address the crisis. A demoralized body politic that does not believe that government representatives can implement desired change equitably may choose in the future to elect officials who reflect their pessimistic views of the capacity of the public sector to play a constructive role. This would diminish society's capacity to achieve collective responses to many challenges that are not well handled by private markets alone.

63. Given that the focus should be on restarting lending, governments should expand their strategies to include additional options such as the establishment of a new bank or banks operating without the bad debts of the failed institutions and to provide (partial) guarantees for new lending. The terms at which any newly established institution should be provided support should be such as not to give the new bank a competitive advantage over existing banks that have not required additional funding.

64. In transferring assets and liabilities between the public and private sector, particular attention needs to be paid to the prices paid; overpaying the private sector for a particular asset or a bundle of assets represents an unwarranted transfer to the firm at the expense of the taxpayers. In addition, some schemes for asset sales will utilize public money to buy impaired assets from solvent financial institutions at subsidized prices. This is an inefficient use of public funds. Preventing such transfers is, however, difficult, given that one of the features of this (and similar) crisis is the failure of markets to function properly. In such a situation, minimizing the scope for unwarranted transfers from the public to the private sector should be one of the objectives of public policy. Similarly, in providing equity injections into banks, it is important that the value of the shares obtained be commensurate with the funds provided. This has not been the case in some countries.

65. There is a strong presumption that government should set rules to protect the taxpayers and to ensure that financial firms play by the rules. These rules entail reorganization when bank capital falls below certain levels. Banks that are too big to fail are not too big to be financially reorganized. Financial reorganizations that do not impose costs on shareholders and bondholders lead to future moral hazard problems. Moreover, public subsidies to the financial sector lead to distorted resource allocations. The fact that there have been repeated, *ad hoc* bail-outs of the financial sector suggests failures in their ability to assess creditworthiness and suggest systemic problems that must be addressed both as part of the bail-out and the long-term strategies for preventing another crisis. More discussion of these issues is made in Chapter 3.

66. Five principles should guide bail-outs: they should (a) be designed to restore capital adequacy; (b) impose the minimal burden on the public sector budget; (c) establish proper governance/incentive structures; (d) reduce—and certainly not exacerbate—existing problems in the financial system; and (e) be viewed to be fair. In some bailout plans most of the capital has been supplied by the government, while the government has little or no governance role. A failure to align ownership and control almost inevitably gives rise to incentive problems, some of which have been manifest in recent bailouts, where attempts at recapitalization have been partially undone as the banks have paid out large amounts in bonuses and dividends.

67. Moreover some of the bailouts of financial firms in the wealthiest economies have exacerbated the problems arising from institutions that are "too big to fail". Bailouts of large failing institutions does not penalize them for their misallocation of resources. Moreover this encourages further consolidation and thereby increasing systemic risk in the future.

68. Such consolidation fortifies a market structure with inherent moral hazard and prone to repeated bouts of excessive risk taking. The mere fact of the vulnerability of the real economy to spillovers from the experience of financial crisis informs the expectations of risk takers. The foreknowledge of their ability to induce bailouts is most profound in these large highly leveraged institutions whose executives are politically very powerful. The G-20, Financial Stability Board and BIS Committees must give more substantial consideration to the long-term consequences of too big to fail institutions if they are to design sound public policies for the world economy using the lessons of the crisis. Excessive deference to the wishes of large institutions for a particular form of regulatory design has been, and will continue to be, part of the problem rather than part of the solution to this very damaging experience.

69. The role of open bank assistance and the use of guarantees on a contingent basis are costly methods even if in some instances they deter funding instability. These methods need to be formally represented on budgets and their implication for exacerbating moral hazard must be addressed explicitly.

70. The use of guarantees for wholesale liabilities may also serve to impair the credit quality of the sovereign debt of the country providing the guarantee when the balance sheets of impaired financial institutions are very large in relation to the size of the economy. The credibility and effectiveness of these guarantees may also be called into question in such cases.

71. Providing more money to financial institutions supplying credit to small- and medium-sized enterprises may be viewed as fairer and more effective in rekindling lending. In any case, any strategy for restructuring the financial system needs to focus on the functions which the financial system should be providing, and take due account of the repeated failures in recent decades. Chapter 3 discusses the potential relevance of a 'nationalized core' for the banking system.

The Role of Central Banks

72. Several aspects of the conduct of monetary and credit policies contributed directly to the crisis. The deregulatory pressures of the last two decades, as well as the successful management of recent financial crises led to a larger appetite for risk, were central to the breakdown of the financial system. Regulators leaning against these currents faced substantial pressure. These issues are discussed more extensively in Chapter 3. This section focuses on Central Bank monetary policies, and the governance of Central Banks, which may affect their conduct of monetary policy. Certain widely-held beliefs about the appropriate role for Central Bank policies may have contributed to these problems.

73. There has been a widespread belief that price stability was necessary and (nearly) sufficient for economic growth and financial stability. However, success in stabilising goods prices was often accompanied by inflation in asset prices, causing unsustainable speculation. This created a policy dilemma. Decisions to focus on price behaviour in the real sector led Central Banks to ignore the broader impact of financial innovations on risk and liquidity management in financial markets. Thus, while price stability was achieved, Central Banks did not prevent, and may even have contributed to, the gravest financial turmoil since the Great Depression. In particular, it is clear that the economic cost of financial fragility was much greater than the economic costs that might have resulted from the slight distortions in resource allocation as a result of relative price misalignments which can arise with uncoordinated price changes in the presence of low to moderate inflation.

74. Underlying these failures was perhaps an excessive reliance on a particular set of models making unrealistic assumptions concerning rational behaviour. They tended to ignore key aspects of the economy, including the importance of information asymmetries, diversity of economic agents, and the behaviour of banking institutions. Instead they focused on the efficiencies arising from the diversification of risk associated with securitization while ignoring the problems of information asymmetry to which securitization gave rise.

75. In the period before the outbreak of the crisis, inflation spread from financial asset prices to petroleum, and then to other commodities and food, as they became financial asset classes subject to financial investment and speculation. While it became impossible for Central Banks to ignore the impact of asset inflation on goods inflation, the appropriate policy response was not clear. This was the case in particular for Central Banks following inflation targeting of goods prices.

76. Since food and energy prices represent a larger fraction of the consumer price index in developing countries, attempting to control inflation may require especially high interest rates to influence them. In addition since this inflation is imported, it is relatively unaffected by changes in the interest rates. There is thus little effect on the rate of inflation except through the appreciation of the exchange rate with devastating effects on the real economy. Those economies that allowed exchange rate appreciation soon faced conditions in which the advanced industrial countries (followed by the emerging markets) were responding to the threat of deflation with lower interest rates. The interest rate differentials in favour of these developing countries then reinforced the exchange rate appreciation, with its adverse macro-economic effects, until the impending global crisis reversed the rise in oil and food prices, and interest rates could be reduced. The fall in interest rates, combined with the sudden change in market appetite for risk and capital repatriation then led to rapid depreciation in

exchange rates. All of this exerted a high toll on developing countries that followed these policies.

77. Countries that judiciously intervened in their foreign exchange markets and capital markets have fared better than those that did not. Risk absorption mechanisms, especially in developing countries, both in the public and in the private sector, are not well developed, and the capacity of firms and households is limited because of low levels of wealth available to absorb shocks of these magnitudes. Those Central Banks that used the flexibility implicit in an inflation targeting approach also may have fared better.

78. The lesson of this experience is that monetary policy decisions should be sensitive to the source of inflation. Increasing interest rates to counter increasing prices of tradable goods in an open economy or increases in government administered prices is unlikely to have any direct impact on inflation. In some developing countries, these sources of inflation can constitute three-fourths or more of GDP. Hence, attempting to rein in inflation by raising interest rates imposes a high cost on the economy, and especially on interest sensitive non-traded sectors.

79. The recent food and energy crisis also highlighted the problem of the choice of the appropriate target for monetary policy dedicated to price stability. Some Central Banks have focused on "core inflation", a measure of goods price inflation that excludes the volatile energy and food sectors. But in developing countries this measure of inflation excludes the prices that have the highest impact on household purchasing power and are thus most important in influencing inflationary expectations.

80. Monetary authorities should, at the same time, be sensitive to the consequences of asset price bubbles and other factors that might affect financial stability, and thus economic stability and growth.

81. Another lesson to emerge from this crisis is that the definition of national and global macroeconomic stability needs to be broadened. It is clear that Central Banks need to assess the impact of their policy on other aspects of stability than just price stability. In particular the stability of the real economy and the financial system should also be taken into account.

82. But because these objectives will also be influenced by the behaviour of the real economy including incomes and employment, better coordination of fiscal and monetary policy, as well as social policy, is required.

83. While high, accelerating levels of inflation do present a problem, there is little evidence that moderate, non-accelerating levels of inflation lead to reduced growth. Moreover, history suggests that deflation represents just as great a threat to economic prosperity as hyperinflation. A gently rising price level, as the late Sir Austin Robinson put it, has the merit of speeding up the efficiency of the market process in reallocating resources.

Risks and policy trade-offs

84. Monetary policy has tended to focus exclusively on the stability of prices of real goods and services. Many Central Bankers claim that asset price stability is either not their

responsibility or that they do not have the capacity or instruments to control asset prices. Certain Central Bank governors, for instance, claimed that they could not ascertain whether there was a speculative element present in market prices, or that there was a bubble, but that even had they been able to influence asst prices they only had one instrument, the interest rate, to deal with two objectives. Using tight interest rates to dampen asset price inflation would have caused an unnecessary sacrifice of real output.

85. While one cannot ascertain the presence of a speculative bubble with certainty, there are indicators that suggest the likelihood of its presence. But, nothing in economics is certain. If policy actions were restricted take actions with certain consequences no decision would ever be taken. Economic policy is always conducted under uncertainty, and part of the art and science of policy making is to assess and balance the risks. It is clear that many Central Banks failed to do so.

Multiple instruments

86. It is also important to note that Central Banks do have a number of additional policy instruments at their disposal, such as margin requirements which (together with other regulatory restrictions discussed in Chapter 3) could have been used to dampen speculative activity in asset markets. It is also not the case that each institution in an economy should use only one instrument and be responsible for only one objective. Only in the context of highly simplified models can such assignments be optimal.

Changing structure of the financial sector

87. The large interventions in financial markets by Central Banks raise a number of other difficult issues, some of which are discussed below. One overriding issue is that there have been large changes in the structure of financial markets in recent decades, e.g. the growth of securitization, increasing leverage and the decline in the role of relationship banking. Some of the failings of the financial system may be related to these changes. Government intervention will have an effect on the future evolution of the structure of the financial sector. Governments and Central Banks need to take decisions that they believe will be most effective in generating the benefits that can be derived from a well-performing financial sector—and which will insulate the real economy from the risks to which it has been exposed as a result of the malfunctioning of the financial sector.

Governance

88. The large role that some Central Banks have been taking in direct lending to financial institutions raises further questions about the governance of Central Banks: when they are engaged in a quasi-fiscal role is the independence from political interference required by the need to gain "policy credibility"? As already noted, many interventions by Central Banks have a fiscal character: implicit subsidies and taxes, unfunded or contingent liabilities etc. While in the past these quasi-fiscal operations were limited and their effect on public finance was more or less regular, in the present crisis these operations have greatly increased in number and in magnitude. The problem is that when Central Banks engage in quasi fiscal activity conventional measures of fiscal activity such as the Non Financial Public Sector borrowing requirement or the deficit of the central government becomes misleading

indicators of the size or impact of fiscal policy. Therefore, activities with fiscal implications must be closely coordinated with government.

Multiple and New Objectives

89. Beyond the immediate issues currently being addressed by most countries –stimulating their economies and restarting the flow of credit– there are some basic problems which have to be addressed, in particular: redressing national inequalities and global imbalances. The policies that are currently being introduced to deal with the economic crisis may exacerbate national inequalities and global imbalances.

The Need for Economic Restructuring

90. In addition to the problems confronting the global economy described above, many countries face problems in economic restructuring. Rapid increases in productivity in manufacturing combined with globalization has translated into rapid improvements in competitiveness in developing countries and has resulted in rapid changes in comparative advantage across developed and developing countries. This has led to changes in the international division of labour. Such adjustments are always very costly and painful, especially when there is high unemployment, and in countries which provide insufficient adjustment assistance to their citizens and in circumstances in which many citizens have seen large fractions of their wealth –which might have provided a buffer against such changes– disappear. High interest rates and lack of availability of credit –a problem facing many developing countries-- hinders structural adjustments and increases the difficulties of economic restructuring, while excessively low interest rates may impede restructuring by leading to overinvestment and excess capacity, if financial markets are dysfunctional and especially if they are under-regulated, and fail to allocate capital to high productivity uses.

91. There is also a need to restructure the global economy to meet the challenges of global warming. Providing a clear price signal concerning the economic costs associated with global warming would provide strong incentives to the private sector, both for households to change consumption patterns and firms to change modes of production. Restructuring the capital stock would provide large demands for investment that could be a major stimulus for the economy. There may also be a need for government to assist in financing these investments in resource conservation and environmental protection.

Impacts on Developing Countries

92. Rapid introduction of measures to avoid a further deepening of the crisis in emerging and developing countries are needed. These include restoring and expanding social protection and reducing the pro-cyclical features of the economic system. Delay will mean that the eventual cost of dealing with the problem will be higher and the length and depth of the downturn will be greater, with more innocent victims losing their jobs, with more small and large businesses forced into bankruptcy. The crisis is likely to extract a particularly high toll on developing countries for four reasons.

Why developing countries are being hurt so badly

93. First, the citizens of developing countries have fewer resources with which to cope with a crisis of this magnitude. Secondly, they already suffer from a lack of automatic stabilizers due to the embryonic nature of their fiscal and social protection systems. Third, "markets" impose constraints on their ability to pursue countercyclical fiscal and monetary policies. Many are forced to pursue pro-cyclical policies. This is especially true of those countries that have fully opened their capital accounts and have engaged in financial market liberalization, and have turned in boom years to international capital markets. Those markets are now greatly impaired. Fourth, the size of capital flows to developing countries is likely to be markedly lower this year than in earlier years. Risk premia have suddenly increased, so that emerging markets often face higher borrowing costs. Many firms and countries will face credit constraints. Some countries, faced with large capital outflows, may be tempted to raise interest rates with adverse effects on the real economy. As the economy slows, confidence erodes, and capital flees even faster.

94. These ever-present threats have been exacerbated by financial market integration. Many countries have come to rely on foreign banks, and some foreign banks from countries that practiced inadequate regulation and that followed inappropriate macro-economic policies find their capital badly impaired. They are now repatriating capital with adverse effects on developing countries. The difficulty is compounded by the fact that many developing countries have entered in free trade agreements (FTA), bilateral investment treaties (BIT) and World Trade Organization (WTO) commitments which prevent them from regulating the operation of financial institutions and instruments or regulating capital flows.

95. For example if a developing country decides to nationalize some services such as banking, this can require compensation if the sector has been liberalized under the WTO GATS agreements on trade in financial services or under an FTA/BIT. When these agreements and commitments are enforced, developing countries have to pay compensation or suffer from the imposition of tariffs on their exports to the complainant if they do not comply.

The Role of Protectionism

96. These adverse effects of financial globalization have been further exacerbated by a wave of financial protectionism. Governments that have provided large amounts of capital to their banks, either under recapitalization programs or through the Central Banks providing liquidity in unusual amounts and in unusual ways understandably expect an increase in domestic lending. The irony is that this kind of financial protectionism does not seem to be subject to sanction.

97. Certain policy measures taken by developed countries have exacerbated these problems further. Credit guarantees have contributed to the reversal of capital flows. Even if developing countries believed it was desirable and appropriate for government to provide guarantees of the depth and breadth provided by some advanced industrial countries, their guarantees would be less credible. Symmetric policies can have asymmetric effects. Credit guarantees not paid for are clearly a violation of the spirit of the "level playing field" in international trade that the international community has attempted to construct over the past half century. Most countries providing such extended guarantees have made no attempt to

ensure that those receiving these guarantees pay for them on an actuarially fair basis. In the absence of such full payment, such guarantees represent a major subsidy.

98. Market forces and resource constraints may also limit the ability of developing countries to pursue countercyclical fiscal policies. They may not have sufficient domestic resources, and when they turn to global markets to finance the deficits required to manage countercyclical fiscal policies they may find international markets either unwilling to lend, or willing to lend only at very high interest rates. This is one of the reasons that some developing countries have resorted to policies to reduce external constraints and build up large reserves (see Chapter 5 for a more extensive discussion of these issues).

99. Market inequities have been exacerbated by government distortions in another way. There have been massive bail-outs of financial institutions, but increasingly of firms in other sectors of the economy. Most developing countries do not have the resources to match these support measures. Again this problem may be aggravated if the developing country is part of an international agreement (FTA or BIT). In that case in effect the agreement would require that if a country wants to support domestic companies facing difficulty it should provide equal treatment to foreign companies. Here too the apparent symmetrical treatment which appears in the agreement has deep asymmetrical effects. In rich countries, large firms are usually national, and the foreign firms, especially those originating from developing countries are much smaller in size. The opposite is generally the case in developing countries. It would be very difficult for a developing country to bail out a large foreign company, in view of its limited resources, and this represents a de facto impediment to providing assistance to local companies. The same de facto asymmetry applies to stimulus packages which require equal treatment of firms whatever their country of origin.

100. The same consideration applies to public procurement policy. But here again there is an asymmetry. There are multilateral procurement agreements among developed countries, but relatively few between developed and less developed countries. Hence, if a developed country adopts a "buy national" policy with an exception for WTO commitments, the effect is to discriminate against purchases from developing countries that do not have such commitments.

101. In addition, many developing countries have been constrained by international financial institutions to adopt restrictive policies in times of slow growth or even recession. These policies are markedly different from the countercyclical policies being adopted by the advanced industrial countries, and increase the risks faced by investors in developing countries relative to those in developed. The asymmetry in IMF policy stances has become apparent in the current crisis in several countries. And there has even been some contagion: the EU is imposing pro-cyclical policies on the enlargement countries, including wage and expenditure reductions in the public sector.

102. More broadly, developing country dependence on IMF financing has constricted their ability to adopt countercyclical policy and other countercyclical measures and may impede their willingness to turn to international institutions in a timely way, resulting in costly delays.

103. If strict measures are not taken quickly by the international community, developing countries will suffer from the attempts by developed countries to protect themselves from

the crisis. In the short and medium term, countercyclical policies, social protection measures, infrastructure development, and credit guarantees are indispensable for developing countries and may enhance global fairness.

Developing countries need additional funding

104. Developing countries will need substantial funding in addition to that provided by traditional sources of development assistance to participate effectively in a coordinated global stimulus. They will also need funds for other important responses: to protect their most vulnerable individuals by strengthening social protection, to provide trade finance and finance to corporations whose sources of international credit may have dried up, and to bolster domestic financial institutions weakened both by the withdrawal of funds and by the precipitous collapse of export earnings. Developing countries need low-conditionality financing to tackle volatility in commodity prices and other external vulnerabilities which are not dependent on their domestic policies and to compensate them for the adverse effects of the intentional and unintentional protectionist measures of the developed countries.

105. Sources of funding for developing countries that could be activated quickly and are not subject to inappropriate conditionality are necessary. Indeed, additional funding would be required just to offset the imbalances and inequities created by the massive stimulus and bail-out measures introduced in advanced industrialised countries. As in developed countries, substantial portions of this stimulus spending could be directed to environmental measures, in part fulfilling developed country commitments under the United Nations Framework Convention on Climate Change.

106. Failure to maintain the levels of official assistance and provide this additional assistance will have long-term effects. There will be an increase in poverty and malnutrition and the education of many young people will be interrupted, with life-long effects. The sense of global social solidarity will be impaired, making agreement on key global issues, such as responding to the challenges of climate change, more difficult. Failure to provide such assistance can be counterproductive even in a more narrow sense: it can impair the global recovery.

107. Such funding could be provided immediately by completion of the issuance of Special Drawing Rights approved by the IMF Board in September 1997 through the proposed Fourth Amendment of the Articles of Agreement to double cumulative SDR allocations to SDR 42.8 billion. In addition, rapid action should be taken to provide for the issuance of additional SDRs through standard procedures in the amount of at least $250 billion per year for the duration of the crisis (see Chapter 5).

108. To make these allocations fully effective, it will be important that the advanced industrial countries receiving SDR allocations transfer them to developing countries. The priority should be given to transfers to the lowest income countries and countries which might otherwise pose a systemic risk to the global economy. It will be important to develop better mechanisms for facilitating this transfer. *Ad hoc* measures may have to suffice in this crisis, but the international community should consider changes in the Articles of Agreement that would provide for alternative systems of allocating SDRs (see Chapter 5) and facilitate the transfer of SDRs.

109. In addition regional efforts to augment liquidity should be supported. For instance, extension of liquidity support under the Chiang Mai initiative without the requirement of an active IMF programme should be given immediate consideration. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighbouring countries.

110. These additional sources of funding should be in addition to traditional official development assistance. More broadly, developed countries must make a renewed effort to meet the commitments made in the 2000 Millennium Declaration, the 2002 Monterrey Consensus, the 2005 Global Summit, and the 2008 Doha Declaration, by 2015.

111. In thinking about additional funding, it is important to distinguish between support for countercyclical macro-economic policies and longer term development financing, though increases in the latter can have important countercyclical effects. Traditionally, the World Bank and the regional and sub regional development banks have played the central role in development assistance, while the IMF has played a more important role in managing crises. Some studies have emphasized that it should not play a central role in development assistance. The question is what role it should play in the provision of credit in the current crisis, and what role should credit itself play.

112. At the beginning of the decade, there was considerable concern about excess debt burdens of developing countries. In addressing this crisis, it is important to avoid a build-up of unsustainable debt, or debt that would crowd out developmental efforts. Thus, the bulk of assistance to the least developed countries should take the form of transfers, rather than loans. There is concern that the initiatives announced by the G-20 rely largely on the provision of credit.

113. A potential source of funding for such assistance would be a commitment by the developed countries to devote 1% of any stimulus package to direct expenditures in developing countries.

114. Over the longer run, the international community should consider establishing a special facility to provide support for those countries creating strong systems of social protection. While such systems may be largely self-funded, it will take time to build up the required reserves, and the international community should consider back-stopping these efforts. Such commitments might have important incentive effects in inducing the creation of such systems, which, through their automatic stabilizers, would also serve to help stabilize the global economic system.

115. The magnitude of the necessary support could be increased by involving multiple sources of fund, including regional development banks, the IMF, the World Bank, and possibly a newly created credit facility to be described below.

116. While it is essential to continue the important work of harmonization of official development assistance, it is also important that harmonization, especially of counter-cyclical lending, does not lead to concerted imposition of pro-cyclical conditionality. This is

important given the need for countries to undertake quickly measures to stimulate activity protect the vulnerable, and maintain the flow of credit.

117. The reluctance of many countries to accept assistance from certain institutions, and the reluctance of some potential lenders to provide funds to certain institutions, constitutes an impediment that may not be fully addressed by the reforms that are likely to be made in the short run. The availability of alternative mechanisms of disbursement might not only accelerate the flow of funds, but also make it less likely that they be accompanied by pro-cyclical conditionality either *de jure* or *de facto*.

New Credit Facility

118. It is thus imperative that, during the recovery phase developing countries should have access to additional sources of external funding, including credit and liquidity facilities for social protection, infrastructure investment and environmental interventions, for government support, for support of developing country financial systems, and for corporate borrowing. Without such support the global crisis may grow worse and long-term global cooperation may be impeded.

119. Alternative financing could be provided through the creation of special funds in existing institutions administered under more accountable governance arrangements, or through the creation of new international economic institutions or facilities.

120. Existing facilities presently do not meet these needs for several reasons. First, the current system does not provide an efficient mechanism for mobilizing the funds available in countries that have accumulated large reserves. It would be beneficial for all participants in the global economy if savings from emerging markets could be utilized in support of developing countries. Government agencies in some emerging market countries that have reserves are reluctant to provide development funds to existing multilateral institutions, because these countries are often under-represented in their governance structure and because they perceive the policy advice and conditionalities provided by these institutions as inappropriate to the needs of developing countries.

121. In addition, there is a lack of appropriate funding facilities to respond to the interests of some developing countries with high reserves, such as sovereign wealth funds that seek investments with acceptable return and limited risk. The current financial system does not provide this intermediation facility. Moreover, as already noted, there may be a reluctance by some developing countries to turn to certain international institutions
.

122. In assessing the alternative options, concern should focus both on the speed with which a new facility can be established, as well as the role that it might play in helping construct better long-run architecture. Some worry that creating a new facility will take too long, though personnel could be seconded from existing institutions, and if macro- or micro-conditionality is excluded, implementation problems could be greatly reduced. Others worry that necessary or desirable reforms within existing institutions may occur too slowly. These concerns have been increased as a result of the appearance of large discrepancies between official discourse on changes in IMF operating policies and their official implementation in lending agreements that appear to require fiscal tightening, inflation targeting and even tight

constraint on nominal wage growth in the public sector. The World Bank seems to have made more progress in revamping its approach to developing countries, but also requires substantial progress which will take time to achieve.

123. Thus it appears preferable to create a *new* credit facility, perhaps administered by an existing multilateral institution or a consortium of multilateral institutions, but with its own governance structure. Such a new credit facility could draw upon the administrative expertise of existing institutions, and could be created rapidly. Its governance would reflect more recent thinking concerning appropriate governance structures, ensuring not only greater say for those countries providing the funds, but also for recipient countries. Given the limited remit of IMFs new flexible credit line, and the relatively minimal conditionality related to the usage of the funds, it may be easier to achieve agreement on details of governance. The introduction of alternative voting arrangements, including double majority voting, should be given serious consideration.

124. Special consideration should be given to timely environmental investments addressing problems of climate change. The facility could adopt climate change principles to ensure that the short-run focus of this spending is consistent with longer-term development strategies.

125. The governance structure of this facility could be more modular with regional groupings (for example by the Inter American Development Bank, the Asian Development Bank , the African Development Bank and others) charged with its operation.

126. The other question to be resolved in the creation of a new credit facility is the origin of its resources. There are different possibilities, which are not mutually exclusive. It might be provided by a new allocation of Special Drawing Rights, by increased contributions from developed countries, in addition to existing commitments of official development assistance, by contributions from countries with large international non-borrowed reserves, or by regional arrangements such as Bank of the South or the swap arrangements under the Chiang Mai initiative.

127. There are other options which should be simultaneously pursued. In particular, the reforms in the international financial architecture and the provision of global reserves should include further expansion of already existing regional arrangements. Whatever the financing arrangement, the inherent asymmetrical treatment of countries by private markets does not justify imposing symmetrical policy responses on developing countries.

128. The advanced industrial countries should maintain their existing commitments for official development assistance. To offset potential imbalances arising from the disparity in resources with which to address the crisis, there should be an increase in Official Development Assistance. The initiative of the World Bank to induce developed countries to increase such aid in tandem with the assistance they provide to their own economies is therefore appropriate. It needs to be ensured however that such funding is additional to existing aid commitments.

Concluding Remarks

129. As the world addresses the exigencies posed by this crisis, through stimulus packages, monetary and credit policies, and bail-outs and guarantees, the international community should not to lose sight of remedies for the underlying causes of the crisis. National economic systems which give rise to high levels of inequality pose problems not only for social and political sustainability, but also for economic sustainability, i.e., excessive increases of household and public debt.

130. It is also of crucial importance that the crisis response should fully take into account the need for transforming the present mode of growth by trying to slow down the overexploitation of natural resources, in particular of oil reserves, which may imply a change in consumer habits to support environmental sustainability. In this respect, investment in new environment and energy technologies to address adaptation and mitigation of climate change is a formidable opportunity for countercyclical stimulus. "New environment and energy technologies" (NE^2T) include all technologies able to lower the energy and emissions content of our standard of living, technologies leading to the production of energy from renewable resources, and technologies helping to preserve, repair and improve ecosystems. For developing countries, the full incremental costs of these investments, justified by their global benefit should be financed by industrialized countries and transferred to developing countries in exchange for commitments on climate change and biodiversity. Such commitments of resources have already been made as part of earlier international environmental conventions, but substantial additional resources to fulfil those commitments have yet to be provided. The imperative to address this question is enhanced by the fact that while developed countries are by far the biggest global polluters up to now, emerging and some developing countries could become the biggest global polluters in future. It is thus rational to make large investments today to develop those technologies and, through technological transfer, make them available freely to developing and emerging countries. Climate change and biodiversity are quintessential global public goods. Supporting developing countries in their own efforts to address climate change and preserve biodiversity should be seen as part of the solution, part of the way that the international community can ensure that these global objectives are effectively addressed.

131. Hence, the political feasibility of additional mechanisms and innovative sources of financing such as emission rights trading and financial transactions taxes should be enhanced. These and other innovative sources of finance are discussed in Chapter 5.

132. Policy makers need to be particularly attentive that, in addressing the crisis, these and other underlying problems are not exacerbated. As noted elsewhere, bank consolidation increases the risk of creating more institutions that are too big to fail, one of the problems giving rise to this crisis. Similarly, poorly designed bailouts may lead to increased inequality, exacerbating one of the fundamental problems giving rise to this crisis; and without appropriate action directed at developing countries, global imbalances, another of the fundamental problems, may be exacerbated. Moreover, unless policies are well designed there is a risk there national and government debts are increased unnecessarily, constraining policy spaces for the future.

133. To date, there has been little effort to coordinate international responses to the crisis. Reactions in almost all countries have been simply to launch a recovery programme. These programmes have been nationally designed with almost no coordination between countries,

even in the Euro area. Traditional thinking, derived from crises arising in a single country, entails identifying areas in which domestic multipliers are high. But since approaches may lead to recovery programs that are far from optimal, delivering less global stimulus relative to the size of the increase in total spending or indebtedness, underlying problems like global imbalances may not only be ignored, but may be exacerbated. There is an especial need for surplus countries to take strong actions. Moreover, macroeconomic coordination would avoid the risk of self-defeating beggar-thy-neighbour strategies aimed at increasing exports while attempting to decrease imports, or increasing credit available to home country firms at the expense of credit available elsewhere. These new forms of protectionism can be even more detrimental to the global economic system, and unfair to developing countries. Protectionism through subsidies and guarantees are particularly disturbing, since while developing countries can match such actions taken by developed countries, they cannot match the subsidies and guarantees.

134. A cross cutting issue is therefore the need for significant improvements in regulatory cooperation. This includes the need for cooperation on tax regulation and on capital controls, in addition to the proposals for coordination above. It is critical, for example to have a reliable metric to differentiate illegal tax evasions and the establishment of international financial centres. Bilateral tax treaties often have the perverse effect of discriminating against residents which encourages 'round-tripping' of capital and undermines the workings of the world economy. To that extent, there is an urgent requirement for preventing regulatory arbitrage which can work to distort capital allocation and undermine state efforts at reinvigorating their economies.

135. Because countries are at different phases of the business cycle, and different countries have different automatic stabilizers and de-stabilizers, mechanisms for coordinating macroeconomic policy and evaluating relative contributions will be difficult. Developing countries have a stronger external dependence and vulnerability to external cycles and have a much weaker capacity to undertake countercyclical policies.

136. This is the most significant global crisis in seventy five years; it may be the most significant global crisis in history. It is clear that the global arrangements that have facilitated rapid growth in many parts of the world have not come without a cost: growing inequality in many countries, sometimes a loss of national sovereignty in matters that are of vital importance to citizens, in some cases excessively rapid depletion of natural resources and degradation of the environment. This crisis has shown another manifestation: while globalization offered the promise of greater economic stability it has led to a global recession. Toxic products, flawed regulatory philosophies, and deficient institutional practices were exported from countries claiming to be exemplars for others to follow. The debate about appropriate institutional practices and arrangements, and the economic, political, psychological and social theories on which they rest will continue for years. However, it is clear that current institutions and arrangements governing globalization and many national government policies have been based on a certain set of ideas and ideologies, while other ideas which might have been more helpful in avoiding the crisis and mitigating its size were overlooked. The ideas and ideologies underlying key aspects of what has variously been called neo-liberalism, market fundamentalism, or the Washington consensus doctrines have been found wanting. As the international community approaches the challenge of working towards a quick return to robust and sustainable growth and a reform

of international institutions and arrangements that ensure long term democratic, equitable, stable, and sustainable growth, it does so with a broader respect for a wider range of ideas and perspectives.

Chapter 3: Reforming Global Regulation to Enhance Global Economic Stability

Failure of the Prevailing Regulatory Philosophy

1. The use of markets is often recommended as the most efficient means to achieve social goals. In addition, financial markets, which serve to gather savings and channel them toward productive investment, as well as distribute risk to where it is best borne within society, are viewed as a means to enhance the efficiency of the use of the economy's resources. However, in recent years, the size and scale of financial market activity in relation to the underlying economy has led some to question whether unfettered free markets had let finance, the servant, become the master of the economy, and more broadly society.

2. The current crisis comes on the heels of a period of time when many political leaders and thinkers who were promoted and held in the highest esteem, put forth a vision that strongly espoused deregulation, efficient financial markets, and put little emphasis on the notion of market imperfections and externalities. The sheer magnitude and pervasiveness of this crisis is a profound refutation of that vision espoused in recent years, often called free market fundamentalism. It can be rightly deemed a failed philosophy.

3. Serious questions have thus arisen about the nature of market processes, and the abstract models that are used by economists to illuminate and describe them. The models used to describe economic process and the underlying (often implicit) assumptions contained within, are debated by scholars, policy makers, and practical people continuously. The recent experience should greatly invigorate that conversation.

4. While important arguments surround the prescription of regulatory regimes and the incentives that make for proper regulation and regulatory enforcement, the current crisis, which is estimated to have cost society several trillion dollars around the world, is a clarion call for re-opening a debate that has been resolved by force of will of the beneficiaries more than the power of reason in the last 30 years.

5. As the Congressional Oversight Panel of the TARP in the United States concludes in its report on regulatory reform: "But at the root, the regulatory failure that gave rise to the current crisis was one of philosophy more than structure." (1/29/09 Congressional Oversight Panel: Special Report on Regulatory Reform.)

6. Yet the prevailing view was that market prices were the best available signals; market prices were the defense against market failure. Such a view ignores the fundamentally and uniquely systemic nature of finance, the theoretical arguments explaining why financial markets often fail to produce efficient or stable outcomes, and the long historical experience of crises in financial markets. The current crisis is a direct consequence of these ideas, which resulted in the elimination of many regulations that had supported the ability of markets to function efficiently. The failure to adopt new regulations reflecting the changing economy, and the weakening supervision of banks, suggests that effective government regulation and oversight of financial participants and markets is imperative.

7. To illustrate, at a very simple level, the knowledge that the failure of large complex financial institution can do great harm to the economy, and that policy makers will be induced to take action to mitigate the consequences for the real economy in the event of a financial crisis, is the underpinning of a market context in which private incentives to take risk are beyond those that are socially optimal. This challenge can be illustrated by a game payoff matrix where ex ante society decides whether or not to strongly regulate financial institutions and ex post must choose, at the onset of a financial crisis whether or not to bailout those institutions.

	BAILOUT	NO BAILOUT
REGULATION	A	B
NO REGULATION	C	D

8. A Free Market adherent suggests a regime of little regulation and no bailouts such as position D. That is a consistent system design in the event that no financial institution is large enough to do harm to the real economy to the degree that it can induce the authorities to break the pledge of no bailouts. In fact, in the presence of many large financial institutions the entire right column is not credible or viable. The choice for society is between positions A and C. No probability weight is given to column two and that knowledge is embodied in the expectations of the management of financial institutions ex ante. Given that in the future and financial crisis will require a bailout, the ex ante position A restrains the desire of financial institutions to exploit the misalignment of social and private incentives. Combination C tolerates too much risk taking from a social perspective. This simple logic has become powerfully obvious in the recent crisis.

9. In fact, the current crisis opens up debates on both how to use regulatory policy to align private and social incentives in the presence of spillover externalities and secondly, how to align managerial incentives within the large financial institutions so that the leaders within those firms are not incented to raise the risk of social harm excessively. The exploration of how these regimes are designed, implemented, and enforced is another area that is worthy of renewed consideration in light of the power and persistence of an unhealthy regime of regulation in recent years and the costs of that outcome. The incentives faced by public officials, regulators, and elected officials and the role of money in politics are important antidotes to romantic notions of the efficacy of regulation to correct for market failures. In addition the role of expertise, and the incentives of experts who themselves are motivated by considerations of power, prestigious awards and compensation should be thoroughly examined.

10. Before the crisis there was a heated debate between regulation based on "principle" and based on "rules". The former were proposed by those concerned that banks would use rules as goalposts to circumvent basic banking principles, while the latter were proposed by those concerned by the possibility of regulatory capture. But the crisis overwhelmed both rule-based and principle-based regulatory systems, suggesting that this dichotomy was not as

important as it may have appeared. Both principles that set out the objectives of regulation and rules that try to apply these principles appear to be required.

The Purpose of Financial Regulation

11. Firms operating in the financial sector are subjected to additional regulations than those applied to other firms for two principal reasons. The first is that consumers require additional protection in the use of financial products than other products. This is because the failure of financial products can have life-changing ramifications. But, the market is not good at differentiating good and bad products because the performance of a financial product cannot easily be tested before, at, or shortly after the point of purchase.

12. The second reason why financial firms are subject to additional regulation is that the nature of the credit economy is that the lending by one bank is often a deposit at another and this deposit may be used to provide collateral for borrowing at a third. An essential part of banking is that banks lend to banks in a way that shoe shops and car companies do not. This means that the behaviour of individual banking institutions can have systemic influence. The failure of a single bank can bring down the entire financial system, either directly, or as a result of a general loss of confidence in all banks. The result would be a cessation of lending in the inter-bank markets. At another time in history this discussion would appear a little academic, but the current liquidity crisis has underscored the systemic nature of bank failures and the role of confidence.

13. The financial sector is the interface between households' savings and the financing of business investment. In the language of economics, there may be large negative externalities associated with the operation of banks and financial markets. Failures in financial markets have large repercussions for the rest of the economy. Financial markets have a tendency to produce market failure. Recessions that follow banking crises are often more severe and long-lasting than recessions that have their origins elsewhere. Regulation should be especially directed at reducing the scope for these market failures.

14. The role that banks (institutions licensed and regulated for banking operations and having access to liquidity from the Central Bank) play in a credit economy is unique and quite different from the role played by non-banks such as traditional investment funds, insurance companies, hedge funds. While this became a distinction without a difference in the run up to this crisis with some insurance companies and hedge funds behaving like banks and some banks owning investment funds. The crisis has also highlighted that bank access to Central Bank liquidity and provision of liquidity to the rest of the economy played a critical role in the transmission, first of the boom, and later the bust. This distinction, discussed more fully below, provides a basis for recommendations to regulate the activities of core banking activities (deposits from individuals and loans to companies) more heavily than non-bank institutions, while making regulation more comprehensive across the local and international financial system.

15. The objectives of banking regulation set out above may appear narrow from some perspectives and it is necessary to recognise the broader role that banks and financial markets can play in society by considering financial regulation as a subset of overall financial

policy.

Financial policy and regulatory policy

16. Regulatory policy fits within the broad ambit of financial policy, but is more narrowly focused on facilitating the attainment of social and economic objectives through consumer and investor protection (deposit insurance, rules against fraud, market manipulation, misrepresentation of products, and laws promoting competition), ensuring the safety and soundness of individual institutions, ensuring that there is access to finance, and other interventions designed to promote the maintenance of orderly markets. Ensuring systemic stability, however, goes beyond ensuring the safety and soundness of individual institutions. Such regulations can support and safeguard confidence in the financial system as a whole, and enhance financial and economic stability. While they may not be able to prevent crises such as the current one, they can make them less frequent and less severe.

17. Regulations are not costless. As always, one must balance the costs and the benefits. Today, the global economy is paying a very high price for inadequate regulations as well as a failure to effectively enforce those that did exist. Clearly, regulators in the main financial centres of the world failed to get the balance right, and their failures have imposed heavy costs on the entire global economy. While the general principles of regulation and the purpose and functions of particular aspects of regulation need to be specified, the particular institutional framework and implementation of these regulations can be flexible and tailored to the circumstances of each country.

18. Ensuring global financial stability to support economic stability is, in this sense, a global public good. This Chapter sets forth some of the general principles of financial sector regulation, and some of the reforms that are needed to bring existing national and international regulatory practices in line with these principles.

Failure of the Prevailing Regulatory Philosophy

19. Although the current crisis had many causes, there was one feature that underlay several of the most important: a flawed economic philosophy. The reason for the failure of regulation noted above is a number of market failures regarding the internalising of individual and social risks. Yet the prevailing view was that market prices were the best available signals; market prices were the defence against market failure. Such a view ignores the fundamentally and uniquely systemic nature of finance, the theoretical arguments explaining why financial markets often fail to produce efficient or stable outcomes, and the long historical experience of crises in financial markets. The current crisis is a direct consequence of these ideas, which resulted in the elimination of many regulations that had supported the ability of markets to function efficiently. The failure to adopt new regulations reflecting the changing economy, and the weakening supervision of banks, suggests that effective government regulation and oversight of financial participants and markets is imperative.

20. Before the crisis there was a heated debate between regulation based on "principle" and based on "rules". The former were proposed by those concerned that banks would use rules

as goalposts to circumvent basic banking principles, while the latter were proposed by those concerned by the possibility of regulatory capture. But the crisis overwhelmed both rule-based and principle-based regulatory systems, suggesting that this dichotomy was not as important as it may have appeared. Both principles that set out the objectives of regulation and rules that try to apply these principles appear to be required.

21. The failure of financial markets to provide the appropriate allocation of financial resources to support the productive economy and to manage risk has been one of the contributing factors in the present crisis. Financial policy is thus necessary to ensure that finance is available to meet the needs of the real economy as well as social goals attuned to local conditions such as banking the un-banked, insuring the uninsured, better allocation of savings and investment, supporting sustainable growth, trade etc. The measure of success of financial policy is not the rate of growth or the size of the financial sector as a share of GDP. Indeed, an excessively large financial sector relative to the GDP of a medium to large economy should be a cause of concern to those interested in long-term economic growth because financial crises are associated with unsustainable growth of the financial sector.

Regulation and innovation

22. Unregulated market forces have provided incentives for the creation of an abundance of financial products with little relevance to meeting these social goals and under-production of financial products that support social goals. At the same time incentives have been created for financial behaviour which are socially suboptimal. Such behaviour is supported by incentive structures in which there are higher fees and commissions for activities such as excessive trading or "churning", while products which might help manage important risks, like GDP-linked or commodity-price linked bonds, do not generate sufficient fees to attract the interest of financial markets. One of the roles of financial policy is to address these market failures in financial product development.

23. One of the potential costs of regulation is to reduce the scope for innovation. But much of the recent innovations in the financial system have had as their objective to increase the short run profitability of the financial sector, but not the ability of the financial markets to perform its essential features of managing risk or allocating capital; they have served to engender financial instability rather than increasing the productivity of the economy and the well being of citizens. From the point of view of the economy as a whole, some of the innovations were clearly negative. It is important to design regulatory structures that encourage economic and socially productive innovations and place adequate constraints on socially dubious innovations; good regulation may actual enhance the scope for positive innovations.

Regulatory Capture

24. Regulatory design needs to be robust to attempts by the industry to influence regulators and divert them from their core responsibilities for consumer and investor protection and systemic stability. Much can be done to design regulatory systems that have built-in resistance to capture, such as a reliance on simple and transparent rules on the regulation of instruments sold to unsophisticated, retail consumers or sold to wholesale consumers that are potentially of systemic significance. The design of regulatory governance can also reduce

the scope for capture.

Boundaries of financial regulation

25. Traditionally regulation has been differentiated by institutional forms: banks are regulated and non-banks are not. Insurance products are regulated by insurance regulators, but derivatives that act essentially like insurance are unregulated. This represents the legacy of the past, rather than an analytical approach to regulation, is vulnerable to regulatory arbitrage and is in need adjustment. Regulation needs to be comprehensive with boundaries determined by the economic functions of financial institutions, not by what they are called or where they may be located.

26. Coverage should extend to all relevant institutions and instruments. The coherence of different regulatory frameworks needs to be considered when attempting to delineate the boundaries of regulation. Regulatory authorities need to coordinate seamless coverage across national and international capital markets, securities markets and deposit-takers. If there is not comprehensive and coherent regulation, there is likely to be regulatory arbitrage.

27. However, there is no guarantee that all the practices which expose the financial sector and the economy to excessive risk can be properly monitored and regulated. In these cases, regulation will have to put special emphasis on setting the right incentives and strengthen financial responsibility in order to restrain excessively risky activities and to reduce the scope for adverse consequences.

28. At the international level comprehensive coverage should eliminate exposure of national financial systems to the possibility that "rogue" states or institutions should fail to implement regulation. At the same time, care should be taken that regulatory standards should not be an anti-competitive ploy by developed financial centres to maintain their positions, in part attained through previous periods of regulatory and tax competition.

29. Comprehensive regulatory systems need to focus on both micro-prudential regulation and macro-prudential regulation. While regulators will need to give priority to systemically important activities, institutions and instruments, they all should be subject to oversight, even if the intensity of regulation differs among them on the basis of their systemic importance. There should be clear principles to determine what is considered systemically important, such as leverage, size, exposure to retail investors, and/or degree of correlation with other activities. Regulators must have comprehensive authority. Regulation must occur continuously, on a day to day basis, while at the same time ensuring long-term consistency.

Micro-prudential regulation

30. Micro-prudential regulation, geared towards consumer protection, should apply to all financial institutions, with particular attention given to protection of unsophisticated, "vulnerable" consumers. Macro-prudential regulation should be focused on key components of systemic risk: leverage, the failure of large, inter-connected institutions, and systemically important behaviour and instruments and their interactions with the economic cycle.

31. Macro-prudential regulation, geared towards the containment of systemic risks, should be focused on those institutions most likely to have systemic consequences, which means those with the greatest leverage and size. But the experiences of this and previous crises suggest that it is difficult to tell which financial institutions have systemic consequences, so that it is imperative to maintain some oversight over all activities, institutions and instruments. Macro-prudential regulation thus must go beyond banking institutions. This is particularly important given the tendency, and incentives, for financial market participants to engage in regulatory arbitrage through activities that have led to the creation of what has come to be called the "shadow banking system", which has a parallel in the creation of a "shadow insurance system". There should also be a special focus on aspects of the financial sector that are most likely to have significant consequences for the "real economy." This entails protecting the payments system and ensuring the flow of credit.

32. Instruments should be regulated where their use might be harmful to vulnerable consumers or pose systemic risks to the economy. This could be achieved through the creation of a *Financial Products Safety Commission* to ascertain the safety and appropriate use of various financial instruments and practices for retail consumers. Alternatively, governments could create within their regulatory structure a corresponding body that focuses on these issues. It will be important to recognize that seemingly safe instruments can have damaging consequences when their use alters, and that instruments used for hedging and insurance can also be used for speculation. Safety of financial products should thus be assessed not only in terms of their appropriateness in meeting the needs and objectives of retail consumers, but also terms of their impact on systemic behaviour. Safety should be continuously reviewed with respect to prevailing practice and the consequences for product safety. While great care should be taken in approving products for use by vulnerable consumers, all consumers need some protection.

33. Regulation is necessarily dynamic, with some instruments appearing safe initially, but becoming "dangerous" with changing or growing use. Other instruments might appear initially to be excessively risky for some uses, but as their risk or complexity becomes understood, and appropriate offsetting measures are devised, or as their safety is demonstrated in less highly regulated markets, they might be approved for specific uses in more regulated markets.

34. A key part of supervision is the continuous monitoring and consideration of instruments, institutions, markets and behaviour of more systemic importance and requiring greater oversight.

Ring-fencing

35. While there may be a case for differential regulation of financial market participants based on their ability to bear risk and sophistication, it should also be recognized that in financial markets it is difficult to erect hermetically sealed barriers between the highly regulated actors posing systemic risks and the less regulated actors who do not. For instance, credit inter-linkages are likely to remain. As a result, depending on the depth of a financial crisis, regulators may feel forced to rescue risky players who are interlinked in order to protect the interest of vulnerable participants and to avoid adverse systemic consequences, though typically, it is more "fiscally efficient" to bail out directly those that

must be supported because of their direct systemic importance. To the extent that the government does not regulate all financial institutions tightly to prevent problems in the unregulated sector spreading to the regulated, the less regulated must be, at least to some extent, ring fenced, with sensible controls on the extent of interaction with the more regulated sector. Governments need to be aware of the danger of contagion from one part of the financial system to others. Thus, financial systems that are better and more comprehensively regulated may be more integrated and less segmented. The advantages of diversification provided by a large integrated market may be more than offset by the risks of contagion, as a problem in one part of the economy spreads throughout the whole. This appears to be the case especially in real estate. Had mortgages been centred in a specialized set of institutions, problems might have been contained, as they were in the Savings and Loan crisis. Regulators have to be especially attentive to the ever-present attempts at circumvention, including through the creation of special purpose vehicles.

Some Common Principles of Macro- and Micro-Prudential Regulation

Incentives

36. Incentives are the key to an efficient and effective financial system. Regulators need to make sure that the incentives of financial institutions and those of management are compatible with the objectives of a good financial system. It will never be possible to monitor and regulate all the practices which expose banks and the economy to excessive risk. It is therefore imperative to get incentives right. It is clear that private rewards have not been linked to social returns. This means that there are perverse incentives that produce adverse outcomes.

37. Flawed incentive structures are in part the result of flawed corporate governance structures. The fact that so many firms have adopted incentive structures that served shareholders and other stakeholders well in the short run, but so poorly in the long run, is suggestive of serious and pervasive failures in corporate governance. Weaknesses in corporate governance in both developed and developing countries have long been recognized, but not enough has been done. This crisis should provide an opportunity to revisit these issues. The payment of large bonuses to top executives of banks making record losses shows that " incentive pay" was not closely related to performance—something that some statistical studies also suggest to be the case.

38. One long-recognized problem is that current incentive structures encourage excessive risk taking and short-sighted behaviour. Methods to remedy these problems include suspension of the practice of cancelling long-term and non-transferable stock options when an employee leaves, requiring incentive compensation schemes to be based on long-term performance, and implementation of a requirement that firms pay higher capital charges if their remuneration schemes are not designed to limit excessive risk-taking. Taking into account other indicators than economic success could be another option to create incentive schemes that are more commensurate with social objectives, e.g. by rewarding achievements in corporate social responsibility. Payment through stock options can provide particularly perverse incentives, because it encourages deceptive accounting practices that contribute to (temporarily) high stock prices. Firms must take a conservative approach to accounting for stock options. Stock options should be reported as a form of remuneration--expensed and

valued at the time of issue or the re-setting of stock option prices. The financial sector should not be paying their top executives in forms that are not transparent, and in ways that shareholders cannot easily value.

39. When banks become too big to fail, they have perverse incentives for excessive risk taking. It is imperative that governments impose strong anti-trust policies, with criteria that are stronger than just market power. Under current arrangements, large banks, knowing that they are too big to fail, have an unwarranted competitive advantage over smaller banks because of the implicit insurance. Accordingly, any large bank that is not broken up should face have capital adequacy requirements.

40. Regulators should be particularly attentive to conflicts of interest. The scandals in US financial markets earlier in the decade exposed the conflicts of interests between investment banks, their analysts, the companies issuing IPO's, and customers. Some actions were taken with respect to analysts, but many of the other problems remain. For instance, investment bank analysts' views affect markets—and those views may be tainted by the positions held by their employers. These scandals highlighted conflicts of interest between the role of financial institutions as commercial banks and investment banks. Disclosure is an important first step. Disclosure is necessary, but almost surely not sufficient. For example, mortgage originating companies should not be allowed to own their own appraisal companies.

41. Guarantees and insurance distort incentives since there is no risk of loss. The higher potential gain from more risky behaviour accrues to the individual while loss is absorbed by the government. Such behaviour was common in the Savings and Loan crisis of the later 1980s, with significant social consequences. However, in times of economic crisis guarantees and insurance may be part of a government's crisis response in order to stimulate countercyclical economic activity and to prevent runs on banks. In some cases, issuing government guarantees may even be a strategy to attract individuals to investments with relatively high risk, but with a perspective of high long-term positive social or ecological effects. Adverse incentive effects can be mitigated by providing only partial insurance/guarantees.

Securitization

42. Securitization held open the promise of risk-diversification and access to new sources of funding. But it also opened up new information asymmetries and avenues of inappropriate behaviour by investors who did not possess the ability to bear the risks or could not evaluate them appropriately since they did not have the relevant knowledge of the underlying assets available to the originators. Markets, regulators and the models used by bankers, credit rating agencies, and investors to assess risks overestimated the benefits of risk diversification and underestimated the costs of the information asymmetries and concentration of investor behaviour.

43. Securitization has also presented new problems in debt restructuring (problems that arose earlier in the debt crises of the latter part of the last century). Governments will need to address the legal issues raised by debt renegotiation in ways which balance the rights and interests of creditors and debtors, with due account of systemic consequences of a failure to renegotiate. Originators of securities should be required to hold a stake of at least 10 per

cent in each issue of securities they underwrite. While this would significantly reduce the capacity for future securitization, it would also substantially reduce the potential for systemic risks associated with structured products and would encourage higher underwriting and lending standards.

44. The perverse incentives and distorted market signals that are produced from the behaviour of the economy may be offset by counter-cyclical regulation. The introduction of time-varying capital adequacy requirements that rise and fall with the business cycle provides an example. To better combine macro-prudential and micro-prudential regulation regulators and Central Banks might jointly agree an annual rate of expansion in bank lending and the bands around that rate, above which a bank would be required to increase its capital adequacy requirements, or below which it would be able to reduce its requirements. If time-varying capital adequacy requirements would have been in place, the magnitude of the previous boom and its inevitable crash would have been moderated. Relating macro-prudential regulation to the rate of growth of bank lending would further enhance the temptation for banks to hide their own lending in associated off-balance sheet vehicles, like conduits and SIVs. Regulators must prevent this happening by treating all such associated vehicles as effectively remaining on the balance sheets of the banks.

45. The privatized government sponsored enterprise (GSE) model, in which government provides funding or what is interpreted as effective government guarantees may be a particularly hard model to design to work well. The potential conflicts between managerial interests in maximizing their own returns or returns to shareholders may conflict with public interests.

46. Recent government bailouts and government guarantees have raised issues of conflicts of interest and divergences between the interests of firm managers and those of the government providing capital. It exacerbates the usual incentive problems that arise when there is a separation between ownership and control. The much criticized behaviour of banks taking money that was intended to recapitalize them and paying it out in bonuses and dividends instead is fully explicable in terms of the differences in interests between those making the decisions (the bank officers) and that of the public providing the money. The risks should have been apparent. (See the discussion in Chapter 2).

47. Perverse incentives can become most acute as financial institutions face the possibility of bankruptcy or falling below capital requirements.

48. While mark-to-market value accounting may not be appropriate for the risk management of some long-term institutions, it is important to recognize that failure to apply mark to market accounting may induce other forms of perverse incentives. Banks may have an incentive to undertake excessive risk taking: assets that go down in price can be kept, and those that go up in price can be sold. The result is to increase the divergence between mark to market values and "book" value. This incentive has been compounded by recent actions to suspend mark-to-market accounting in the crash, having promoted it in the boom. At the same time, there needs to be recognition of the different uses to which accounting information is put. Much of the accounting framework is designed to assist in the evaluation of shares. From this perspective, increasing market value when there is a decrease in the value of outstanding bonds because of market perceptions of an increased

probability of default makes sense. But bank regulators are concerned with the risk that the bank will not have sufficient assets to pay off its depositors (and possibly other creditors). In this context, it makes little sense to suggest that the bank is in a better position because the market thinks it is going to default.

49. In economies where banks are publicly listed and are subject to takeover, supervision needs to be particularly intense in circumstances where incentive structures are such as to increase the likelihood of excessively risky, short-sighted and fraudulent behaviour and when managerial incentives may not be well aligned with other stakeholders. Financial institutions where the government has provided much of the capital, but government's financial stake is not fully reflected in voting shares, are also prone to incentive misalignments and need to be especially tightly supervised.

50. Whenever banks are too big to fail because failure might create systemic instability there are incentives to engage in excessive risk taking. Such institutions need to be closely supervised.

Transparency

51. Much of the discussion on regulatory reform has focused on transparency. It is sometimes suggested that lack of transparency is the major market failure, and the introduction of full transparency would resolve the problems of market failure. It is unlikely that in aggregate, the excessive lending and borrowing would have been substantially less if there was greater transparency, but transparency plays an important role in the distribution of losses and is critical for consumer and investor protection. In this crisis, a lack of transparency was evident not only in off-balance sheet activity, but also in the extensive utilization of the hard-to-evaluate over the counter derivatives. The lack of transparency is often a symptom of deeper market failures that produces incentives to limit information, and these deeper market failures may have other manifestations. Moreover, lack of transparency is only one of several market failures.

52. There is now widespread agreement that private markets do not necessarily provide optimal incentives for transparency. There may even be incentives for providing distorted information, e.g. associated with executive compensation schemes based on stock options. Regulatory arbitrage provides another set of incentives to reduce transparency. Lack of transparency may also be a management defence mechanism for it creates additional uncertainties for any firm contemplating a takeover. Lack of transparency may also enable banks to price discriminate and enhance profitability in other socially detrimental ways.

53. Banks should be restricted in creating off-balance sheet vehicles. Overall, there needs to be more transparency in accounts. Mark-to-market accounting was introduced to increase transparency. But some have argued that its inappropriate application to all assets contributes to market volatility. The problem is not with mark-to-market accounting, but with how the information provided is used by firms, markets and regulators. The adverse effects of mark-to-market accounting could be offset by countercyclical capital adequacy and provisioning described above. It would be a major retreat from transparency to move away from mark-to-market accounting, however, where institutions have long-term funding or liabilities, it may be important to supplement mark-to-market accounting with a mark-to-

funding accounting when it is more appropriate in the risk management of the financial firm.

54. Accounting standards should make information as transparent as possible for shareholders and bondholders. This might require thinking about changing other existing standards. For example, while dynamic, counter-cyclical provisioning is a desirable feature, accounting boards are not currently well disposed to such proposals since they prefer event based to statistical accounting. Statistical techniques may be the best means of providing reliable estimates of future losses.

55. Anomalies in accounting systems, such as failure to expense stock options, need to be addressed. These can not only make it difficult for investors to appraise the firm's economic position, but distort behaviour as well as the provision of information.

56. No single information system can provide all the relevant information. For institutions with long-term funding or liabilities–something which the regulatory system should reward–mark-to-funding accounting could be useful (and in some cases even more relevant). Life insurance firms, for instance, with long-term liabilities but with assets matching those liabilities should not be placed at a disadvantage. But this is what would happen with mark-to-market accounting if liquidity risk spreads rose and the long-term assets in which they had invested fell in value. It would be inefficient to match each asset with its funding, but pools of assets could be matched with pools of funding. One issue in a mark-to-funding or mark-to-liability approach would be determining the maturity of funding. Life insurance policies might normally be held to maturity, but the contract provides a liquidity option–owners can borrow against them. They also have a cash value. Demand deposits are normally held for a long time; but in a panic, they can be withdrawn overnight.

57. Transparency is important, but stronger transparency and disclosure standards are not enough. Even if there had been full disclosure of financial products, many are complex and the level of financial understanding insufficient. The nature of over-the-counter products can be highly complex, making it difficult to assess risks and to net out positions for hedging purposes or in the case of bankruptcy. Over-the-counter trading should be restricted and those engaging in such trades should be required to set aside appropriate margins reflecting the systemic risk those trades might pose. As argued more fully below, trading in over-the-counter products by Highly Regulated Financial Institutions such as commercial banks should be limited to covering "insurable risks."

58. Economic theory suggests that transparency may actually lead to more volatility. But even if this proves to be the case, most of the time, the benefits of transparency outweigh the costs, and so there should be a strong presumption for greater transparency. Without good information, resources cannot be efficiently allocated, and lack of transparency can too easily contribute to exploitation and corruption.

59. Just as accounting standards should allow for as much information and transparency as possible, the same should be the case for actions of regulators. While regulators should in principle be free to ask for information from private actors, the public dissemination of any findings needs to be carefully handled. The regulator should have an obligation to put transactions involving public money in the public domain, but perhaps with a lag if there are

concerns about market sensitivity. If proprietary information issues restrict full disclosure of firm-level data, there should be full disclosure of aggregative data. Parties not willing to transact with the government on the basis of transparency should be prohibited from receiving public funds or entering into contracts with the government.

60. Transparency should be encouraged when a financial rescue plan is being undertaken. In the current scenario the manner in which financial rescues/bailouts are being conducted are often opaque and uncertain. As a result, a great deal of confusion has been sown about the principles underlying the financial restructuring that is occurring and about the process by which the terms of the deals are determined. This has contributed to market uncertainty. While in the past, a simple adage "save the banks, not the bankers" has been followed, in the current crisis, in some countries this important distinction has been blurred. In such a scenario clear principles need to be agreed upon beforehand which recognize that while banks may be systematically important, not all elements of their capital structures are. An expedient resolution through recapitalization, (temporary) nationalization, and/or super (or expedited) "Chapter 11" bankruptcy (conservatorship) could restore the credit intermediation process in the most rapid and most transparent manner possible.

Macro-prudential regulation

61. Regulation should be more focused on the capacity of the financial system as a whole to bear and allocate risks and where this is best done, rather than solely on measures of individual firm risks. Risk is not just about assets. It is about how the assets are funded and how the assets are used. Regulation of systemic risks needs to include an assessment of funding liquidity.

62. Financial liquidity and stability requires diversity of action and opinion. If all firms respond in the same way (e.g. trying to sell some asset at the same time), markets may exhibit extreme volatility. It is important that regulators do what they can to preserve natural diversity, especially in the face of enhanced transparency, common accounting standards and the increasing comprehensiveness of regulation.

63. The benefit of diversity is another argument in favour of a return to more specialized, simpler institutions and the segmentation of markets, perhaps with a return to the "public utility" aspect of banking for core deposit-taking institutions and regulatory segmentation of institutions into areas such as retail banking, long-term savings institutions and wholesale investment banking. Each function could then be regulated to discourage it from holding risks it does not have a natural capacity to hold.[1].

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[1] In the United States, the regulatory segmentation was largely eliminated in the era of free market philosophy from 1980 to 2000. The Gramm-Leach-Bliley (GLB) Act of 1999 was the key legislation repealing the Glass Steagall Act of 1933 that segmented banks from other financial activities. Under GLB, banks and other financial institutions were permitted to commingle banking, insurance, and securities activities within a holding company structure. At the time the promoters of such legislation emphasized the benefits of diversification and ability to compete with foreign institutions that were permitted to combine these activities in one institution. Little concern about conflicts of interest between the various dimensions of the business or about the commingling of risky activities with the core activities of the payment system and deposit protection was voiced. It was only in the aftermath of the events illuminated by the crisis where the political power and moral hazard implications of too big to fail institutions have been shown to be of critical importance. The Group of

64. The virtue of differentiated regulatory structures and standards for different kinds of financial institutions has to be offset against the risks of regulatory arbitrage.

Countercyclical regulations

65. There should be countercyclical capital adequacy and provisioning requirements, based on simple rules, which call, for instance, for an increase in capital requirements as the rate of growth of the assets of a bank increases or the rate of growth of a particular class of assets within the bank increases. Provisioning requirements automatically ensure that the bank set aside more funds as it lends more. But since the riskiness of lending is likely to increase as the pace of lending accelerates, the likelihood of problems increases, implying that the requisite provisioning should go up. By the same token, as the ratio of the value of housing to income increases, the probability of a problem increases, and so the magnitude of the provisioning (or the capital adequacy required) needs to be adjusted. (It may be necessary to develop accounting frameworks based on statistical loss estimates to deal appropriately with these issues.) Regulators need to be aware of distortions in capital allocation when provisioning and capital adequacy requirements do not accord well with actuarial risks.

Capital market liberalization

66. Regulations which affect the flow of capital into and out of a country, especially of small or medium-size, may be among the most important in determining macro-economic stability and the scope for policy responses, in the event of a crisis. There is growing consensus that capital market liberalization may contribute to economic volatility, especially in developing countries. More broadly, a fully integrated global financial system may be subject to more volatility than one with "circuit breakers" and "surge protectors" (to use an analogy to electricity networks). Part of the reason for this is that capital flows tend to be pro-cyclical. And yet there is little conclusive evidence that, especially for less developed countries, capital market liberalization contributes significantly to economic growth. Part of the reason for this is that much of the cyclical lending finances consumption, rather than investment; and part of the reason is that the increased volatility associated with liberalization imposes a high costs on an economy, raising risk premia, and forcing governments to set aside larger reserves. The opportunity costs of these funds may be large, and the building of these reserves contributes to global imbalances, and in an international system with a single reserve currency may add to global financial fragility.

Capital Account Management for Development

67. Developing countries often need to stabilize international financial flows for a variety of reasons. These include the need to promote financial stability; to encourage desirable investment and financing arrangements; to enhance policy autonomy, including the

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30, under the leadership of Paul A. Volcker, has raised concerns about these issues in their report entitled *Financial Reform: A Framework for Financial Stability*. Their report states that: "The clear implication is that at least the very large and complex banking organizations that now account for so much of the extensions of credit and carry the major responsibility for maintaining the financial infrastructure will need to be held to more rigorous standards of prudential regulation and supervision, with new constraints on the type and scope of their risk-taking activities."

maintenance of stable and competitive exchange rates; and to enhance national sovereignty and democracy. Full capital account convertibility as well as implicit and explicit agreements to forego intervention in international capital markets can serve to prevent such desirable outcomes, and should therefore not be seen as ends in themselves.

68. To achieve these objectives, Governments should be given space to undertake capital management techniques as part of their development and risk management strategies. Such techniques –which have been used successfully in the past– have included, but are not limited to, prudential management of foreign borrowing, the imposition of unremunerated reserve requirements, the placing of limits on equity ownership of certain financial and other activities, and so on. It is imperative for the success of development strategies that countries be allowed to undertake dynamic capital management by having the flexibility to both tighten and loosen controls as and when necessary.

Capital market interventions during crises

69. Governments have a variety of policy tools to help stabilize financial flows. In a crisis, when traditional instruments such as interest rates are less effective, they may consider temporary restrictions or longer-term taxes on inflows and on outflows, as well as both price and quantity restrictions. Particularly in the context of a financial and economic crisis, countries may find it necessary to impose restrictions on capital outflows, in order to give them more scope for monetary policy discretion.

70. To a limited extent, recommendations for "host versus "home" country regulation and proposals for counter-cyclical capital charges can also act as "speed limits" on international capital that flows in and out of the domestic banking system. In similar vein, greater prudential regulation of banks–to avoid currency mismatches–can simultaneously be used as an important instrument in capital account management.

Financial market liberalization

71. The framework of financial market liberalization under the Financial Services Agreement of the WTO may serve to restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors. At the same time, existing agreements do not seem to be designed in ways to prevent financial market protectionism and arbitrary "black listing" on the part of developed countries or to prevent major adverse effects on developing countries.

72. There is some evidence that, at least in some countries, the entry of foreign banks has led to reduced lending in general, or to small and medium enterprises (SMEs) in particular, and/or speedier unwinding of lending. Restrictions of the kind proposed in the following paragraphs may be helpful in addressing this concern. Such restrictions should be imposed broadly, on both domestic and foreign banks, even if such uniform restrictions indirectly have a differential effect on foreign banks.

73. Problems in the home country banking system can spread to other countries in which that bank has branches or subsidiaries. They may, for instance, reduce lending. Such

problems are exacerbated when governments put pressure on their banks to use what limited capital resources they have for lending to the home country. Such pressure is not surprising when home governments have provided large amounts of funding for the survival of domestic banks. Earlier discussions emphasized the importance of "national treatment," that foreign banks should not be treated in a disadvantageous way. The current crisis has shown the need for a new dimension of "national treatment": foreign borrowers (branches, subsidiaries) should be treated as well as those at home. Since such discrimination may be tacit and/or difficult to detect, it may be difficult to enforce these aspects of national treatment that can be of great importance to the well being of developing countries.

74. Developing countries may find it desirable to require foreign banks operating within their countries to operate as subsidiaries rather than as branches in order to ensure that there is adequate funding for domestic lending by foreign banks and that the effective capital underlying such lending is not repatriated, as seems to have happened in some instances.

Further issues in Micro-regulation

Restricting excessively risky practices

75. It is clear that the banks have engaged in excessively risky practices. The discussion of countercyclical capital adequacy and/or provisioning requirements provides one approach to discourage such activities. Governments, especially in developing countries, may want to consider others. For instance, quantitative restrictions on the fraction of bank portfolios that can be allocated to certain sectors prone to speculative activity such as real estate, may not only lead to greater stability, but ensure greater financing for infrastructure or employment related investments on a longer-term basis.

76. Countries that allowed banks to own equity shares in non-financial companies may experience greater volatility, because even when their lending practices are sound, a sudden decrease in stock prices can force a credit contraction. The comparative advantage and institutional role of banks in our economy society is in providing credit. An argument can thus be made that they should be subject to appropriate regulation if equity shares are part of their investments.

77. Some of the problems in earlier crises were a result of foreign exchange mismatches. Regulations should place strict limits on uncovered foreign exchange exposures. Similarly, there should be restrictions on engaging in swaps and other insurance and derivative products other than to hedge or mitigate existing risks. Banks, with their implicit or explicit government guarantees, should be restricted from being engaged in activities that may significantly increase their individual and systemic risks.

78. Countries that allowed their banks to grow beyond the size of their economy are not in a position to provide guarantees should the bank fail, or can do so only at great costs to the rest of society. It is thus necessary that either (i) a global deposit insurance fund be created, funded through contributions of the banks with fees depending on their individual capital adequacy ratio or through a tax on all cross border deposits and set at a rate that is deemed

to be actuarial fair, and backed by the government of the depositors or (ii) depositors in foreign banks not explicitly insured by the host country recognize that those deposits are not insured. The second approach is likely to limit the extent of cross border financial flows. The provision by the host country of deposit insurance should only extend to separately capitalized subsidiaries of foreign banks, with strong restrictions on the pay-out of capital to the holding company, and close oversight by host country regulators.

79. This approach will not be welcomed by international banks who will claim that it will reduce the efficient allocation of capital and restrict international capital flows. It is likely to prove a price worth paying.

Restricting securities markets

80. Banks are only one part of the modern financial system, and many non-bank operations in the securities market contributed to the current crisis. Excessive volatility in securities markets can have adverse effects throughout the financial system. Core financial institutions should not be allowed to undertake excessively risky market positions such as "naked" short sales, and governments should consider broadening such restrictions to all participants in financial markets.

81. Comprehensive regulation entails ensuring that equivalent instruments be treated the same, i.e. if there are restrictions on naked short sales, there should be analogous restrictions on the use of derivatives and credit default swaps.

Regulation of Credit Derivatives, Swaps

82. Since the default of a large corporation can have far greater monetary implications than the size of any of its outstanding liabilities, it may be prudent for lenders to hedge the risk of a default of the company affecting its suppliers, dealers, pensioners, stores local to the employees etc., so the outstanding value of credit default swaps (CDS) may be larger than any single liability. However, there are systemic implications of a large CDS market where there is no centralized clearing house or regulated exchange trading. Hence, centralized clearing should be the preferred route and OTC should be subject to enhanced monitoring, with margin above and beyond that required on an exchange and disciplined pricing that does not rely upon mark to model methods. The regulator should further have access and information both for OTC and centralized clearing through a system of ex-post reporting to a centralized agency.

83. The regulatory agencies should also be authorized to declare any CDS transactions that it considers to have become of systemic importance to comply with a range of requirements, including, a registration process, centralized clearing and, where appropriate to the risks being taken, margin and capital requirements. While the regulator should have a preference for exchange-traded instruments relative to over-the-counter instruments, if the latter are approved, there should be adequate transparency in the form of mandated and regular reporting to the regulator and aggregate information should be put in the public domain as determined by the regulator.

Predatory lending and usury

84. Regulating predatory lending is mostly a matter of consumer/investor protection, but, as this crisis has shown, it is also a matter of risk management. The subprime mortgage market provided examples of predatory lending, but there have been other abusive practices as well.

85. The elimination of usury restrictions has been advocated on the grounds that it encourages risk taking. But it may have resulted in excessive risk taking and abuse of ill-informed borrowers. Regulators need to be attentive to the variety of forms that circumvention can take, e.g. through rent-a-centre and other commercial activities such as pay day loans.

86. Recent years have seen particular abuses in regulations covering the use of credit cards. Such practices have flourished in part because of anti-competitive behaviour, which has helped generate above market returns. In some countries, such anti-competitive behaviour has been restricted, while in others proposals for restricting abusive and anti-competitive behaviour have, not surprisingly, met resistance from the industry. Governments are strongly encouraged to consider introducing such actions, which would contribute to a more efficient and more equitable financial markets. Moreover, abusive lending practices lead to high returns to lending, and have contributed to the build-up of excessive household debt. The misery of the ill-informed borrower is compounded by the recourse by lenders to recovery agents who use unregulated and uncivilized means of loan recovery.

Lending and public banking to promote development

87. The objective of financial policy is not only to regulate institutions and the system in a prudential manner, but also to ensure that the financial sector can live up to its positive potential contribution to society, including ensuring access to credit for all and the provision of credit for long-term development. In the past, many financial institutions engaged in red-lining, i.e., excluding lending to certain discriminated against groups. Certain key sectors of the economy did not have sufficient access to credit. Government created institutions, including the establishing and support of public banks, as well as supporting development banks, may need to play an important role in the provision of credit to underserved sectors and segments of society, financial sector policy in general and on occasion regulatory policy can play an important role

88. While there has been a presumption that a fully private banking sector is the best system to ensure the most productive and efficient management of liquidity, risk and development, the current crisis and other experiences in various developing countries suggest reasons to support a much more substantial role for publicly owned banks. A public bank can substantially realign incentives driving bank managers and can harmonize the role of bank operations and supervision. Further, by making the inherent and incessant profit motive subordinate to social objectives, it allows the financial system to exploit the potential for cross subsidization and to direct credit –even if the bank incurs higher costs to targeted sectors and disadvantaged sections of society. Given that a significant determinant of poverty is limited access to finance, public banking can thereby permit financial inclusion. In the experience of several successful development strategies, public banking has allowed

for the mobilization of technical and scientific talent to deliver both credit and technical support to agriculture and the small-scale industrial sector which have the most direct effect on job creation and poverty reduction. Moreover, public lending is less likely to engage in the abusive practices that marked the US financial sector in this decade. Development banks have played an important role in the successful financing of development of several countries. Recent crises have shown another problem with private sector lending –it can be highly cyclical, exacerbating economic fluctuations. Nevertheless there is always a danger that public banks may have their portfolios manipulated for political rather than social reasons, and the record of public banks has been spotty. Some recent experiences, however, of public development banks with better and more transparent governance structures is encouraging.

89. In some countries, mandates for lending to underserved segments have played an important role, and have, in the long term, even proven profitable. Apart from implementing direct public banking, countries should encourage the availability of banking services to the unbanked and insurance to the uninsured. This could include a direct subsidy to offset the credit monitoring costs of dealing with small loans, or through mandating lending to certain groups such as the US Community Reinvestment Act (CRA) requirements. Because information is at the heart of banking, requirements that banks open up branches in underserved parts of a country can also be an important instrument of development.

90. Lending to the real estate sector can have a number of social benefits, but it is also a common source of excessive lending and asset market bubbles. Consequently, limits to real-estate-related lending such as loan-to-value limits on mortgage lending should be instituted. These limits should be time-variant, rising in a boom and falling in a crash. Restricting lending, e.g. to the real estate sector, may also be an important instrument in encouraging lending to other sectors. Such restrictions may both enhance stability and development.

91. Negative and positive "priority" lending may be most effective when broad based, leaving the private sector with the strongest incentives to find the best commercial opportunities within those constraints.

92. Incentives may be an important part of helping direct lending to areas where social returns might exceed private returns, such as micro-credit, SMEs and rural-sector lending. Similarly, there should be measures to restrain socially damaging activity.

93. In some banking systems, a large proportion of bank investments are in government paper. A number of reasons may be behind this, including the regulation of deposit and lending rates or crowding out of private enterprise by large government deficits rates. Governments should be encouraged to explore various mechanisms by which the banking system could be used to facilitate productive activity. One arrangement, for example, may be to accept savings directly by the government through a network of post offices to reduce the spread between the bank deposit rate and interest charged by banks to government paper.

Regulating other players

94. Financial markets have become more complex over time. Finance is provided by banks and through security markets. There are a host of other actors, some of which may have played an important role in the current crisis, some of which have become the subject of extensive controversy. Comprehensive and fair regulation must ignore past distinctions and be based on economic function. In particular, there are two non-traditional financial firms that require additional attention: rating agencies and sovereign wealth funds.

Credit rating agencies (CRAs)

95. There is a consensus that the rating agencies did not perform their job well, mainly in respect of the rating of securitised credit products. Whether it was a result of a conflict of interest or incompetence –they are paid by those that they were asked to regulate– and the presence of this clear conflict of interest has undermined confidence. Moreover, some generated revenues by advising financial firms on how to improve their grading. Some reforms, such as increased transparency through requiring disclosure of the details of the ratings process may help; but even such mild reforms are not without their controversy. Financial firms may be reluctant to disclose information which they believe might be disclosed more publicly and disclosure of rating methodologies contributed to banks ability to build securitised structures to achieve a desired rating. But greater transparency in the way that rating agencies discuss and present their analyses, clarifying assumptions made and sensitivities of results to these assumptions, should contribute to the functioning of financial markets. In addition, rating agencies should be required to provide information concerning their overall performance and/or an independent government agency should provide such information, which would enhance "positive" competition among rating agencies.

96. Part of the problem is caused by the market structure of the credit ratings agencies as a small oligopoly, which means that rating failures do not lead to significant market discipline. Many investors and hence borrowers are required by their investment by-laws to obtain a rating from each of the main agencies. It may be necessary therefore for the government to impose discipline by penalizing rating failures.

97. Given the difficulties of resolving the problems posed by credit rating agencies, it is important that regulators –and others charged with risk management– reduce their reliance on external ratings. Rating agencies proved to be no less pro-cyclical than market prices and their use by regulators has added to the pro-cyclicality of bank lending. Problems with individual ratings need to be viewed in the broader context of the provision of information. In the Enron and WorldCom scandals, conflicts of interest in the ratings provided by analysts paid by investment banks drew extensive criticism. In the recent food and energy crisis, information provided by some investment banks may have simultaneously enriched those providing the information and contributed to those crises. While the reforms concerning analysts' pay were a move in the right direction, they do not go far enough. There should be disclosure, to the regulator, of positions of investment banks and others capable of "moving" markets, to at least identify potential conflicts of interest.

98. CRAs play a key role in financial markets by reducing information asymmetries between issuers and investors. Their role has expanded with financial globalization and received an additional boost with Basel II, which incorporates the CRAs' ratings into the rules for

assessing credit risk. However, rating agencies have been subject to serious criticism, recently, for generous ratings to complex financial instruments backed by "sub-prime" mortgages. The risk assessments of rating agencies have been highly pro-cyclical, and tend to react to the realization of risks, rather than to risk build-up, in relation to both sovereign and corporate risk. The risk models of CRAs rely, to a large extent, on market-determined variables like equity prices and credit spreads, thus exacerbating pro-cyclicality. Additionally, the independence of the rating is compromised because a dual role of rater and advisor is often assumed by the same CRA.

99. As assessments of creditworthiness by CRAs came to be viewed as authoritative in financial markets, such ratings adversely affected financing for developing countries. Because CRAs operate as unregulated private institutions, the existing regulatory framework and surveillance mechanisms are minimal and inappropriate. To ensure CRAs' accountability, both to issuers and investors, a collective institution should be established to be responsible for assigning agencies for rating particular security issues and for paying them.

Sovereign wealth funds

100. Earlier conventional wisdom argued that ownership did not matter, so long as it was not the government of the country. Developing countries were urged to privatize state-owned assets, paying little attention to the identity of the buyer, who in some cases was even a foreign government. It seemed permissible for a foreign government to own a country's assets, but not the country's own government. As entities owned and controlled by foreign governments have taken a more active role in purchasing assets in developed countries, these views have evolved creating investor uncertainty over the rules of the game. Whatever rules are devised and agreed upon should be universally and fairly applied.

101. There may be particular industries or sectors where ownership matters. Governments should agree on those sectors. If national security provides a rationale for ownership restrictions in one country, there should be a presumption that it provides a rationale for similar limitations on ownership in other countries. If ownership matters, one should be as concerned by aberrant private sector behaviour as by that of a government-owned enterprise. Indeed, some have suggested that governments may be more responsible investors than private agents, precisely because of the greater degree of accountability.

102. Some have suggested that a special code of conduct be imposed on sovereign wealth funds, including provisions relating to transparency and disclosure, including disclosure of the sovereign wealth fund's business model. Others have argued that codes are just window dressing on the part of countries that want the funds, but realize the political sensitivities since almost any action can be cloaked within a business rationale. While transparency and disclosure may be helpful, the argument that it would "solve" the problem it is not convincing. So too with a broader voluntary code of conduct. But any requirements imposed on sovereign wealth funds should be symmetrically imposed on private sector investors. The point is reinforced by the growing blurring of the line between private and public investors, with the bulk of the capital of many Western banks being provided by governments. Moreover, restrictions on sovereign wealth funds may be relatively meaningless, so long as there is no comprehensive disclosure of ownership. Ownership

stakes could be mediated through third parties, without disclosure. If governments are concerned about ownership, there has to be appropriately comprehensive disclosure.

103. If there are certain behaviours of the foreign owner that are a source of concern, those behaviours should be restricted, whether on the part of private or government entities. Worries about their behaviour are thus symptomatic of a lack of confidence in the overall regulatory regime. Countries should identify the inadequacies in their regulatory structures and seek to remedy them.

Regulatory institutions

104. It is not enough to have good regulations; they have to be enforced. The failures in this crisis are not just a failure of regulation, but of regulatory institutions. Those assigned responsibility for regulation did not always effectively implement the regulations. All human institutions are fallible, and it may happen again, especially if those who are appointed to oversee the regulatory system do not believe that regulation has a role.

105. At the same time, it is clear that regulatory structures can be designed in ways that reduce the scope for the failure of regulatory institutions. Regulators may be under pressure during a boom. While the regulator is supposed "to take away the punch bowl just before the party gets going," pressures are often brought to bear to continue the party, since so many are making so much money doing so. Specious arguments are brought forward — such as the impossibility of identifying a bubble until it breaks. This is true, but it is possible to ascertain an increasing probability of a bubble, as prices relative to incomes attain historically high or even unprecedented levels.

106. In light of this pressure, it may be necessary to "hard wire" much of the regulatory structure, leaving less discretion to regulators and supervisors. Provisioning requirements and countercyclical capital adequacy requirements of the kind discussed in previous sections should be rule based.

Capture and voice

107. Regulatory institutions have to be created with recognition of the risks of capture by interests and perspectives of those being regulated, and ensuring that users of finance such as small and medium-sized businesses, pensioners, consumers and perhaps other stakeholders are given voice. Pensioners who are likely to see the hard-earned pension funds disappear as a result of poor regulation should, for instance, have a strong voice in regulatory structures, as should other groups representing retirees. Those who benefited from the continuation of the bubble often have excessive influence on the regulatory institutions as presently constituted.

108. The creation of a specific financial regulator (with appropriate governance structures) whose mandate is to ascertain the safety and appropriate use of various financial products may reduce the likelihood of regulatory capture. Moreover, the benefits and costs of regulatory duplication and segmentation may be worth reconsidering. All institutions are fallible, and the costs of regulatory mistakes are enormous, and overwhelm any costs of duplication. Sectoral regulators with simple objectives and rules may also be harder to

capture.

Regulation and political processes

109. Regulation is part of the political process; failures in public governance contribute to failures in regulatory design. When the political process is unduly influenced by campaign contributions from and other forms of lobbying by the financial sector, failures in the design of financial regulations become more likely. In some countries, "revolving doors" and other pecuniary and non-pecuniary considerations present problems compromising the integrity, adequacy and appropriateness of financial regulation, supervision and enforcement.

Incentive structures

110. To the extent possible, regulatory institutions should be designed to have incentives to encourage good regulation. In this regard there is a consensus that credit rating agencies, paid for by those whom they regulate, should be taken out of regulation

Personnel

111. Many regulatory bodies face difficulties in attracting qualified personnel: the battle between the regulator and the regulated might seem to be an unfair one from the start, given the high salaries paid in the financial sector. But the skills and talents necessary for creating new products and circumventing existing regulations and accounting standards are different from those required for assessing the safety and soundness of financial institutions or the safety and efficacy of particular financial products. Nonetheless, it may be desirable, or even necessary, to link the salaries, financed by a financial sector tax, linked to the salaries of those in the financial sector.

Regulatory Structure

112. Much of the discussion over regulatory design has focused on the problem of assignments of responsibilities, e.g. should there be a single regulatory authority for the entire financial sector? Old models of regulatory structure have been failing because different institutions have been providing services formerly associated with other institutions. Securities markets and insurance firms and futures exchanges all provide opportunities for market participants to speculate on the outcomes of particular events (securities, defaults). Should responsibility be assumed by the Central Bank? While there appears to be no single model, appropriate for all countries, there are certain principles which should guide the design of the regulatory structure.

113. While different countries, at different stages of development, may find different structures better in meeting their overall needs, one possible structure entails two Apex regulatory institutions, working closely together: A New Central Bank (NCB)focusing on macro-economic issues, the other, a Financial Regulatory Authority (FRA), focusing on micro-issues, closely coordinated with each other so that, for instance, the NCB would be aware of the macro-economic consequences of the actions taken by the FRA. This is especially important because micro-prudential regulations have macro-economic

consequences. The FRA would comprise several sub-commissions, a Securities and Exchanges Commission, an Insurance Commission, a Financial Products Safety Commission, an Accounting Oversight Commission, and a Financial Systems Stability Commission. It would have cross-cutting committees to ensure that similar functions performed by different institutions were treated similarly. The Financial Systems Stability Commission could impose high margin requirements or large down payments for products sold to retail customers, if it felt that there was growing excess leverage in the economy or in the market. The Accounting Oversight Commission would ensure that the information provided by firms was not misleading, and represented the best estimate of the overall state of the firm, including its vulnerability. It might overtime develop broader set of metrics that might be of use to investors and other regulators.

Global Regulation

114. This crisis in global financial markets differs from all previous crises in its global reach. The magnitude of the scale of flawed products (toxic mortgages) that were exported from the US is large, with severe consequences for importing countries. While it may not be the only source of the problems facing some European countries, it is a major contributor. As the crisis has evolved, there has been a breakdown of trust: investors no longer trust banks. Citizens no longer trust the regulators who were supposed to regulate them, and regulators in one country no long trust that the regulators in other countries –even those with seemingly good institutions– are doing their jobs properly.

Comprehensiveness

115. As financial markets become global, it is imperative to have global co-ordination of regulation. This is especially important since responsibility for bail-outs remains at the national level.

116. Circumstances in different countries differ, which would suggest that the optimal regulation and regulatory structures might differ. Thus there are items of regulation which should be focused locally, with international coordination where the focus of regulation is international. The dividing line relates to those issues which require a high degree of reciprocity, such as regulation aimed against money laundering and tax secrecy; and/or on those issues where inadequate regulation in one country has large effects on other countries (either because of network effects or because of an induced race to the bottom.)

117. The placement of this dividing line also depends on the representativeness of regulatory bodies. In existing global regulatory bodies, concerns of developing countries are often unrepresented or under represented. For instance, the Basle I standards encouraged short-term lending (relative to long-term lending) by developed to developing countries, exacerbating their volatility. Many have been concerned that Basle II would have had the effect of discriminating against developing countries whose institutions do not have the ability to develop the complicated –and what have been shown to be totally inadequate– risk management systems.

118. Part of the concern about these regulatory systems is that they were arrived at by

international institutions with flawed governance structures –under-representation of developing countries and emerging markets, and over influence of those banks being regulated. Basle II is seen by many developing countries as a prime example.

International Banking Centres and International Tax Cooperation

119. Well-regulated economies have to be protected from those that are under- or unregulated. The problems of tax competition and regulatory arbitrage are often linked. The lack of transparency and regulatory standards in some countries is harmful to the functioning of national tax systems as well as to financial stability. Tax evasion and inappropriate tax practices are major problems for developed as well as developing countries. Each year, developing and developed countries lose revenues that could be used for the financing of development. It is necessary to strive for a universal no-tolerance policy towards financial centres that continue to harbour generalized tax and bank secrecy.

120. While particular attention on this issue has been focused on off-shore financial centres in developing countries, up to the present time the principal sources of tax evasion, tax secrecy, money laundering, and regulatory arbitrage have been located in developed countries' on-shore banking systems. Delaware and Nevada for instance are two US states that make the establishment of anonymous accounts far easier than almost all international banking centres. Bank secrecy remains an issue in several developed centres. London's light touch regulatory regime was a source of much regulatory arbitrage. The biggest money laundering cases involved banks in London, New York and Zurich. The European Commission has decided to refer four smaller member states to the European Court of Justice over non-implementation of the 2005 anti-money laundering directive and two large member states have been given a final warning.

121. The matter is best handled through multilateral agreements on issues of tax secrecy, which have reciprocity and are enforceable by international courts. The major financial centres should sign up to these agreements first and then welcome others to follow, with the threat that those who do not chose to do so, would not be allowed to have linkages with those financial centres that have accepted the conditions of the agreement.

122. *Ad-hoc* and discriminatory targeting of small international financial centres in developing countries while a blind eye is turned to lax rules in developed economies are neither fair nor effective. For instance while many developing country financial centres have several bilateral tax information agreements, the advanced economies do not reciprocate. It is necessary to move away from bilateral to multilateral agreements. Under these multilateral agreements "rogue centres" should be ring-fenced from the rest of the international financial system, but this must be done in an objective manner that could include rich as well as poor countries. For instance, for foreign investors the US is effectively a tax haven and developed countries engage in greater tax incentives, subsidies and tax competition to attract foreign investment than developing countries can afford. Moreover, the development of financial centres such as London, Luxembourg and Dublin, has been based on tax competition.

123. There should not be one rule for the rich and a tougher rule for the poor and the

preservation of centres and practices in developed countries that are not permitted in developing countries. This is why focus should be on the removal of tax secrecy that facilitates tax evasion and shining a light on tax avoidance practices. Responsible small states that adhere to the multilateral agreements recommended above to deal with the problems of tax secrecy could then export high-value services that are found around international financial centres in a viable development strategy that has in fact been promoted by the International Financial Institutions over the past two decades.

124. It is important to promote common standards in the tax field and to develop criteria for those countries that do not comply with acknowledged international standards. Common standards have to be enforced effectively, e.g. by restricting dealings with the respective jurisdictions, by requiring companies to close their branches or to prohibit their outsourcing to those financial centres; or by prohibiting transactions between financial institutions in those jurisdictions and those in more highly regulated countries. It is also important that multilateral development banks and governments adopt coherent policies in order to contribute to efforts to combat tax havens.

125. Institutional arrangements for improving harmonization and cooperation on tax matters need to be strengthened. A new intergovernmental Commission to strengthen international tax cooperation should be created under the auspices of the Economic and Social Council (ECOSOC) of the United Nations. The existing UN Committee of Experts on International Cooperation under ECOSOC will serve this Commission in identifying, analyzing and proposing solutions for the commission's consideration. The IMF and other bodies could also have consultative status with the new Commission. In order to effectively mobilize public resources, many developing countries need to urgently undertake measures to enhance their tax revenues and fiscal capacity by rationalizing their tax systems, improving collection, limiting tax evasion and widening their tax base. National efforts to enhance tax revenues must be complemented at the global level by strengthening international cooperation and technical coordination and assistance on tax matters. While the United Nations Committee of Experts on International Cooperation on Tax Matters has helped developing countries mobilize public revenues by enhancing international cooperation in areas such as limiting tax evasion, and strengthening tax administration and taxation of services and natural resource use, the Committee's ability to further international cooperation in such areas could be significantly enhanced. An International Tax Compact should be instituted that would complement existing initiatives and programmes, strengthen voice and participation of developing countries in ongoing processes and provide coordinated approach to support national tax systems in developing countries.

126. But tax cooperation has also its important national component. There is a need not only for more, but in particular for more stable, domestic sources of finance for development. Combating tax evasion and improving tax collection is a priority in this regard. Weak domestic tax systems and onshore and offshore financial centres weaken domestic resource mobilisation in developing countries. Development cooperation thus needs to support measures to reduce tax evasion and avoidance. The international community is encouraged to start dialogue on how to tackle these problems within the proposed framework of an International Tax Compact.

International cooperation on taxation

Home versus host country regulation

127. Equality of treatment has been a mantra of regulation that demands greater circumspection. Not all consumers should use all products. The developmental priorities of financial policy will differ among countries. Macro-prudential regulation will differ between countries at different stages in the credit cycle. The trend in supervision has been away from host countries towards home countries and this will need to be reversed. Indeed, since host countries still are responsible for the functioning of their real and financial sectors, they can fulfil that responsibility only with tight oversight of all financial institutions operating within their country. This entails host-country supervision, and, as suggested elsewhere in this Report, almost surely a requirement that banks operating in a country operate through subsidiaries rather than branches.

128. Strengthening host country regulation, introducing counter-cyclical capital charges, redefining the boundary of regulation to be more comprehensive while promoting diversity, is all under the remit of domestic regulation (and permitted within the supervisory discretion in Basle II.) Of course, ideally, while these initiatives could be executed locally, the principles behind these domestic initiatives would be agreed and harmonized internationally by the Global Financial Authority proposed below.

Beyond financial regulation

129. Ensuring a well-functioning financial market requires, as already noted, more than just financial sector regulation. Inadequate corporate governance contributed to incentive structures that served neither shareholders nor borrowers well. Failure to enforce anti-trust policies led to excessive concentration in the financial sector, and banks that were too big to fail (though not to be financially restructured). Given that there has been considerable consolidation in response to the crisis, some banks may have large market power in some markets, and the abuse of that market power is likely to lead to higher lending rates and a consequent slower recovery.

130. Recent experience in the developed countries has revealed a very disturbing process where some institutions have been revealed to be too big to resolve (TBTR). When faced with the challenge of restructuring such large and multifaceted institutions on the doorstep of failure, public officials have chosen deliberate forbearance on the grounds that it would disrupt the financial markets, and quickly thereafter the real economy, to put these institutions into a conservatorship. The avoidance of resolution on grounds that it would do tremendous harm to the economy rests on the argument that governments do not have the resolution powers for financial services holding companies and insurance companies that they have in the case of banks. In addition, some have suggested that the sheer size and complexity of these institutions changing organizational form would start a run on other institutions that are heavily intertwined with the behemoth institutions on the threshold of insolvency. Still others have suggested that governments are incapable of taking over and running such institutions and that substantial "going concern" value would be lost irreversibly in the process. In essence, society is faced with a policy regime where officials claim they cannot protect government finances and the taxpayers from the excesses of the TBTR firm.

131. This TBTR regime goes beyond Too Big to Fail, whereby critical functions of restructured institutions have to be preserved. A TBTR regime implies that managements, creditors are immune from consequence. A policy regime such as this is not consistent with a market economy that performs its social function well in the longer term. A strategy of entangling a financial institution so deeply and largely into the fabric of the economy that it could not be permitted to be resolved puts society in a position of great fiscal danger. It no longer has control of the scale of fiscal losses than can be imposed upon it by the financial institutions managers. This puts the management of TBTR institutions in a very powerful position that is incompatible with wider social goals. Their incentives are misaligned with social incentives and some activities undertaken rationally by management, though reckless from a social perspective, can induce bailouts of unlimited magnitude with no consequences for managers (firing) or creditors in the event of loss, while gains accrue to the managers of risky activities pay off. In some countries, even at present, the scale of these institutions has reached a magnitude that the quality of guarantees on liabilities is drawn into question. This entire process is amplified by the fact that knowledge of TBTR status removes risk from the creditors of the institution and the funding cost advantage contained within the creditors' expectations give an advantage to TBTR enabling them to further increase their size.

132. It is imperative for policy officials around the world to come to grips with this challenge. The aforementioned enhanced resolution powers must be promptly enacted and strategies to limit the absolute size of financial institutions must be created to mitigate the costs for officials of choosing to restructure them. In addition extensive examination of large institutions on an ongoing basis can prepare officials for controlled restructuring. There is no basis for allowing these large institutions any degree of opacity *vis a vis* regulators who must always be prepared for the contingency of a resolution. While antitrust laws have often been invoked for anti-competitive practices, a new consideration of the role of antitrust, akin to the spirit of Theodore Roosevelt in the early 20th century may be necessary to put the structure of capital markets back on a footing that is sound and manageable.

133. As noted above, financial sector regulation is a key instrument of financial policy. But there are other instruments, which countries, especially developing countries, should consider to ensure that the objectives of a good financial system are attained:

Direct Lending

134. Even in more advanced industrial countries, there are certain areas where governments have traditionally taken an active role in lending. Public student lending programs have been far more efficient than private lending, and have avoided the corruption and abuses that have marked private lending. In many countries, including the US, the government has had to introduce special programs to ensure adequate access for small and medium-sized enterprises (e.g. partial guarantees, as under the Small Business Administration). In many successful developing countries, development banks have played an important role at particular stages of their development. Given the record of abusive lending to poor individuals, governments may need to consider whether regulatory mechanisms suffice, or whether direct lending programs should be established.

Innovation

135. Government (financial policy) can also play an important catalytic role in the development of financial markets (as it has done in mortgage markets in many countries) and in the creation of new products (like inflation or GDP indexed bonds, or Danish mortgage bonds). Private financial markets have failed to make innovations that address many of the critical needs associated with creating products that meet the needs of ordinary citizens. In some cases, after the potential of those markets has been established, the private sector can take over.

136. These innovations are important both domestically and internationally, e.g. in improving the distribution of risk bearing between developed and less developed countries. Examples of the kinds of innovations that might be helpful are discussed in Chapter 5.

Electronic payments mechanism

137. One important area of innovation is in the payments mechanism itself. Changes in technology enable the creation of a low cost electronic payments mechanism. Introducing this requires some cooperation among financial institutions. Unfortunately, in some countries financial institutions have colluded to maintain a high cost payments mechanism. Therefore, regulators need to pursue a policy of creating incentives for the use of electronic payments both for efficiency and financial inclusion.

Chapter 4: International Institutions

The Challenges Ahead–The Need for New Global Economic Governance

1. The response of international financial institutions to the global financial crisis has demonstrated the urgency to review the adequacy of their mandates. This review must be open to consideration of new institutional arrangements as well as to modification of internal governance mechanisms to provide more effective voice and representation of developing countries. More importantly, immediate attention needs to be paid to the policies and philosophies underlying their operations. Above all, it is imperative that reform should re-establish credibility as truly international institutions contributing to growth with equity and stability for all countries.

2. The existing system of international economic governance has relied on two basic principles: specialization and coordination. A set of global institutions–specialized agencies–each with a mandate to deal with a specific and limited set of issues. The first such institutions were the specialized agencies within the UN system, the World Bank and the International Monetary Fund. A third agency called for in the Havana Charter, the International Trade Organization (ITO) was to deal with commercial policy, employment policy coordination and the position of developing countries was never approved. Only the GATT survived, and provided the basis for the WTO, which is not formally part of the UN system. These three post-war international economic institutions were expected to work in a complementary fashion to promote sustained economic recovery and growth, full employment and thus economic welfare, as well as reconstruction and development of economic capacities and capabilities.

3. The overall coordination of UN activities concerned with economic, social, and ecological affairs, including the specialized agencies, was to be entrusted to the Economic and Social Council (ECOSOC), one of the UN system's main organs, acting under the authority of the General Assembly. Coherence is not a new concept in the arena of international relations, as the original UN model provided, in theory, for the coherent design of policies for the achievement of internationally agreed goals. Although the system has never worked the way it was originally envisioned, its internal logic remains compelling; the incomplete arrangements provided support to post-war reconstruction and the Golden Age of Keynesian-inspired economic growth until the 1970s.

4. The underlying challenge to effective global economic governance originates from the absence, in a world of sovereign states, of an adequate body or bodies as a locus of coordination and accountability, and to enforce transparency and elicit compliance. A series of issues ranging from cooperation in trade in goods and services, cross-border environmental goods, cross-border labour policies, payments and clearing, regulation, contract enforcement, to exchange rates and other related cross-border matters have to be addressed through coordinated arrangements and negotiated derogations of sovereignty for specific purposes.

Global Governance Implications of the Current Crisis

5. The current crisis reflects problems that go beyond the conduct of monetary policy and regulation of the financial sector. It has made clear that globalization of trade and finance calls for enhanced global cooperation and global regulation. The international community is confronted with multiple, interrelated threats of unprecedented scope. The collapse of the global financial system and the worldwide economic downturn, the growing divide between poor and rich within and between countries, the risk of unabated global warming that might result in systemic climate change, the energy and the food crises–these are all interconnected global challenges that threaten to unravel the fragile state of globalization. Because global economic integration has outpaced the development of the appropriate political institutions and arrangements for governance of the global economic system there is a pressing need for a substantial improvement in the coordination of global economic policy.

6. The crisis has brought to the fore severe structural lacunas in the existing global economic governance structure, in particular the lack of incentives for global collective action (e.g. with regard to the provision of global and regional public goods and poverty reduction) and the failure of the institutional framework to ensure coherence of global policy making.

7. The ability of the atmosphere to absorb greenhouse gas emissions had appeared to be available to all without cost. However, the limit has been reached where these emissions challenge the stability of the climatic system. The international community thus faces a collective action problem: who will take over what responsibility to provide an international set of rules or set incentives that would foreclose free-riding and ensure international cooperation in preserving the atmosphere.

Collective Action and Coherence

8. Effective collective action depends on a strong institutional framework, ensuring coherence in decision making. Managing global threats in an interconnected world critically depends on cross-sector and cross-institutional actions to assure system-wide coherence in norms, policy frameworks and operational standards. Political consensus and compromise within the international community are inconceivable without the design of complex inter-issue linkages, thereby facilitating a fair allocation of costs and benefits over a wide range of global concerns. As the crisis is global and multi-faceted, it is important to foster greater cooperation among governments, international organizations, and other stakeholders in support of a stronger, cleaner and fairer economy. It is key to achieving the goal of greater coherence between financial, trade, social, environmental and development goals.

9. In order to pursue joint goals, such as adequate and appropriate provision of global and regional public goods, strong collective action is needed. By definition, without coordination countries do not have sufficient incentives to invest in global and regional public goods (e.g. economic, financial and ecosystem stability). The same is true for other common objectives, such as combating poverty. To achieve the goal of sustainable development, stronger collective action is needed in a number of inter-related areas.

10. With the adoption of the Millennium Development Goals, the international community reiterated its commitment to the overarching goal to eradicate poverty. Joint approaches have been agreed upon and many countries have developed a joint understanding on the relevant financing needs and the respective burden sharing. However, commitments have to be monitored and implemented.

11. Institutional arrangements failed to take the actions that might have prevented the current crisis from developing. Some institutions have even actually promoted arrangements that facilitated the transmission and contagion of the crisis across borders, thereby contributing to its amplification. Without the reform of these institutions, it will be difficult to ensure financial stability. There is clearly an urgent need to reform the international monetary and financial system to ensure that it is more inclusive and equitable, and to thus enable more effective and credible global economic governance. Already, some developed countries, such as the United Kingdom and France, and many developing countries, such as those in the Commonwealth, have called for an international conference to redesign the system of international economic governance into a new post-Bretton Woods system, designed to restore accountability and transparency in international economic policy-making and to overcome existing systemic weaknesses.

12. Developing countries now represent a much larger proportion of world economic activity than in 1944. Developing countries, as a group, also have a direct interest in a more equitable global governance system.

Global Economic Governance and the United Nations

13. Neither the Group of 7 of industrialized countries nor the Group of 20 represents a sufficiently inclusive global steering group for addressing global systemic challenges. The G-7 have initiated a number of initiatives important for developing countries, and are engaged in a systematic dialogue particularly with African countries. While the G-20 are more broadly based, there is still no representation of the remaining 172 countries. The shape of any future governance format must ensure inclusiveness and adequate representation of developing countries, including LDCs, promote complementarity and coherence and should establish links between existing and new fora.

14. There has been growing attention and interest in the working of the G-7 and G-20. However, such informal groups which are growing in significance should not be allowed to undermine the functioning of formal institutional arrangements and the discharge of their respective mandates as per the desirable standards of governance and transparency specified.

15. There currently is a unique opportunity for bringing forward global economic governance reforms. The current financial and economic crisis clearly calls for enhanced cooperation and coordination of existing and emerging actors on economic questions.

16. Sustainable progress in managing global governance requires a comprehensive, systemic and long-term oriented effort. As the world moves into an uncertain phase of global interconnectedness and mutual vulnerabilities, unforeseen risks unfold just as unexpected opportunities for institutional innovations may arise. Not only the current challenges of the financial and economic crisis, but also other global issues such as climate change or the food

and energy crisis clearly call for the international community to take a systematic and global approach towards a sustainable and socially balanced economic development. It is therefore important to strengthen international institutions, especially the United Nations, the body which is most universal, legitimate and accountable to the people of the world. This inclusive response will require the participation and the involvement of the entire international community. Apart from the G-7, G-8 or G-20, it must encompass representatives of the entire G-192.

17. The United Nations is the most legitimate forum for achieving greater coherence among different actors. Given the specific institutional foci of the IMF, the World Bank and other international institutions, there is a need for better coordination and political accountability and for a forum for consensus building to broaden and guide their policy agendas. An overarching theme of the UN Financing for Development (FfD) conference and the resulting Monterrey Consensus was the need to enhance the coherence and consistency of the international monetary, financial and trading systems, to ensure that they support the internationally agreed development goals, including social and environmental sustainability.

A Global Economic Coordination Council could lead the way forward

18. The variety of international institutions and organizations with specific mandates requires an overarching inclusive body allowing for an integrated view of the scope of mandates, topics and policies and the establishment of adequate instruments for effective global economic governance. A globally representative forum to address areas of concern in the functioning of the global economic system in a comprehensive and sustainable way must be created.

19. As an immediate step, an Intergovernmental Panel tasked with the assessment and monitoring of systemic risks in the global economy should be established. The Panel could serve as an internationally recognized source of scientific expertise in support of better coherence and effectiveness in the global governance system, fostering dialogue between policy makers, the academic world, international organizations and recognised social movements. The Panel should primarily analyze systemic risks in relation to the global economy, their root-causes and implications for human development. It should establish criteria for the identification of systemic risks and issue recommendations as to preventive measures and sound economic policy-making, thereby also attributing an early-warning function to the Panel. The Panel should be made up of renowned experts from all continents, OECD countries, emerging and developing countries. It would not undertake its own research, but pool the global knowledge and resources of a large number of acknowledged experts. While its analysis would focus on economic issues, it would also take into account the social and ecological dimensions of economic trends and policies, and would analyze their long-term developmental implications and identify obstacles to economic systems achieving developmental, social, and environmental goals. It should therefore adopt a multidisciplinary and long-term approach to observed economic change. Its institutional setup and functioning could follow the very successful example of the Intergovernmental Panel on Climate Change (IPCC). In consultation between science and politics, it should be assigned the role to work out normative and value-based standards for economic and financial decision-making, once established and operational, the Panel would serve as advisory body to the UN System (including ECOSOC), the Bretton Woods

institutions and other international organizations dealing with economic, financial and social issues.

20. In the longer-term a Global Economic Coordination Council should be established at a level equivalent with the General Assembly and the Security Council. Its mandate would be to assess developments and provide leadership in economic issues while taking into account social and ecological factors. Based on this mandate it would promote development, secure consistency of policy goals of major international organizations, and support consensus building among governments on efficient and effective solutions for issues of global economic, social and environmental governance. The Council could also promote accountability of all international economic organizations, and identify gaps that need to be filled to ensure the efficient operation of the global economic and financial system. Representation could be based on a constituency system designed to ensure that all continents and all major economies are represented. At the same time, its size should be guided by the fact that the council must remain small enough for effective discussion and decision making. In addition, active participation by other important institutions, such as the World Bank, IMF, ILO, WTO, would be crucial. The intergovernmental Panel could play an important role in further defining the mandate, working mechanisms, composition and the interaction of the Council with the UN system. Once established, the Council could rely on consultancy and expertise provided by the Intergovernmental Panel.

Bretton Woods Institutions and Regional Development Banks

21. The International Monetary Fund (IMF) and the Multilateral and Regional Development Banks continue to have a very important role in the international economic financial architecture. The mandate of the IMF is to assure global financial and economic stability. It has been expected to survey the economic performance of its member countries, alert them of economic dangers and provide policy advice and financing to members facing balance of payments difficulties besides helping developing nations to achieve macroeconomic stability and support employment. The World Bank and the other multilateral development banks are also supposed to have a key role in supporting the developing countries. To achieve their objectives they provide concessional loans and grants to developing countries, as well as technical assistance. Within their mandate of poverty reduction and the promotion of sustainable development and inclusive growth, they should play a counter-cyclical role in tackling the crisis. The Multilateral Development Banks have recently revised their policy approach, moving away from earlier market-fundamentalist approaches, starting with HIPC debt relief and the adoption of new poverty alleviation strategies.

22. However, there have been severe shortcomings in the mandate, policies, resources and governance of these institutions. These problems have impaired their ability to take adequate actions to prevent and respond to the crisis; they have also had a negative impact on their mandate to promote sustainable development. The ability of the IMF to safeguard the stability of the global economy has been undermined by the vastly greater resources and volatility of globally integrated private financial institutions, uncoordinated national policy responses as well as the emerging influence of non-inclusive arrangements including those introduced by the G-7, and the OECD. In fact, the IMF has been effectively sidelined in handling the present crisis; on its own admission it did not perform well in identifying systemic vulnerabilities or in anticipating the crisis.

23. The limited relevance of the Bretton Woods Institutions also stems from their skewed voting structures and governance, the chequered record of their forecasting, policy and other recommendations, including the onerous conditionalities they have imposed on borrowing countries and their tendency to proffer pro-cyclical, rather than counter-cyclical policy advice. Major reforms are thus necessary.

24. The recommendation to recycle substantial amounts of capital to developing countries that have been the victims of a crisis in the developed world is in itself uncontroversial. The means to achieve those capital flows to the developed world on the other hand, is. On the one hand, both borrowers and lenders have been reluctant in recent years to utilize the IMF. In response to this demonstrated reluctance, some have advocated setting up a new institution with very different governance and objectives. The cost of such a fresh start is one of timeliness. The need to channel capital to developing countries is extremely urgent.

25. The IMF can address this aspect of the challenges because it already has a substantial staff that is present, active and experienced in the assessment and monitoring of many of the countries in question. The concerns utilizing the IMF centre on their prescriptions rather than on their capacity to do timely diagnosis. It appears that the culture of the IMF has for a long time embraced an economic philosophy and economic models that, like those espoused by the financial sector described above, have serious flaws, have contributed to the recent crisis, and have been shown by events to have failed.

26. For the IMF to regain its importance and to play a meaningfully positive role in the future resolution of crisis they will be required to significantly retool their thinking. For their prescriptions and policy recommendations to inspire the participation of borrowers and lenders alike, they will have to place much greater weight on the role of externalities and other market imperfections in the design of conditions and responses to meet the crisis. In addition, in periods of global underemployment such as the present, they must come to a more enlightened understanding of the role of deflationary bias, and the associated cross country externalities, in exacerbating the problems within a country and for the global economic system as a whole.

Mandates

27. There is a need for independent and even-handed macroeconomic surveillance. The IMF has not implemented its mandate consistently and even-handedly. For example, in recent decades, it has largely ignored its mandate to sustain growth and employment while focusing almost exclusively on curbing inflation. It has also promoted financial, including capital account, liberalization, although it's Articles of Agreement clearly allow governments to use capital controls. Before the current crisis, the IMF also failed to provide early warnings -- unlike the United Nations system in various publications such as the *World Economic Situation and Prospects* and the *Trade and Development Report*.

Better integrate global and regional public goods into the work of the MDBs

28. The participation of developing countries is essential if there is to be an adequate provision of global and regional public goods, such as climate protection and financial

stability. Accordingly, these agendas can only be successfully realized if the developing country perspective is appropriately reflected in global decision making. At the same time, the developing countries' actions in support of the provision of global and regional public goods needs additional funding, if other developmental objectives are not to be compromised. The provision of global and regional public goods should thus be an important part of development institutions' work and mandate. The different dimensions of this issue urgently need to be assessed, for example the implications for the UNFCCC and the World Bank's respective mandates, its policies and governance structure.

Create a Pro-Development Climate Architecture

29. The architecture for financing defence of the climate will be reviewed in the course of the UN climate negotiations. From a development perspective, the key issue is that climate-related tasks in the developing countries are considered as an integral part of a sustainable development agenda and that all partners act accordingly. To that end, the full set of existing development instruments, procedures and institutions must be used and further developed. Multilateral climate financing must come under the authority of the UN Framework Convention on Climate Change (UNFCCC) and serve to meet its climate change mitigation and adaptation objectives.

Governance

30. There is a growing international consensus in support of reform of the governance, accountability, and transparency in the International Financial Institutions. The governance reforms have to be based on a joint understanding of the respective mandates and a common understanding on the strategic directions of the respective institutions. On this basis, major reforms in the governance of these institutions, including giving greater voice to developing countries and greater transparency have to be accelerated. See the Report of the Committee of Eminent Persons on IMF Governance Reform chaired by Trevor Manuel in this regard.

31. The inconsistency between the economic and financial weight of developing countries in the world economy, their role as recipients of IMF and World Bank funds on the one hand, and their representation in these institutions on the other, is one of the factors behind the loss of legitimacy and relevance of those organizations in addressing systemic issues. The decisions for broader reform taken by the Board of Governors of the Fund at the Annual Meetings in Singapore in 2006 and in Washington in 2008 have resulted in modest progress. Quota increases have only been made on an *ad-hoc* basis, first in 2006 for a small group of emerging market countries, and in April 2008, for the larger membership, leading to marginal changes and failing to shift significantly the balance of power between developed and developing countries. The April 2008 decision by the Board of Governors to adopt a new quota formula is not sufficient to address the problems in governance. In fact, the new formula actually shifts voting weight to industrial countries at the expense of middle- and low-income ones, with the modest progress achieved due to voluntary forgoing of votes by major industrial countries and ad hoc decisions. Therefore, a step towards more inclusiveness and representative governance at the IMF would require an improved quota formula and/or alternative procedural reforms.

32. A governance reform of the IFIs must also strengthen the weight of low-income countries, e.g. by recognizing the dependence of these countries on financial from both the World Bank through the International Development Association (IDA) and the IMF through the Poverty Reduction and Growth Fund (PRGF). This can be done by increasing quotas or by further increasing the share of basic votes. When the IMF was established in 1944, basic votes were set at 250 votes for each member and represented 11.3 per cent of total voting power when it had 44 members. However, as a result of the increase in quotas that has occurred over the years, the share of basic votes has fallen considerably and reached its lowest level of 2.1 per cent of total voting power for 184 members in mid-decade! The April 2008 decision taken by the IMF Board of Governors to reverse this trend by tripling basic votes only increased the total share of basic votes to 5.5 per cent of current voting power, and falls far short of restoring the share, let alone the weight of basic votes.

33. The application of double majority voting to a broader set of decisions could also compensate for voting imbalances in the Fund. At present, a double majority–85 per cent of voting power and a 60 per cent majority of members–is required to amend the Articles of Agreement. Double majority voting (shares and chairs) should be extended to the selection of the Managing Director and the chair of the IMFC, as well as for key policy decisions and to approve access to lending operations. Also, the reform must consider eliminating effective veto powers over decisions to amend the Articles of Agreement. These changes could help strengthen the sense of ownership in the Fund by requiring a significant majority of members to support key decisions that determine the direction of the organization.

34. Some basic principles for IMF governance reform would apply to reforming other international financial institutions, such as the World Bank. However, the Bank's specific mandate as a development bank is distinct from the IMF and its governance should reflect this difference. Hence, in determining the participation rights of its members, distinct World Bank governance arrangements would be needed.

A roadmap with a time frame to enhance voice and representation in the IMF

35. To strengthen the effectiveness and legitimacy of the IMF its governance must be enhanced to ensure that it fully reflects changes in the world economy. Emerging and developing economies, including the poorest, should have greater voice and representation. The next quota review is currently scheduled for 2013, but it would be helpful to accelerate this process and to bring it forward to 2011.

Reform of the World Bank's governance structure should be completed swiftly

36. The first stage of the World Bank's voice reform should be implemented rapidly. The doubling of basic votes and the third African seat on the Board will increase the influence of developing countries. The second stage, focusing on a reform of quotas, should be accelerated and completed by the Spring Meetings in 2010. Against the background of the challenges ahead, such as the financial crisis and climate change, the second stage of the reform process should start with an in-depth debate on the Bank's mandate and its strategic directions. The World Bank Group has already different "arms", such as IDA and IBRD, with their own governance structures. It has to be born in mind that new or reinforced fields, such as the increasing role of the Bank in the area of global and regional public goods,

might also require new governance structures. With regard to the quota reform, three criteria should be taken into account for allocating votes: the member state's economic weight, their contribution to the development mandate of the World Bank (for example, measured in terms of contributions to IDA and trust funds) and the significance of borrowing levels from the Bank. The two latter criteria would reward member states for being closely connected with the Bank.

37. Within the Fund and the World Bank, a merit-based, transparent process for the selection of the senior management should be encouraged through implementation of clear guidelines. Conventions associated with the choice of the leaders of the World Bank and the International Monetary Fund make little sense in the twenty-first century. Progress should also be made in identifying those decisions where double majority voting is appropriate and a timely decision made on this reform.

Policy coherence for development also has to be improved on the national level

38. The current crisis has not only revealed a lack of international coordination and regulation; at the national level, too, players have failed to introduce the requisite reforms and regulations. Against the background of the current crisis, policy coherence for development is of utmost importance. It should be examined how the development- impact of government policies can be better measured and monitored.

39. In particular, national governments must ensure better policy coherence for development in the various international institutions. The role and mandate of World Bank and IMF has changed since the foundation of both organizations. Given the wide impact of IMF programs and the steady expansion of its operations into the areas of development and poverty alleviation, it does not seem appropriate that the Fund should just reflect the views of representatives from finance ministries and Central Banks. In addition, the views of development, foreign and planning ministries should be better integrated. The same principle should be applied to the World Bank as it has along the way added new tasks to its mandate, in particular in the area of global and regional public goods such as health and environmental policy.

Policies and Instruments

Review policy advice

40. The World Bank and the IMF have already begun to move away from free market ideology, but the importance of taking frictions into account in policymaking (incomplete information, imperfect information, imperfect institutions, bounded rationality, etc.) is not equally accepted by all departments of these institutions. In particular, the advice offered in the past by the World Bank and the IMF on capital account and financial market liberalization was often problematic. In view of the current crisis, IFIs should overcome market fundamentalist concepts and should allow for more pragmatic approaches. In particular, there is a need to comprehensively review these issues and to draw lessons for the policies of these institutions.

41. The IFIs have to strengthen their capacity to implement counter-cyclical instruments. The global crisis puts recent progress in helping the poorest, and the 2015 targets of the Millennium Development Goals, at risk. The World Bank and other Multilateral Development Banks have already increased lending and mobilized additional financing for trade credit, infrastructure financing, recapitalization of banks and microfinance. But more needs to be done so that the MDBs also play their part in enabling countries to support global demand and cushioning the impact of the crisis on the poorest. In particular, the MDBs should, in close coordination with the IMF, move forward on flexible, fast disbursing, and front-loaded instruments designed to substantially and quickly assist developing countries facing financing gaps in the context of the current crisis. For example the IFIs should pro-actively develop flexible instruments designed to support specific development budget financing as contingency arrangements during times of market disruption for countries with sound policies, including backstopping social protection and deposit insurance arrangements that may not yet be fully funded. Also, the option to extend guarantees for credit enhancement of government issuances on the market should be examined. The IFIs should more actively take the role as market maker for new risk bearing instruments.

42. The World Bank and the IMF must further improve their strategies for preventing crises and reducing the scope for contagion, and helping countries cope with external shocks. Given, the absence of global systems of risk bearing and the lack of, and in some cases resistance to, innovations in the private sector that would facilitate efficient risk bearing, there is a need to push ahead with the development of new instruments to better shield developing countries from the ever-increasing volatility of markets (commodities, foreign exchange, food, etc.). Examples would be local currency lending instruments and risk-mitigating facilities or GDP-indexed bonds (more fully described in Chapter 5). MDBs must play an active role in the promotion of such financial products. Credit facilities with flexible debt service are another option to be explored more pro-actively. International financial institutions need to explore meaningful innovations that would enhance risk management and distribution and how markets might be encouraged to do a better job. In particular, while there have been some expansion in capital markets in domestic currencies in developing countries, developing countries still bear the brunt of exchange and interest rate fluctuations. IFI lending in single local currencies or baskets of local currencies and the provision of exchange and interest rate cover might be important steps in improving international risk markets.

43. Each country needs to find the model of financial sector development which is most appropriate for its current level of development, needs, and institutional capacity. The IFIs must consider that premature and inappropriate financial and capital market liberalization is prone to fail, as acknowledged even by the proponents of these liberalizations. The current crisis has illustrated how they may serve to exacerbate the impact of mistaken policies in developed countries on their own economies, even when they have managed them well. Developing countries face a difficult trade-off regarding the design and regulation of their financial systems. On the one hand, access to finance is necessary for economic development. On the other hand, a more sophisticated financial sector may also to lead to an increase in total risk. If the second effect dominates the first, financial liberalization may lead to an increase of systemic risk. In choosing where to position themselves, developing countries should recognize that there is no model that is right for all countries or at all times.

44. However, financial liberalization makes little sense if financial sector institutions are weak; appropriate sequencing of reforms is crucial. Liberalization opens the markets to short-term, volatile capital flows which might lead to a destabilization of the financial market. Therefore timing and sequencing is important to allow for a step by step and cushioned opening to the international market. And financial and capital market liberalization needs to be linked to the development of an effective regulatory system, along the lines discussed in Chapter 2. The IMF and the World Bank have to strengthen these principles in their policy advice. They should link their policy advice regarding liberalization of financial and capital markets better to the country specific situation and its economic soundness.

45. The World Bank should strengthen the support it provides in the area of financial regulation. The experiences of financial crises in countries that were supposed to have good institutions and policies suggests that ascertaining what are good institutions and policies may be more difficult than was at once thought to be the case. These experiences may also highlight the dynamic nature of markets. What are considered good institutions and policies at one time, can quickly evolve into those that are not at another. It also highlights the important role that political processes have played in the shaping of the liberalization-deregulation agenda, and how difficult it may be to develop and maintain adequate protections in the context of liberalization. The World Bank should therefore review its own approach to financial sector policies in the light of experience from the recent crisis and thereafter with increase its support to financial sector development with a focus on financial regulation. Activities should include, in particular (a) strengthening national banking and financial market oversight; (b) establishing a multi-country crisis management system to respond to financial crises; (c) developing national credit registers; and (d) developing standards for responsible, fair, transparent banking transactions that meet the requirements of responsible finance. It is imperative for the World Bank to learn from the successful experience of other developing and emerging market economies, rather than to pursue models adopted in developed economies or premised on the growth of presumed ideal conditions.

The Bretton Woods institutions must support national capital account management

46. There is no evidence that capital account liberalization has contributed significantly to economic growth. One reason could be that much of the short-term lending finances consumption rather than investment. Also, the growth impact of capital inflows depends to a large extent on the strength of existing institutions and capacities. Capital account liberalization may contribute to economic volatility as these flows tend to be pro-cyclical. This implies high costs for the economy as it raises risk premia and forces governments to set aside large funds of reserves. Also, there are doubts whether new and increased regulation alone would be enough to curb explosive speculation on financial markets. Therefore, it might be necessary to re-examine the need for management of capital flows, especially for high-volatility short-term capital inflows. In the interest of long-term stability, it may be necessary to introduce some kind of capital controls, coupled with serious limitation of scope for the securitization processes and leveraged financing instruments. Clearly, past policy advice by the Bretton Woods Institutions in this area was often

misguided. These institutions should pro-actively assist their shareholders on how to design and implement policies in the area of capital account management. Capital account management may involve price and/or quantitative instruments.

47. Conditionality has often required developing countries to pursue pro-cyclical policies or to adopt the kinds of monetary and regulatory policies which contributed to the current crisis. In addition, these conditionalities contribute to global asymmetries, disadvantage developing countries relative to the developed, and undermine incentives for developing countries to seek support funding, contributing to global economic weakness. While the IMF initiatives to reduce counterproductive conditionalities are to be commended, they might be insufficient, and in many cases countries are still required to introduce pro-cyclical policies. In order to avoid pro-cyclical conditionality, additional IMF and other external resources must be mobilized. The economic models on which IMF's financial programming is based, should be re-examined in order to identify any built-in restrictive biases (e.g. with regard to the assumed private sector response to reduced government spending). One of the tasks of the Panel discussed in paragraph 19 above would be to evaluate and assess accuracy and bias in the models and policy frameworks.

Other international financial bodies

48. The governance of global financial regulation remains a question of concern. It is imperative that there should be consideration of a new Global Financial Authority to co-ordinate financial regulation in general and establish global rules in certain areas, such as with regards to money laundering and tax secrecy. The current proposals to re-establish the Financial Stability Forum with a wider membership as the Financial Stability Board (FSB) is a step with potential. However, there is no indication as yet that the FSB is considering the adoption of a robust regulatory environment. Continuing with the current structure or making marginal changes would not ameliorate the current situation, nor would it necessarily be more effective in preventing future crises, judging by the previous Financial Stability Forum's (FSF) track record in the decade since its establishment, especially in the run-up to the current crisis. While national regulatory authorities have the ability and mandate to protect the vulnerable within their borders, there is a difficulty in extending this mission across borders. While much of what it to be done at the international level will be difficult to achieve in the short term, there is a great deal that can be done at the domestic level without prior international agreement.

49. If the FSB is to become the main instrument for the formulation of reforms of the global financial system, it must better take into consideration the importance of financial stability for economic development. The original FSF was created in the aftermath of the 1997/98 financial crisis in order to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country and to enhance the institutional framework to support global financial stability. It is now apparent that the reforms that it has proposed, although important, have not been sufficient to avoid major global financial instability.

50. Strengthening and reforming the FSF into the FSB as agreed at the 2 April 2009 G-20 Summit should only be an initial step toward establishing much more representative, appropriate and effective financial regulation at both national and international levels. The

task of ensuring coherence in regulatory principles among national authorities must be undertaken by such authorities supported by an accountable Secretariat which should have access to a diversity of viewpoints. For the FSB to take on the role as a global authority in identifying systemic risk for the financial system it would require an international capability that goes beyond the mandates and capabilities of the Financial Stability Forum and the Bank for International Settlements (BIS). International financial regulation will require coordination beyond Central Bank authorities (the major concern of the BIS) and must include securities and corporate regulators as well as accounting standards among its key priorities.

51. The FSB and all standard setting institutions must become more representative and accountable to adequately reflect the views of and the conditions in developing countries. Most developing countries are not represented in today's standard setting institutions. The Basle Committee of the Bank for International Settlements (BIS) and the FSF/FSB set important global economic standards in areas such as data dissemination, bank supervision, financial regulation and corporate governance. The inadequate representation of developing countries in these *ad hoc* bodies, however, makes their analysis and recommendations incomplete and biased in crucial aspects, as recently demonstrated by the Basel II capital adequacy criteria. Inattention to the fact that countries are at different stages of economic development with varying financial and institutional capacities poses a challenge for global acceptance of standards and codes developed by these non-inclusive bodies. This dilemma is a major obstacle to ensure universal and effective implementation. While standard-setters liaise with developing and transition economies from time to time, consultations do not substitute for participating in the decision-making.

52. The challenge is to create globally representative institutions, cognizant of the concerns of the advanced industrial countries, emerging markets, and developing countries. Even if it is not easy to change institutional cultures, more inclusive, representative and appropriate representation in the BIS and FSF/FSB would result not only in a fairer system, but also in better regulation leading to a more stable global financial system with welfare-enhancing effects for all. Increased international public oversight in the governance of the international financial system requires that critical standard setting activities are, at a minimum, reported to an intergovernmental body for coordination.

53. The lack of accountability of important private standard setting bodies is an additional area of concern. Private entities such as the International Accounting Standards Board (IASB) and the International Organization of Securities Commissions (IOSCO) develop, for instance, standards for cross-border regulation that have systemic impacts on the international financial system, exempt from any political accountability. Increased international public oversight of governance of the international financial system requires that critical standard setting activities are, at a minimum, reported to an intergovernmental body for approval. This is particularly important in light of the greater interconnectedness among financial market segments. Global banks have increasingly expanded their operations into securities markets and own or control brokerage and security firms.

International lending and ODA

54. There is an urgent need for donors to fulfil their existing bilateral and multilateral ODA commitments which must be closely monitored. Developed countries must make a renewed effort to meet the commitments made in the Millennium Declaration, the Monterrey Consensus, the 2005 Global Summit, and the Doha Declaration by 2015. Failure to increase the levels of official assistance as required will have long-term effects. There will be an increase in poverty and malnutrition and the education of many young people will be interrupted, with life-long effects. The sense of global social solidarity will be impaired, making agreement on key global issues, such as responding to the challenges of climate change, more difficult. Failure to provide such assistance can be counterproductive even in a more narrow sense: it can impair the global recovery.

Additional funding for developing countries is needed

55. Funding is required to contain the negative impact of the crisis on developing countries as well as to offset the distortions of the level playing field created by some of the massive stimulus and bail-out programs of the advanced industrial countries, including large subsidies to financial institutions and corporations and extensive guarantees (See the discussion in Chapter 2, paragraph 104).

Aid Effectiveness

56. The processes for achieving aid effectiveness need significant enhancement. The 2002 Monterrey Consensus asserted that "Effective partnerships among donors and recipients are based on the recognition of national leadership and ownership of development plans and, within that framework, sound policies and good governance at all levels, are necessary to ensure ODA effectiveness." The 2005 Paris Declaration on Aid Effectiveness sought to operationally these basic principles. Despite commendable early OECD leadership in this area, a more universal body, where all parties share responsibility for progress, can effectively lead in further enhancing aid effectiveness. The Development Cooperation Forum (DCF) of ECOSOC has begun promising work in this area.

57. Donor conditionalities and realizing national ownership of development strategies were the most contentious issues in negotiating the 2008 Accra Agenda for Action, which affirmed that national ownership and effective leadership are unattainable without a reform of conditionality. Achieving national leadership will require a shared understanding of what conditionality is appropriate and mutually acceptable. Aid recipients must meaningfully participate in the agenda-setting and operations of multilateral institutions which manage development aid. ODA should not undermine national accountability, democratic processes, parliamentary oversight and national capacities for designing, negotiating and implementing development strategies appropriate to domestic conditions.

58. Ironically, ODA has proven to be the most volatile of foreign flows to many of the poorest countries in the world. Improving the predictability of aid is necessary for aid effectiveness. The international community must make progress to genuinely align aid programs with national priorities.

59. The use of governance indicators (and more broadly, the Country Policy and Institutional Assessment indicators) for aid allocation and other international cooperation has been greatly discredited. These indicators are now a critical element in determining access to aid and debt financing for developing countries, and should be repudiated. They represent a hidden form of conditionality.

Expansion of resources by IFIs

60. Steps must be taken to ensure that the World Bank and the regional development institutions have sufficient financial capabilities, as these institutions must be able to provide counter-cyclical financing. It is necessary to determine whether certain international financial institutions may possibly require a capital increase, which is doubtless the case with the Asian Development Bank. In order to be able to react more promptly in future crises, the MDBs' policies and facilities should be reviewed. There could prove to be a need for additional facilities within their respective mandate and the establishment of a fast-track mode of project preparation. In addition regional efforts to augment liquidity should be supported. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighbouring countries.

The IMF needs an immediate expansion of its resources

61. It is obvious that the IMF's current lending resources are not sufficient to allow it to respond appropriately to the worsening problems in developing countries. To allow the IMF to fulfil its mandate of stabilizing the global economy and to respond to increased members' demands in the current uncertain international environment, the Fund's position should be strengthened through a very substantial increase in the IMF's lending capacity along the lines already decided at the London G-20 meeting. This will require reviewing the various options, including the allocation of further special drawing rights (SDRs), bilateral loans, an expansion of the membership and scale of the New Agreements to Borrow (NAB), the agreement of swap arrangements and a capital increase through contributions from member countries. The resource increase should go in parallel with decisive progress in long-overdue governance and voice reforms. The additional capital disbursement should not increase the dominance of the industrial economies. The international community has to ensure that low income countries have sustainable financing which does not increase debt commitments to launch countercyclical responses to the crisis. The current provisions of the G-20 in this regard are too limited in scope.

Review developing countries' debt sustainability in light of the financial crisis

62. Several developing countries are facing debt sustainability problems. The new Debt Sustainability Framework recently introduced by the IFIs may act pro-cyclically, because debt ratios tend to rise as tax revenues decline and expenditures might rise due to the crisis. In view of this, there should be an assessment of debt dynamics in the light of the current crisis, as well as a review of MDBs' policies. In those countries where the crisis is seriously threatening debt sustainability, consideration could be given to debt moratoria and, where appropriate, partial debt cancellation within the framework of a permanent international

debt regime (see Chapter 5 for further details). Furthermore, low-income countries in particular need more access to highly concessional funds, if they are to meet their essential spending needs without getting back into debt difficulties. The various options, such as an early replenishment of IDA should be examined. Also, MDBs and other donors should make every effort to make repayment flexible in response to exogenous shocks.

Establish a new credit facility

63. In order to mobilize additional funds, the creation of a new credit facility is a matter of urgency. The new facility could draw upon financial contributions from all countries. It could leverage any equity funds contributed by borrowing in financial markets. Countries that have accumulated large reserves and those who are commodity exporters could use their surpluses to make direct investments in developing countries. It would benefit both developing countries and the world economy if savings from emerging markets could be at least partly transferred to developing country projects. Its ability to borrow could be enhanced through guarantees provided by governments, especially those of the advanced industrial countries. The funds could be channelled into investment projects in key sectors, such as agriculture. Another possibility is to use those funds to help developing countries finance guarantees for trade credit or for the debt of their corporations, forestalling the risk of a run on these corporations. The current financial system does not provide this intermediary service. Such a facility would be governed quite differently from existing global financial institutions, reflecting the new sources of global funds and the necessity of giving a greater voice to emerging markets and the less developed countries. It could be located under the umbrella of an existing institution–such as the World Bank or a Regional Development Bank, where developing countries are already strong represented, or established as a new institution. (See Chapter 2, paragraph 118 ff.)

Trade and Investment

64. The World Trade Organization (WTO) is the only universal body for setting trade rules and resolving trade disputes. The WTO is the only universal intergovernmental institution which, at the insistence of major industrial countries, does not have an institutional agreement with the UN (i.e. the "Arrangements for Effective Cooperation with other Intergovernmental Organizations – Relations Between the WTO and the United Nations" of 15 November, 1995 provides only for informational cooperation), even though it has separately acceded to coherence commitments with the Bretton Woods Institutions. Given its status as a major stakeholder in the UN financing for development process, the WTO should be brought into the UN system of global economic governance, while maintaining its legal and institutional constituency.

65. Through the WTO dispute settlement mechanism, small or weak countries have a means to defend themselves against unfair trade practices, but asymmetric legal and other resources, as well as limited developing country participation in drawing up existing rules and regulations, limit its potential to promote justice and development. Imbalances in its accession practices, trade dispute mechanisms, and negotiation modalities have also placed developing countries and new members at a disadvantage, besides deterring the possibility that it might serve as a model for a similar organization for international finance.

66. Reform of rules governing international trade has the potential to stem protectionism and could provide a signal of confidence in time of crisis. However, after the initiation of the Doha Round negotiations, the development thrust has been lost, and whatever the merits of the current proposals, they do not deserve to be called a "development round." This experience does do not augur well for progress on international financial regulation.

67. The current state of the Doha negotiations on multilateral trade risk descending into a "one size fits all" approach with narrow focus on market access to all countries, irrespective of their existing share of global trade and their economic potential. It has been increasingly reduced to an endless bargaining between industrialized countries and emerging markets about market access in industrialized goods. Consequently as the original spirit of development orientation has faded away, the likely benefits to low income countries diminished and completion of the round has become endangered by deadlocked positions of major WTO members. Serious studies suggest that the conclusion of the round, regardless of its symbolic value, is unlikely to make much difference for low income countries and particularly least developing countries. An agreement at the existing stage of negotiations could or would be at the cost of its development content, without providing any change to international market dynamics in favour of developing counties.

68. An important step forward would be the elimination of all forms of export subsidies by the end of 2013, (as agreed to during the Hong Kong Ministerial Conference of December 2005). Making such commitment a legally binding one by concluding the Round as a "single undertaking" should effectively prevent those developed countries from distorting export markets in this way beyond 2013.

69. The global crisis has been marked by precipitous declines in world trade. Throughout the world, protectionism has increased. In its initial communiqué, the G-20 warned of these dangers and the members committed themselves not to engage in protectionism. Yet, pressures for protectionism have been difficult to resist. The dangers of trade contraction represent a far more serious risk to the global economy than in the Great Depression, because trade today is so much more important for many economies. Those low income countries that are heavily dependent on the exports of only a few raw materials will suffer severely from trade contraction.

70. Reductions in non-tariff barriers could substantially stimulate the global economy. As tariff barriers come down, the importance of non-tariff barriers increases, and some such as phyto-sanitary conditions are particularly and differentially harmful to developing countries.

71. Trade restrictions, subsidies, guarantees and domestic restrictions on procurement contained in some stimulus packages distort world markets. Although international agreements contain the same rules for each country, due to very different economic and social points of departure, seemingly "symmetric" provisions can have markedly asymmetric effects. Subsidies, implicit and explicit, can be just as distorting to open and fair trade as tariffs. As has been recognized, subsidies can create an uneven playing field just as tariffs, but these are even more unfair, since only rich countries can afford subsidies. Government procurement provisions under the financial packages are sometimes heavily distorting competition at the expense of developing countries, since members of the WTO provisions

on government procurement are mainly industrialized countries, i.e. most favoured nation (MFN) provisions only apply to them. Firms in developing countries simply can't compete against those who receive massive assistance from their governments in the more developed countries. While the domestic imperatives that give rise to domestic subsidies are understandable, efforts need to be made to finance additional support to developing countries to mitigate the impact of the crisis as well as of both open and hidden subsidies (i.e. state assistance through lending programs and guarantees) in order to avoid further distortions. The WTO should systematically assess the appropriateness of policies conducted by Member States in the framework of their stimulus packages, giving adequate attention to national sovereignty and to the respective levels of development.

72. Capital and financial market liberalization, pushed not only by the IMF, but also within certain trade agreements, exposed developing countries to more risk. In particular, trade-related financial services liberalization has been advanced under the rubric of the WTO's General Agreement on Trade in Services (GATS) Financial Services Agreement with inappropriate regard for its consequences on orderly financial flows, exchange rate management, macroeconomic stability, dollarization, and the prudential regulation of domestic financial systems. It needs to be emphasized that externalities exerted by volatility in the financial sector have severe negative effects on all areas of the economy and are an impediment for a stable development path. Contracting parties directly involved in these agreements, many of which are driven by sectoral interests, often do not realize the incoherence and vulnerabilities that these commitments in the area of trade impose on other aspects of their economy or the international economy. Ironically, the Agreement provides the only significant regulatory framework for international financial services, but was not conceived and negotiated with this objective. This Agreement needs to be reviewed to ensure that it becomes more consistent with the need for an inclusive international regulatory framework more conducive to crisis prevention and management, counter-cyclical and prudential safeguards, provision of development and inclusive finance as well as generally cheaper and better finance for developing countries. Agreements which restrict countries' revising their regulatory regimes in light of what has been learned about their deficiencies in this crisis obviously have to be altered.

73. Developing countries need policy frameworks that can enable them to protect themselves from regulatory and macro-economic failures in systemically significant countries. To achieve this, policy space is a necessary precondition. Policy space is restricted not only by a lack of resources, but also by multilateral and bilateral agreements and by the conditionalities accompanying assistance. The 2004 ILO Commission on the Social Dimension of Globalization pointed out, that developing countries today cannot take advantage of many policies that have been used by industrialized countries in their developmental process. Many bilateral and regional trade agreements contain commitments that restrict the ability of countries to respond to the current crisis with appropriate regulatory, structural, and macro-economic reforms and support packages. Not only deregulation policies akin to those that are now recognized as having played a role in the onset of the crisis been imposed on developing countries, but that have also faced restrictions on their ability to manage their capital account and financial systems (e.g. as a result of financial and capital market liberalization policies). These policies are now placing a heavy burden on many developing countries.

74. All trade agreements need to be reviewed to ensure that they are consistent with the need for an inclusive and comprehensive international regulatory framework which is conducive to crisis prevention and management, counter-cyclical and prudential safeguards, provision of development and inclusive finance. Commitments and existing multilateral agreements (such as GATS) as well as regional trade agreements, which seek greater liberalization of financial flows and services, need to be critically reviewed in terms of their balance of payments effects, macroeconomic stability and financial regulation. This is of particular importance for small and vulnerable economies with weak institutional capacities. The IMF needs to adhere to its Articles of Agreement and should not promote capital account liberalization such as those proposed in bilateral, plurilateral and regional trade and investment agreements. They often undermine multilateral trade and sustainable development efforts, and greatly strengthen investment and intellectual property protection, with greater benefits to developed countries the undifferentiated enforcement of intellectual property rights threatens the ability of developing countries to provide public health services, while policies dealing with the mitigation of bio piracy and protection of traditional knowledge of developing countries have been neglected.

75. There are a number of lessons to be drawn from experience with financial liberalization: in order to achieve efficient domestic financial market regulation, the exceptions granted for prudential regulations allowed in the multilateral annex for financial services should be interpreted to allow policy space, in particular to provide sufficient time and allow public support (credit and guarantees) to restructure the banking sector in case of financial market distress.

76. The reciprocal impact of liberalizing trade in financial services and liberalizing capital account transactions need to be thoroughly considered by developing country authorities. In case of liberalization there needs to be consistency between both areas as well as the implementation of regulatory and supervisory frameworks for the financial sector.

77. Macroeconomic stability and an efficient regulatory framework and functioning institutions are a precondition for liberalization of financial services and the capital account, not vice versa. Strategies and concepts of opening up developing economies need to include appropriate reforms and sequencing.

Commodities Trade and Compensatory Financing

78. The volatility of export earnings of countries dependent on primary commodity exports has long been recognized as a key source of instability in the global economic system. Unless they take strong protective measures, these countries not only experience boom-bust cycles, but also tend to find themselves in debt distress and in need of additional aid when commodity prices collapse. Developing countries that are dependent on exports of commodities with high price volatility need to establish stabilization funds and to otherwise manage their macro-economy to reduce the extent of the boom-bust cycle, including by restricting borrowing during the boom phase. But, inevitably, such management will be imperfect, and there will be need for compensatory finance. When it is provided, it is important that it be done in ways which do not impose counterproductive conditionalities. The international community, including the IFI's, should explore ways of mitigating the risks

from commodity fluctuations, including perhaps by providing loans in which repayments vary with commodity prices.

Appendix: The Doha Round and Development

79. Export subsidies do not constitute the bulk of the distorting trade arsenal of developed countries. Developing countries would greatly benefit if other forms of distorting support are substantially reduced in line with the Doha mandate. This means bringing down permitted levels of Overall Trade-Distorting Domestic Support (OTDS), and further limitation to the various "boxes" (AMS, Blue Box and green box or de minimis) as well as effective monitoring in order to prevent big subsidizing developed nations from shifting their domestic programs from one "box" to another. This is to be complemented by product specific disciplines that restrain maximum allowed levels of support by developed country on a per product basis. This is an especially important outcome of the Round for developing countries as it improves market conditions for agricultural goods of particular interest to them.

80. The cotton dispute is a dramatic example of how trade distorting export subsidies and internal support in the rich developed economies can undermine income generation and growth prospects in poor countries, affecting their capacity to become players in their own right in the global marketplace, and thereby relegating them to dependence on aid, or on other kinds of non-binding commitments or concessions over which they have no control.

81. The fact that distorting cotton subsidies remain in place, in spite of the ruling of the WTO's Appellate Body against them, threatens the credibility of the WTO dispute settlement system.

82. In the important area of industrial goods or non-agricultural market access (NAMA), there cannot be full reciprocity in tariff reduction if the asymmetries that have worked historically to the detriment of developing countries are to be addressed. Furthermore, developed countries should not try to extract additional concessions from developing countries in sectoral negotiations that would negate the principle of less than full reciprocity. Special attention needs to be given to the problem of tariff escalation, which restricts the ability of developing countries moving up the value chain.

83. Moreover, an acceptable package must also include binding commitments on special and differential treatment for developing countries through longer transition periods for LDCs to implement their obligations, and other mechanisms that allow developing countries greater flexibility in coping with the challenges posed by gradual trade liberalization.

84. Much could be done, of course, on a voluntary basis. Meaningful undertakings by developed countries and developing countries in a position to do so of full 13 duty-free quota-free (DF-QF) treatment in favour of LDCs would be an important step towards mitigating the effects of the global financial crisis on the poorest and most vulnerable. But voluntary measures are not substitute for binding commitments, because they can be withdrawn at any time, and the threat of such withdrawal can be used as an important political and negotiating weapon.

85. Supporting South-South trade can also make a big difference for developing countries during the global economic recession, since these trade flows have been increasing well above world trade average growth, contribute to export diversification and improvements in the regional value addend chain, and are becoming a significant source of dynamism for the regional and global economy. More attention should be paid to enhancing the Global System of Trade Preferences among developing countries (GSTP), along with additional and non-conditional facilities for South-South trade financing.

86. In devising a Doha Round "Aid for Trade" (AFT) package, a set of baseline rules are called for: they should not be construed as a substitute for the development gains to be derived from negotiations on market access and the approval of balanced trade rules; they should be funded with additional resources in concessional terms or grant form; provided without conditionalities and taking into account the specificities of each country; they should not be used as a bargaining tool; they should be commitments enforceable like other commitments in the Trade Agreements, and there should be no conditionality, other than that implicit in adhering to the Doha agreement.

87. Mechanisms for monitoring respect for and implementation of Special and Differential treatment provisions, as well as for allowing members to request AFT in accordance with their own priorities and needs should be created as an integral part of the Doha Round "single undertaking".

88. Further hiking up levels of intellectual property protection beyond the standards set in the trade related aspects of intellectual property rights (TRIPS) Agreement, or imposing trade distorting or public health threatening levels of intellectual property (IP) enforcement that negatively affect access to medicines by poor developing countries would certainly not be a welcome result in any negotiation premised on a development perspective. What is positive in this sense about the Doha Round is that changes to IP obligations are not on the negotiating table except for two very specific and narrowly defined areas, of which one, an amendment to the TRIPS Agreement to mitigate bio piracy and protect traditional knowledge, has actually become a point of proactive negotiation by the virtual majority of developing countries members of the WTO. A mandatory requirement for disclosure of the country providing/source of genetic resources and mechanisms such as Access and Benefit Sharing and Prior Informed Consent should be implemented in the TRIPS Agreement.

89. By now it is clear that an agreement on modalities for concluding the Doha Round has to encompass all areas of the mandate in order to create a critical mass of bargaining elements that would allow developed members to overcome long entrenched domestic lobbies that otherwise will resist the call for the elimination and reduction of trade distorting subsidies.

90. Even the commitment to phase out export subsidies by 2013 agreed to in Hong Kong hinges upon a series of other mandated negotiating objectives being met. It is in the nature of negotiations that early harvest outcomes, based on selected elements of the negotiating modalities–however attractive they may seem–risk reducing the gains that would accrue to developing countries, and may have the effect of making an outcome in areas of crucial relevance to developing countries less likely politically; not more.

91. A successful conclusion of the Doha Round would set the basis for adapting the WTO to the actual needs of the world economy. Climate change and the social dimension of globalization are just two examples of new issues with an impact on international trade which are not yet dealt with in the WTO. There is strong need to differentiate between countries according to criteria such as national income, economic power and trading potential and to develop a scheme for clustering developing countries adequately. Rules, transition periods, asymmetric liberalization and burden sharing then can be designed systematically, while ensuring incentive compatibility, alongside economic power and development prospects of countries. Major reports about the future of the WTO, such as the Sutherland and the Warwick report point into this direction and provide concrete proposals. On this basis, a discussion on possible reforms of WTO should directly be addressed after the conclusion of the Round.

Chapter 5: International Financial Innovations

1. Previous Chapters have analyzed what macroeconomic policy and regulatory reforms are needed to guarantee a sustainable and development friendly recovery of the world economy. Chapter 4 presented reforms of current financial institutions and broader institutional innovations. This Chapter analyses a final set of innovations: those that relate to the global reserve system, the management of sovereign debt defaults, and innovations aimed at better distributing the risks between lenders and borrowers in world markets and at increasing development financing.

The Global Reserve System

2. Since the breakdown of the Bretton Woods System and the suspension of the gold convertibility of the dollar, a system of flexible exchange rates among major currencies has predominated. Although alternative national and regional currencies (such as the euro) compete with each other as international reserve assets and means of international settlement, the dollar has maintained its predominant role in both regards, a predominance that became firmly established after the Second World War. In a significant sense, therefore, the post-Bretton Woods system has been a "fiduciary dollar standard".

3. This system has proven to be unstable, incompatible with global full employment, and inequitable.

4. One of the main problems of the Bretton Woods system was identified by Robert Triffin in the 1950s: the use of a *national* currency (the US dollar) as the *international* reserve currency generated a difficult dilemma: dollar deficits were necessary to increase global liquidity, but at the same time eroded the confidence in the dollar as a reserve currency, which generated in particular increasing risks as to the capacity to maintain the dollar-gold parity. Although abandonment of dollar convertibility and flexible exchanges rates eliminated some of these problems, it created new ones. Instead of uncertainty over the ability to maintain the dollar-gold parity, the "Triffin dilemma" is now associated with the large swings in the current account imbalances of the U.S. and associated volatility of the dollar exchange rate, and in the long run with the risk of the loss in the value of foreign exchange reserves held in dollars as U.S. external deficits increase.

5. The instability and incapacity to guarantee full employment are also associated with the fact that, even after the introduction of flexible exchange rates, the system was unable to eliminate the deflationary (contractionary) bias associated with asymmetric adjustment to payments imbalances falling on deficit countries –the fact that deficit countries face stronger pressures to reduce their payments imbalances (the major exception being the reserve issuing country) than surplus countries face to correct theirs. Flexible exchange rates also introduced new forms of instability in a world of increasing free capital mobility: those associated with the volatility of capital flows, particularly but not only short-term flows.

6. Finally, the inequities are generated by the fact that, as a result of a sequence of severe crises, developing countries learnt that they need better instruments to protect themselves against global financial and economic instability. Coupled with the increasing unwillingness

of developing countries to submit to the conditionality associated with IMF support, this has led a massive accumulation of reserves over the past two decades. However, as these reserves are mostly held in hard currency, they also represent a transfer of resources to the United States and other industrialized countries.

7. Many believe that this problem could be eliminated by creating a supranational international reserve currency. Indeed, the idea of an international reserve currency issued by a supranational bank is not new. It was broached more than seventy five years ago by John Maynard Keynes in his 1930 *Treatise on Money*, and refined in his Bretton Woods proposals for an International Clearing Union. There currently exist a number of alternative proposals for a new global reserve currency, for how the system might be administered, how the emissions of the new currency might be allocated, and how the transition to the new system might be managed. Considerable international discussion will be required for the international community to decide the precise arrangements. However, this is an idea whose time has come. This is a feasible proposal and it is imperative that the international community begins working on the creation of such a new global reserve system. A failure to do so will jeopardize prospects for a stable international financial system, which is necessary to support a return to robust and stable growth.

Instability

8. The current international system is marred by a number of sources of instability. One of the major problems, as noted, is that as holdings of the reserve currency accumulate over time, confidence in its value as a store of value is likely to wane. After abandonment of fixed exchange rates in the early 1970s, the main manifestation of the creation of excess dollar liquidity was a tendency for the U.S. dollar to depreciate. When the U.S. responds with action to reduce its external deficit, in part to restore the credibility of its reserve currency status, this generates dollar appreciation accompanied by contractionary pressure on the world economy. Irrespective of the phases of the global cycle of liquidity demand, U.S. monetary policies are implemented with little consideration of their international impact and are thus a potential cause of instability in exchange rates and global activity.

9. Since the 1960s, the system has indeed been plagued with cycles of confidence in the U.S. dollar. These cycles have become particularly intense since the 1980s, leading to unprecedented volatility both in the U.S. current account deficit and the effective exchange rate of the U.S. dollar. As a result, the major attribute of an international store of value and reserve asset, a stable external value, has been eroded. There is another sense in which the current system is unstable.

10. By definition, for the world economy, the sum of all deficit countries' balance of payments must equal the sum of all other countries' surpluses. But the way surplus and deficits are brought into equality is not necessarily smooth and will usually involve changes in incomes of individual countries. If a large number of countries choose policies aimed at increasing their trade surpluses, or if international institutions encourage deficit countries to improve their balance of payments, the deficits of the remaining country or countries will become increasingly large. With the dollar as the major international reserve currency, unless the U.S. is willing to be the "deficit country of last resort", the adjustment will take place through a decline in global income. In turn, if the U.S. macroeconomic policies are overtly

expansionary, unless other countries accept balance of payment surpluses the adjustment will take place through expanding global income and inflation. In both cases, the result is likely to be growing global imbalances, exchange rate instability and the erosion in confidence in the dollar as a reserve currency.

11. The introduction of flexible exchange rates in the presence of growing private international capital flows failed to meet the expectations that adjustment of balance of payments would become smoother while leaving each country the necessary autonomy to guarantee their domestic macroeconomic policy objectives. The basic reason is that countries can avoid adjustment as long as they can attract sufficient external flows. When these prove to be insufficient to cover funding for the imbalance or are reversed because of lack of confidence, the adjustment takes the form of a financial crisis. The asymmetry remains, but the negative impact on the deficit country is much greater, as the continued financial crises since the mid-1970s has made clear.

Self-insurance and Deflationary Bias of the Global Reserve System

12. Global imbalances, associated in part to the way different countries reacted to the financial instability of the late 1990s and early 2000s, played an important role in the macroeconomic conditions leading to the current world financial crisis. The asymmetric adjustments to these global imbalances in their turn played a part in generating the insufficiency of global aggregate demand that has converted a U.S. financial disruption into a global economic recession. Unless both problems are remedied, it will be difficult to restore the economy to robust, stable growth.

13. These difficulties in the design of the international financial system led to large accumulations of reserves by developing countries in recent years, and especially after the Asian and Russian crises of 1997-1998. These crises, as those that preceded it in the late 1970s and early 1980s, showed that developing and emerging countries are subject to strong pro-cyclical capital flows. If authorities react by allowing capital surges during booms to generate rapid exchange rate appreciation and the build up of current account deficits, the outcome is almost certainly a twin balance of payments and domestic financial crisis later on. This problem is particularly acute when the boom is in the form of short-term, largely speculative capital flows, a point that came to be increasingly recognized after the Asian crisis. The decision to build stronger current account positions and to accumulate large foreign exchange reserves in the face of booming capital inflows in 2004-2007 were therefore a common response of these countries to create policy space to respond to the negative impact of the expected recurrence of crises. Similarly, commodity exporting countries have experienced in the past repeated crises, when sharp improvements in the terms of trade are accompanied by unsustainable demand booms and by exchange rate appreciation that generate "Dutch disease" effects. More generally, since the Asian crisis developing and emerging market countries have found it increasingly attractive to save that part of exceptional export proceeds that were considered to be temporary. High commodity prices in the years preceding the current crisis exacerbated the problems that this posed for global balances.

14. These policies could be considered as a form of "self-insurance" or "self-protection" against capital reversals, adverse movements in the terms of trade and excessive exchange

rate volatility associated with financial crises. The fact that the only available "collective insurance", in the form of IMF financial assistance, is highly conditional and often imposes pro-cyclical policies during crises, reinforced the view that self-protection in the form of reserve accumulation was a better strategy.[2]

15. As a result of these factors reserve accumulations rose to 11.7% of world GDP in 2007 vs. 5.6% a decade earlier, at the time the Asian crisis struck. Reserve accumulations in the period 2003-2007, in the run up to the crisis, amounted to an annual average of $777 billion a year or 1.6% of global GDP. The major concern is that if the current crisis is as long and as deep as feared, and if the assistance provided to developing countries is inadequate, there will be attempts to preserve strong external balances through protectionist measures, beggar-thy-neighbour exchange rate policies, and stronger "self-insurance" through reserve accumulation–all measures that will impede a rapid response to the crisis.

16. When reserve accumulation is the result of current account surpluses and not only of the attempt to offset private autonomous foreign capital inflows, there is a reduction in global aggregate demand.[3] In the past, the negative impact on global aggregate demand of these reserve accumulations was offset by other countries running policies that resulted in large current account deficits, particularly loose monetary and fiscal policies in the United States. But such policies, as already argued above in Chapter 2, have been the source of global instability.

17. The question posed by the autonomous reduction in the US deficit is: what will now sustain global aggregate demand? It is unlikely to be another American bubble leading to another period of large and unsustainable American deficits and the continuation of global imbalances. Such a course risks a repeat of the current crisis. Thus, something has to be done about the underlying sources of the insufficiency of global aggregate demand.

18. A global reserve currency whose creation was not linked to the external position of a national economy could provide a better system to manage the deflationary bias that the system faces during crisis, as well as the broader problems of instability analyzed above. It would be possible to regulate the creation of global liquidity, and reduce the ability of a reserve currency country to create excessive liquidity. And the system can be designed in ways to put pressure on countries to reduce their surplus and thus reduce their contribution to the insufficiency of global aggregate demand. This would contribute to the reduction of global imbalances.

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[2] There may be other reasons, such as the need to provide for an aging population that would lead countries to adopt policies to increase domestic savings and hold them in the form of foreign assets. The associated "imbalances" would then simply reflect differences in the propensities of different countries to save and invest. This has led to the general idea that financial flows would be from developed with high saving aging populations to developing countries with younger populations and higher returns on investment. However, this has not been verified in the statistics on international capital flows. Restrictions on the ability to use industrial policies to encourage nascent industries in emerging countries (as many of the currently industrialized countries did in their earlier phases of development) under recent WTO agreements may have led some countries to substitute exchange rate policies to effect similar outcomes, and this too may have contributed to reserve accumulations.

[3] These reserves are sometimes called "owned reserves" to differentiate them from "borrowed reserves", when their counterpart are capital inflows.

19. Other innovations to improve risk sharing mechanisms would reduce the demand for reserve accumulations, and therefore reduce the magnitude of the requisite emissions (see below).

Inequities

20. The current system is also inequitable because it results in developing countries transferring resources to the industrial countries that issue the reserve currencies. In particular, the build up of dollar reserves represents lending to the United States at very low interest rates. This transfer has increased through time due to the realization by developing countries that large foreign exchange reserves are their only defence in a world of acute financial and terms of trade instability.

21. Developing countries are, in effect, lending to developed countries large amounts at low interest rates. In 2007, the last year for which data was available, it amounted to $3.7 trillion. The difference between the lending rate and the interest rate which these countries pay to developed countries when they borrow from them is a transfer of resources to the reserve currency countries that exceeds in value the foreign assistance that developing countries receive from the developed countries. The fact that developing countries choose to hold such reserves provides testimony to their perception of the costs of instability, of the adjustment costs that they would have to bear if they did not have these reserves.

Cost to the reserve currency country

22. The United States also incurs costs associated with its role as supplying global reserves. The demand for global reserves has led to increasing current account deficits in the United States that have had adverse effects on U.S. domestic demand; when dollars are held to meet increased demands for liquidity in surplus countries, they fail to produce any countervailing adjustment in foreign demand. In addition, periodic needs to correct these deficits require contractionary monetary or fiscal policies that have adverse domestic effects on the U.S. economy.

23. Countries holding substantial dollar reserves have started to call for a constraint on U.S. policies that might cause depreciation in the international value of the dollar and thus a decline in the value of their reserve holdings. China, as the major holder of dollar reserves, has already noted the risks to its dollar reserves should the US adopt policies leading to a depreciation of the dollar. The only way to respond to this call would mean for the U.S. a loss of policy autonomy as it would have to take the effects on the rest of the world in designing its monetary policy. Maintaining autonomy to U.S. policy, as it would be required to respond the current crisis, would be the basic advantage for the U.S. to move to a global reserve system, beyond the benefits it would receive from a more stable global financial and economic system.

A two (or multiple) reserve currency system may be worse than a single reserve currency

24. It should be emphasized that a system based on multiple, competing reserve currencies would not solve the inequities of the current system, as reserve assets would still be provided

by industrial countries. It would also add an additional element of instability to a purely dollar-based system, associated with the exchange rate volatility among the currencies used as reserve currencies. Indeed, this problem is already present in the current system. Such volatility results in major gains and losses by Central Banks on their reserve holdings, a feature that increases the risk associated with holding specific reserve assets and, therefore, undermines their value as what they are meant to be: low-risk assets.

25. The basic advantage of a multi-polar reserve world is, of course, that it would provide room for diversification. However, if Central Banks and private agents were to respond to exchange rate fluctuations by changing the composition of their international assets, this would feed into exchange rate instability. Under these conditions, a multiple currency reserve system would generate growing calls for a fixed exchange rate arrangement, but fixing the exchange rates among major currencies in a world of free capital mobility would be a daunting task. It would also require policy coordination and loss of monetary sovereignty that seems unlikely under current political conditions.

Call for a Global Reserve Currency

26. These long standing deficiencies in current arrangements have become manifest in the lead up to the current global financial crisis, and can make it deeper. If countries choose increased protection in the form of higher domestic saving and accumulation of reserves as a response to the uncertainty of global market conditions, this would lead to further deepening of the aggregate demand problems that the world economy is facing. The increases in the U.S. national debt and the balance sheet of the U.S. Federal Reserve have led to concerns in some quarters about the stability of the dollar as a store of value. The low (near zero) return on holdings of dollars means that they are receiving virtually no return in exchange for the foreign exchange rate risk which they bear.

27. These are among the reasons that it is desirable to adopt a truly global reserve currency. Such a global reserve system can also reduce global risks since confidence in and stability of the reserve currency would not depend on the vagaries of the economics and politics of a single country.

28. The current crisis provides, in turn, an ideal opportunity to overcome the political resistance to a new global monetary system. It has brought home problems posed by global imbalances, international instability, and the current insufficiency of global aggregate demand. A global reserve system is a critical step in addressing these problems, in ensuring that as the global economy recovers it moves onto a path of strong growth without setting the stage for another crisis in the future. It is also a propitious moment because the United States may find its reserve currency status increasingly costly. Moreover, the US has embarked on a response to the crisis that will involve large domestic and also potentially large external imbalances, with unpredictable implications for the international reserve system. Thus, both the United States and foreign exchange reserve holding countries may actually find it acceptable to move in the direction of a new system. The former would be able to take policy decisions with less concern about their global impact; the latter would be less concerned about the impact of US policies on their reserve holdings.

Institutional frameworks for a new global reserve system

29. In setting up such a system, a number of details need to be worked out. Among these are, who would issue the reserve currency, in what amounts, to whom would they be issued, and under what conditions. The issues are largely separable.

30. The responsibility for managing the global reserve system could be given to the IMF, which currently issues the only global currency, Special Drawing Rights (SDRs), on which the system could be built, but it could also be given to a new institution, such as a "Global Reserve Bank". If an existing institution is chosen, this should not inhibit asking more fundamental questions about the necessary reform of its structure in support of the global monetary system.

31. One possible approach would require countries to agree to exchange their own currencies for the new currency –say International Currency Certificates (ICC), which could be SDRs—and vice-versa in much the same way as IMF quotas are made up today (except that developing countries would only contribute their own national currencies, not the proportion of IMF quotas in convertible currencies). This proposal would be equivalent to a system of worldwide "swaps" among Central Banks. The global currency would thus be fully backed by a basket of the currencies of all members.

32. In an alternative approach, the international agency in charge of creating global reserves would simply issue the global currency, allocating ICC to the member countries, much as the IMF Special Drawing Rights are issued today. There would be no "backing" for the global currency, except the commitment of Central Banks to accept it in exchange for their own currencies. This is what would give the ICC (or SDRs) the character of an international reserve currency, the same way acceptance by citizens of payments in a national currency gives it the character of the domestic money. However, if the issues of global currency received by countries are considered deposits in the IMF or the Global Reserve Bank, and the institution in charge of managing the system is allowed to buy the government bonds of member countries or lend to them, then those investments would be the "backing" of the global currency just as domestic moneys are "backed" today by the assets of national Central Banks (the government bonds in their hands and their lending to private sector financial institutions).

33. Under any of these schemes, countries could agree to hold a certain fraction of their reserves in the global currency. The global reserve currency could also pay interest, at a rate attractive enough to induce its use as an investment for Central Bank reserves. Exchange rates would be managed according to the rules that each country chooses, subject to the condition that exchange rate management does not affect other countries –a rule that is already included in the IMF Articles of Agreement and must be subject to appropriate surveillance. As with SDRs, the exchange rate of the global currency would be the weighted average of a basket of convertible currencies, the composition of which would have to be agreed.

34. In the alternative in which the global currency is considered to be a deposit in the IMF or Global Reserve Bank, earnings by these institutions' investments (lending to countries undergoing balance of payments crises, or otherwise in Treasury securities of member countries) would finance the interest paid to those countries that hold deposits of the global

currency (possibly in excess of the original issues they received). Obviously the major advantage to holding the global currency is that the diversification away from individual currencies would generate more stability in the value of reserve holdings.

35. The global currency could be allocated to countries on the basis of some formula (“quota”), based on their weight in the world economy (GDP) or their needs (some estimation of the demand for reserves). Since developing countries hold reserves which are, in proportion to their GDP, several times those of industrial countries (26.4% of GDP in 2007 vs. 4.8% for high-income OECD countries), to manage the trade and capital account volatility they face, a formula that would allocate the currency according to some definition of demand for reserves would result in larger proportional allocations to these countries. One possibility is, of course, to give developing countries all allocations. Note that the current SDR allocation is based on a particular “quota” system, that of the IMF, which continue to be subject to heated debate because richer countries on average get a larger share of new allocations–i.e., the opposite to what a criteria based on need would indicate.

36. The allocation can and should have built into it incentives and/or penalties against maintaining surpluses. Countries that maintained surpluses would lose all or part of their quota allocation if they are not utilized in a timely manner to increase global demand.
37. The size of the annual emissions should be targeted to offset the increase in (non-borrowed) reserves, i.e. reductions in global purchasing power resulting from reserve accumulations. Simpler versions of this proposal would have annual emissions fixed at a given rate of say $150 to $300 billion a year (the first figure corresponds to the world demand for reserves in 1998-2002 but the demand for reserves was much larger in 2003-2007, indicating that even $300 billion a year might be insufficient).

38. More sophisticated and elaborate versions of this proposal would have emissions adjusted in a countercyclical way—larger emissions when global growth is below potential. It might be easier to get global consensus on either of these simpler variants, but more detailed versions would be able to support a variety of global needs (e.g. generate badly needed revenues for development or global public goods).

39. One institutional way of establishing a new global reserve system is simply a broadening of existing SDR arrangements, making their issuance automatic and regular. Doing so could be viewed simply as completing the process that was begun in the 1960s, when SDRs were created. The simplest version, as noted, is an annual issuance equivalent to the estimated additional demand for foreign exchange reserves due to the growth of the world economy. But they could be issued in a counter-cyclical fashion, therefore concentrating the issuance during crisis periods. One of the advantages of using SDRs in such a counter-cyclical fashion is that it would provide a mechanism for the IMF to play a more active role during crises.

40. Still another mechanism to manage SDRs in a counter-cyclical way was suggested by IMF economist Jacques Polak three decades ago: providing all financing during crises with SDR loans. This would generate emissions that would be automatically extinguished once loans are paid back and create the global equivalent to what the Central Banks of industrial countries have been doing on a massive scale during recent months.

41. Indeed, a large counter-cyclical issue of SDRs is the best mechanism to finance world liquidity and official support to developing countries during the current crisis. This was recognized by the G-20 in its decision to issue the equivalent of $250 billion in SDRs. However, this decision also illustrates the problems associated to tying SDRs issuance to IMF quotas, as somewhat less than $100 billion of the proposed emissions would benefit developing countries. This implies that this issue is closely tied to the ongoing debate about reform of IMF quotas. None of the proposed reforms to quotas deals adequately with the issue of equity, and indicates that different rules may have to be applied to quotas and SDR issues, as indicated above.

42. Although developing countries would only receive part of the allocations, the capacity of the Fund to lend would be considerably enhanced if the current system was reformed in such a way as unutilized SDRs, particularly from industrial countries, could be used by the IMF to lend to member countries in need –such as the proposal of treating unused SDRs as deposits in the IMF. However, unless there are strong reforms in the Fund's practices, the ability of the emissions to address the liquidity and macroeconomic management problems noted earlier might be impaired, as developing countries might be reluctant to turn to the IMF for funds. Reforms in that direction were adopted in March 2009 with the creation of the Flexible Credit Line with only ex-ante conditionality, the doubling of all credit lines and the elimination of structural benchmarks in conditional IMF lending. But additional reforms to make access less onerous will be needed.

43. A simple way to further the use of SDR allocations to advance developmental objectives (which might require changing the Articles of Agreement) would be for the International Monetary and Finance Committee and the IMF Board to allow the IMF to invest some of the funds made available through issuance of SDRs in bonds issued by multilateral development banks. This would be similar to the proposal for a "development link" made by the UNCTAD panel of experts in the 1960s (see below).

44. Thus, a well designed global currency system would go a long way to correct the "Triffin dilemma" and the tendency of the current system to generate large global imbalances and the deflationary biases that are characteristic of balance of payments adjustments during crises. Depending on the way emissions are allocated, the system could also correct the inequities associated with the large demand for reserves by developing countries, and provide collective insurance against future shocks. If emissions were issued in a countercyclical way, they could perform an even more important role in stabilization.

Historical antecedents

45. When Keynes revised his idea of a global currency in his proposal for an International Clearing Union, as part of the preparations for what became the Bretton Woods Conference, his major concern was the elimination of asymmetric adjustment between deficit and surplus countries leading to the tendency towards deficiency of global aggregate demand and a constraint on the policy space needed for policies in support of full employment. He also had in mind the significant payments imbalances that would characterize the post-war order and therefore the need to provide a better source of liquidity, both globally and for countries that would leave the war with structural payments deficits. Of course, the first of these

problems, the asymmetric adjustment, was not corrected by the Bretton Woods system, and the second was only partly corrected.

46. In turn, when Special Drawing Rights (SDRs) were created in the 1960s, the major concern was how to provide a more reliable source of global liquidity to replace gold and reserve currency holdings (mainly dollars, but also British pound sterling at the time). It was believed that the existing sources of international liquidity were not reliable, as they depended in the first case on gold production and in the second on deficits of the reserve currency countries, particularly the United States. As the initial problems of global liquidity – the "dollar shortage"—were overcome, the attention shifted to risks of excessive dollar liquidity and, particularly, that the U.S. gold reserves would not be sufficient to support dollar-gold convertibility. This finally generated the demise of the Bretton Woods "dollar-exchange standard" and the adoption of flexible exchange rates among major currencies.

47. At the time SDRs were created, it was hoped that they would become a major component of global reserves, thus creating a system in which the growth of global liquidity would depend on deliberate international decisions. This expectation has not been fulfilled, as SDRs have been created only episodically and in a total of a little over 20 billion SDRs, which represent only a minimal fraction of current world reserves. The nature of the problems of provision of global liquidity was obviously transformed with development of the private financial markets in Eurodollars and other Euro currencies and the introduction of a flexible exchange rate system. These problems associated with the provision of global liquidity are less important today, except during extraordinary conjunctures such as those generated during the severe shortage of liquidity, such as those created by the global liquidity crisis in August 1998 and the world financial crisis since September 2008. But a major problem remains: dependence of global liquidity on the vagrancies of US macroeconomic policies and balance of payments imbalances, which can generate either excessive or limited world liquidity. The recurrent problem of developing country access to international liquidity is still an embedded feature of the system, as a result of the pro-cyclical capital flows. Therefore, although there are no longer risks of insufficient liquidity in the international system, there are problems associated with the control of global liquidity and significant equity issues in the access to such liquidity by developing countries.

48. In Keynes's initial proposal for a post-war arrangement, there was no need to address the problem of equity in issuance since the creation of clearing credits was entirely endogenous. This question was also evaded in the initial issuances of SDRs, although some ideas were proposed at the time on how to tie the issuance of a global currency to development financing, particularly in the proposal made by an UNCTAD expert panel to link the question of liquidity provision for developed economies to the needs of developing economies for development financing. But, as already seen, equity issues cannot be ignored today, as the current system subjects developing countries to recurrent problems of illiquidity or induces them to accumulate large amounts of foreign exchange reserves.

Transition to the new system

49. The reform of the global reserve system could take place through a global agreement or through more evolutionary approaches, including those that could build on a series of regional initiatives.

50. If a large enough group of countries agreed to pool reserves in a system in which they agreed to create and hold a common reserve currency, which they would stand ready to exchange for their own currencies, a regional reserve system or even a system of near-global coverage could be established without the agreement of all countries. So long as the new currency is convertible into any hard currency that itself is convertible into other currencies, it could serve effectively as a reserve currency. The countries participating might also agree to reduce, over time, their holdings of other reserve currencies.

51. Membership in this new "Reserve Currency Association" could be open to all that subscribe to its Articles of Agreement. The advantages of participation are sufficiently great that it is likely to grow over time, embracing more countries, holding a greater fraction of their reserves in the new global reserve currency. Eventually even the United States would probably find it desirable to join. Thus, gradually, through a stable, evolutionary process, the new Global Reserve System may be created as an alternative to the current system. Of course, there is also a risk of adverse selection: as long as participation is voluntary, soft currency countries would be those more willing to participate, and convertible global currencies outside the scheme could remain as the preferred currencies.

52. Existing regional agreements might provide an alternative way of evolving towards a global reserve system. Regional mechanisms have the advantage of their own and can be based either on swap arrangements among Central Banks or on foreign exchange reserve pools. Given the reluctance of governments to give up control over their reserves, swap arrangements may be more acceptable. Reserve pools offer, however, other advantages, such as the possibility of allowing the reserve fund to borrow during periods of stress, and, as noted, to issue a currency or reserve asset that could be used at a regional or global level. In the 1980s, for example, the Latin American Reserve Fund (FLAR) was allowed to issue Andean pesos.[4] This asset, which has never been used, was expected to be used in intra-regional trade, with periodic clearing of those held by Central Banks. The Chiang Mai Initiative, created in 2000 by members of ASEAN, China, Japan and the Republic of Korea is another important example of regional cooperation.[5] Were this initiative to evolve into a reserve fund, it could back the issuance of a regional asset that could actually be attractive to Central Banks in other parts of the world to hold as part of their reserve assets. However, if the Chiang Mai Initiative is to achieve the objectives set forth for a global reserve currency, and if it is to play a more effective role in stabilization, it would be necessary to eliminate the provision that, after a certain threshold of use of existing swap facilities, countries would have to be subject to IMF conditionality.

53. A common criticism of regional arrangements is that they are not effective in providing diversification against systemic crisis, given that regional members are more likely to be adversely affected at the same time. Although this implies that they are a complement and not a substitute for a global solution, the underlying analysis is imprecise. Although the

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[4] The Latin American Reserve Fund was created by the Andean countries in the 1978 and was then called the Andean Reserve Fund. Current members are Bolivia, Colombia, Costa Rica, Ecuador, Peru, Uruguay and Venezuela.

[5] This initiative works as a system of bilateral swaps by member Central Banks, which are in the process of being arranged on a multilateral basis. The system has so far not been used. ASEAN has a swap arrangement of its own that has a longer history.

ability of regional arrangements to address external shocks depends on negative events not being correlated across participating countries, they could still be useful if shocks affect member countries with different intensities or with lags, since this would allow some countries to lend their reserves to those experiencing a more severe or earlier shock. Furthermore, lending at the onset of a liquidity squeeze could prevent a crisis in a given country from affecting other countries, thereby reducing the correlation produced by contagion. More generally, a country would benefits from the regional arrangement if the variability of the regional reserve pool is lower than that of its individual reserves, and if potential access to the pool reduces the possibility of attacks on individual members and therefore acts as a mechanism of collective insurance that is more powerful than self-insurance. Statistical analysis by the UN Economic Commission for Latin American and the Caribbean provides supports for this approach, as it indicates that correlations of relevant macroeconomic variables among countries in the region may be lower than usually assumed.

54. Regional initiatives could become an embedded part of the global reserve system. Some have suggested that the reformed IMF should be a network of such regional reserve funds. Such a decentralized system would have many advantages, including the possibility of solving problems associated with crises in the smaller countries at the regional level. The system would also be attractive for medium and small-sized countries that could have a stronger voice at the regional level. One way to link regional and global arrangements would be to make contributions to regional arrangements one of the factors that could be taken into account in determining SDR allocations.

SOVEREIGN DEBT DEFAULT AND RESTRUCTURING

Inadequacies of the existing system (or "non-system") to manage debt crises

55. Sovereign debt crises have been a major source of the difficulties faced by developing countries in achieving sustained growth and development at different times since the 1980s. Social costs of these crises have been extremely large, and included long periods of lost income and jobs, increased poverty and, in some cases, worsening income inequality. Given the instability of external capital flows, severe financial crises hit even countries that were judged by international opinion to have been soundly managed. In several cases, crises originated in the need for a government to take over the responsibility for servicing private-sector debts, of the banking system or key firms that were judged "too big to fail", in a way not too different from how the US and other industrial country governments have done during in the current global crisis. In other cases, the inability of the Central Bank to provide foreign exchange for private external debt servicing has led to effective official responsibility for the debt. This "nationalization" of private sector external debts was indeed a feature of the Latin American debt crisis of the 1980s and has been quite common in developing country debt crises since then.

56. Not only are current "work-out" processes protracted and costly, often the debt write-downs have been insufficient to provide sustainability. The existence of debt overhangs depresses growth, contributes to poverty, and crowds out essential public services. Often, because write downs have been insufficient, they are soon followed by another crisis. And because of the adverse terms and high costs imposed by the work-out, developing countries are reluctant to default in a timely way, resulting in delays in dealing with the underlying

problems.

57. Moreover, worries about a protracted crisis in one country having spill-overs for others has motivated massive bail-outs, contributing in turn to problems of moral hazard, enhancing the likelihood of future crises.

58. Whether owing to risky policies or the intensified economic fluctuations of liberalized financial environments, the existing system of protracted and creditor-biased resolution of sovereign debt crises is not in the global public interest, and is far from the interest of the poor in the affected countries.

59. The existing "system" (or really "non-system") arose as piecemeal and mostly *ad hoc* intergovernmental responses to sovereign debt crises as they occurred over the past half-century or so. The fact that, as noted, the solutions that the current system provides take time to be adopted and provide inadequate relief, implies that the system for addressing sovereign debtors is clearly inferior to that provided in many countries for corporations and sub-sovereign public entities by national bankruptcy regimes. The latter not only aim to find a quick and equitable solution, but also one that achieves nationally desired economic and social outcomes, particularly a "fresh start" (or "clean slate") when a bankrupt entity is reorganized. The sovereign system is plagued also by horizontal inequities. Official lenders have always complained that private creditors do not follow restructurings agreed in the Paris Club (and have been "free riders"), and the magnitude of debt rescheduling and relief accorded in individual cases has clearly depended on the weight and negotiating capacity of the debtor country.

60. The system for sovereign debtors has operated under the informal and imperfect coordination of the debtor and its creditors by the IMF, under the guidance of the G-7 major industrialized countries. The latter countries set the overall policy directions for the IMF and the other involved institutions, such as the Paris Club, where debts owed to governments are restructured. The system assumes a developing country government in debt distress will adopt an IMF-approved macroeconomic adjustment program, that the program will be effective, and that all the relevant classes of creditors (banks, bondholders and suppliers, government creditors and multilateral institutions) will cooperate in providing the overall amount of relief and financial support deemed necessary on the basis of the Fund documents. Often there is very little real debt relief, only a mere rescheduling of the obligations. And often the magnitude of relief is based on excessively optimistic growth projections–setting the stage for problems down the line.

61. These assumptions never fully held and what confidence there was in the system was severely affected by how the Heavily Indebted Poor Countries (HIPC) Initiative and the East Asian, Russian, Ecuadorian and Argentine crises were handled. The HIPC Initiative was initially judged insufficient to give the poorest countries a fresh start and, after almost a decade of long negotiations, it was supplemented in 2005 with the Multilateral Debt Relief Initiative. Nevertheless, the HIPC initiative was represented the first comprehensive approach to the solution of the debt problem of poor developing countries. The initiative came along with a framework which placed poverty reduction strategies at the centre of development cooperation, based in part on a broad social dialogue including the participation of civil society.

62. In addition the non-HIPC renegotiations that took place after the East Asian crisis have been judged as unsatisfactory. Most single country "workouts" from debt crises in this period were under cooperative voluntary arrangements with the bondholders that did not reduce the level of debt. The transparency of some of these renegotiations processes – including the pressures exerted on debtor countries by other nations and IFIs has also been questioned.

63. Moreover, while creditors have a seat at the table, other claimants such as government retirees, for instance, which have been promised a particular level of pensions do not. Chapter 9 of the US bankruptcy code, which applies to municipalities and other sub-sovereign public entities, gives priority to these "public" claimants on government revenues. In contrast, international procedures seem to pay insufficient attention to their interests.

64. Finally, some critics of current practices suggest that they are unnecessarily onerous because they are designed to provide strong incentives for countries not to default on their obligations. Small and weak countries may be forced to pay the price for ensuring that the overall system exercises discipline on borrowers.

65. Argentine's rapid growth after its 2001 default, in spite of the long delay in the final resolution, shows that eliminating debt overhang can provide conditions for rapid economic growth even in seemingly adverse conditions. Despite rapid growth, however, this country faced significant problem regaining access to private financial markets.

Call for an International Debt Restructuring Court

66. Some have argued that new debt restructuring procedures are not needed; all that is required are small reforms in debt contracts such as collective action clauses. But no country relies solely on collective action clauses for debt resolution, and there is no reason to believe that doing so for international debt would be sufficient. For instance, collective action clauses do not provide effective means of resolving conflicts among different classes of claimants.

67. It is easy to agree that the amount of debt relief accorded to different countries should depend on their circumstances. However, it is artificial to have one set of rules for determining that relief for selected developing countries, as was the case for the HIPCs and later the Multilateral Debt Relief Initiative, and another for the rest of the world. Rather, a single statutory framework for debt relief is needed to ensure that creditors and the debtor restructure the debt so as to provide a fresh start, based on the country's unique economic condition. The debt workout regime should be efficient, equitable, transparent and timely in handling debt problems ex post (as problems become apparent, and especially after default) while promoting efficiency ex ante (when the borrowing takes place).

68. A well-designed process should protect the rights of minority, as well as majority, creditors–as well as "public" claimants. It should give debtors the opportunity to call default through a structured process. The principles of human-centred development, of sustainability and of equity in the treatment of the debtor and its creditors, and among the creditors, should apply equally to all sovereign debt crises resolved through the international

system. As in national bankruptcy systems, principals should be encouraged to reach a workout on their own to the extent possible. But whether such an agreement can be reached, and the nature of the agreement, can be affected by the backdrop of the legal structures.

69. Achieving these objectives require a more structured framework for international cooperation in this area. For the same reason that governments adopt bankruptcy legislation and do not rely solely on voluntary processes for resolving corporate bankruptcies, an efficient sovereign system requires something more than a moral appeal to cooperation. This means the creation of a sovereign debt workout mechanism.

70. This entails the creation of an "International Debt Restructuring Court", similar to national bankruptcy courts. This Court would ensure that agreed international principles regarding priority of claims, necessary overall write downs and the sharing of "haircuts" were followed. It could differentiate between distinct debt categories which might include government, government guaranteed and government acquired private debt so as to make transparent the actual effective liabilities of the sovereign. It could also determine what debts could be considered "odious". And it would be able to grant potential private or public creditors authority to extend "debtor in possession" financing, as in corporate restructurings, National courts would have to recognize the legitimacy of the international court, and both creditors and debtors will therefore follow its rulings.

71. Once proceedings have started, the "Court" might act as a mediator, attempting to establish international norms for sovereign debt restructurings. With a view to realizing a comprehensive workout it would encourage the creditors to coordinate their positions within and across different classes of lenders, in the long run including the government creditors that operate today through the Paris Club as well as multilateral creditors. Were mediation to fail or become unduly lengthy, the Court should have the power to arbitrate. It might also work in cooperation with the IMF, the World Bank, or regional development banks, to help provide interim finance to maintain economic strength while negotiations take place. But such lending should not be a mechanism simply for bailing out creditors who failed to do due diligence in providing lending.

72. Beyond the problems of sovereign debt restructuring, there are also serious problems in managing cross-border private debt workouts, with conflicts between different jurisdictions and with concerns about "home" country bias. The International Debt Restructuring Court could extend its reach to consider bankruptcy cases involving parties in multiple jurisdictions.

73. In earlier discussions of sovereign debt restructuring mechanisms, it was presumed that the IMF, or a separate and newly established division of the IMF, would act as the bankruptcy court. However, while it may be desirable to institutionalize the sovereign debt restructuring mechanism under the umbrella of an international institution, the IMF in its current form is unlikely to be the appropriate institution, as it is also a creditor and subject to disproportionate influence by creditor countries. It is therefore unlikely to be seen as a "neutral" mediator. The arbitration process of the International Centre for the Settlement of Investment Disputes (ICSID) within the World Bank has similarly failed to generate confidence from the developing countries as a fair arbitrator of investor-state disputes under bilateral investment agreements.

74. Any procedure must be based on widely shared principles and processes with political legitimacy. Agreed upon goals, such as that the work-out must be fair, transparent sustainable, and promote development, would boost its credibility with debtors. Indeed this should include all stakeholders, including creditors who would appreciate the reduction of uncertainty under clear rules of the game and the knowledge that any post-workout debt situation would have a larger chance of being sustainable. But translating these goals into agreed upon principles and procedures may be difficult, given the conflicts of interests.

75. There is nothing immutable in the current approach to resolving sovereign debt crises. It arose in the political and economic environment created after the Second World War, and the need to develop a better system remains on the international policy agenda. The international community needs to actively resume the effort to define the specific mechanism to institutionalize the principles advanced here.

Foreign Debt Commission

76. The crisis also gives urgency to reform of institutional structures for debt relief as an increasing number of developing countries, especially the most vulnerable low-income countries, may face difficulties in meeting their external debt commitments. This crisis therefore gives urgency to these reforms. Unless these debts are managed better than they have been in the past, the consequences for developing countries, and especially the poor in these countries, can be serious.

77. Although, as argued above, there is a need for new procedures for restructuring sovereign debt, this reform will take time, as it would require a new international treaty. In the interim, something needs to be done to ensure that debts are better managed–and this may be true even in the long run. It is important to take actions to manage debt better, so that countries are not forced into default.

78. The United Nations should therefore set up a Foreign Debt Commission to consider external debt problems of developing countries and economies in transition. The commission, with balanced geographic representation and technical support from the Bretton Woods, regional and other financial institutions, would address these issues and provide advice on ways to enhance external debt crisis prevention and resolution.[6] It would also examine existing and advise on the design of better debt sustainability frameworks for the international community to follow. It would help debt-distressed countries return to debt sustainability, extend Paris Club-plus type approaches to new official creditors, set up an interim mediation service, and craft on the basis of that experience more permanent debt mediation and arbitration mechanisms.

Innovative Risk Management Instruments

[6] See United Nations, "Doha Declaration on Financing for Development: outcome document of the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus" (A/CONF.212/L.1/Rev.1), Doha, Qatar, 29 November -2 December 2008, paragraph 67.

79. The volatility of private capital flows to developing countries has generated increasing demand for policies and instruments that would allow these countries to better manage and minimize the risks associated with increasing international financial integration and, in particular, to better distribute the risks associated with this integration among different market agents. As has been demonstrated during past and current crises, the pro-cyclical and herding behaviour of international capital flows tends to generate boom-bust cycles, which are particularly damaging for developing countries, and it also reduces the scope they have to undertake counter-cyclical macroeconomic policies. Moreover, many developing and emerging countries borrow short term, in hard currencies, forcing them to bear the risk of interest rate and exchange rate fluctuations. And finally, inadequate debt resolution mechanisms impose high costs on developing countries.

80. In light of this, there have been a variety of ideas and proposals for introduction of innovative financial instruments. The proposed instruments include tools that enable better management of risks arising from the business cycle and fluctuations in commodity prices, particularly GDP and commodity linked bonds and financial guarantees that have a counter-cyclical element embedded in their structure. Promoting local currency bond markets has also been seen as a way to enhance financial development and reduce the currency mismatches that affect debt structures in developing countries.

81. GDP-linked bonds are conventional bonds that pay a low fixed coupon augmented by an additional payment linked by a pre-determined formula to debtor country's GDP growth. This variable return structure links returns to the ability to service and thus reduces the likelihood of costly and disruptive defaults and debt crises. The reduction of a country's debt service when the economy faces financing difficulties can also facilitate a more rapid recovery, as it allows higher public spending in difficult times. For investors GDP-linked bonds reduce the probability of default, and thus the costs of expensive renegotiation, and offer a valuable diversification opportunity. Returns should be higher than with conventional bonds.[7]

82. Since private financial markets are unlikely to develop these instruments autonomously, because of the externalities associated with their introduction multilateral development banks should take an active role in their development. In particular, these institutions could have an active role as "market-makers". The expertise developed by the World Bank as market-maker for the sale of carbon credits under the Kyoto protocol provides a precedent for these activities. The World Bank and regional development banks could, for example, make loans whose servicing would be linked to GDP. The loans could then be sold to financial markets, either individually or grouped and securitized. Alternatively the World Bank or regional banks could buy GDP-linked bonds that developing countries would issue via private placements. The fact that major multilateral development banks became active in this type of lending could, furthermore extend the benefits of adjusting debt service to growth variations

[7] The introduction of these securities must overcome, however, some practical difficulties. One possible set of concerns is associated with lags in the provision and frequent revisions of GDP data, as well as over the quality of these estimates, but these issues should be easy to resolve through international standard setting and the provision of technical assistance. More important in this regard is how to manage concerns that have been raised about the liquidity of such instruments, especially when they are newly issued. Such concerns were similarly raised when inflation indexed bonds were first introduced, but they are now accepted worldwide. Governments and multilaterals might have to help create a deeper market.

to countries that do not have access to the private bond market. GDP-indexed securities are particularly appropriate for Islamic finance, as they can be made compatible with Sharia law which prohibits charging of interest.

83. There might also be alternative ways of ensuring flexible payment arrangements that would allow automatic adjustment for borrowers during bad times. For instance, one possibility is for coupon payments to remain fixed and the amortization schedule to be adjusted instead. Countries would postpone part or all of their debt payments during economic downturns; and they would then make up by pre-paying during economic upswings. A historical precedent was set by the United Kingdom when it borrowed from the United States in the 1940s. The Anglo American Financial Agreement was negotiated by John Maynard Keynes and included a "bisque clause" that provided a waiver of 2% interest payment in any year in which the United Kingdom foreign exchange income was not sufficient to meet its pre war level of imports, adjusted to current prices.

84. Commodity-linked bonds can also play a useful role in reducing country vulnerabilities. Examples of commodity-indexed bonds include oil-backed bonds, such as the Brady bonds with oil warrants that were first issued on behalf of the government of Mexico. In such instruments, the coupon or principal payments are linked to the price of a referenced commodity. Again, it might be desirable for international institutions to help create a market for such bonds.

85. However, the greater complexity of this instrument, in comparison with conventional bonds, and the commodity price risk that the investor faces, may make commodity-linked bonds expensive. Again, it might be desirable for international institutions to help create a market for such bonds. While they are likely to be less useful than GDP-indexed bonds for the growing number of developing countries that have a fairly diversified export structure and therefore lack a natural commodity price to link to bond payments, they have the decided advantage that the risk being "insured" through the bond is not one affected by the actions of the country (i.e. moral hazard is less of a problem.)

86. Another way of addressing the problems created by the inherent tendency of private flows to be pro-cyclical is for public institutions to issue guarantees that have counter-cyclical elements. For example, Multilateral Development Banks (MDBs) and Export Credit Agencies (ECAs) could introduce an explicit counter-cyclical element in all the risk evaluations and the guarantees they issue for lending to developing countries. This requires MDBs and ECAs to assess risk for issuing guarantees with a long-term perspective. When banks or other lenders lowered their exposure to a country, MDBs or ECAs would increase their level of guarantees, if they considered that the country's long-term fundamentals were basically sound. When matters were seen by private banks to improve, and their willingness to lend increased, MDBs or ECAs could reduce their exposure. Alternatively, there could be special stand-alone guarantee mechanisms for trade and/or long-term credit, for example within multilateral or regional development banks, which had a strong explicit counter-cyclical element. This could be activated in periods of sharp decline in capital flows and its aim would be to try to catalyze private sector trade or long-term credits, especially for infrastructure.

87. Finally, a number of developing countries have encouraged development of domestic capital markets, and in particular local currency bond markets. These markets in fact boomed after the Asian crisis, multiplying fivefold between 1997 and 2007 for the twenty large and medium-sized emerging economies for which the Bank of International Settlements provide regular information. This trend can be seen as a response of emerging economies to the volatility and pro-cyclical bias of international capital flows and the volatility of exchange rates. It can be viewed as a means of creating a more stable source of local currency funding for both the public and private sectors, thereby mitigating the funding difficulties created by sudden stops in cross-border capital flows, reducing dependence on bank credit as a source of funding and, above all, lowering the risk of currency mismatches. For foreign investors, it could actually be attractive to form diversified portfolios of emerging market local currency debt issued by sovereign governments or developing country corporations, with a return-to-risk that competes favourably with other major capital market security indices.

88. Further development of these markets is desirable. First, developing countries bond markets are still largely dominated by relatively short-term issues and, therefore tend to correct currency mismatches but to increase maturity mismatches. Second, it has proved to be much easier to develop large and deep local markets for public sector than for corporate debt. As a result, large corporations continued to rely on external financing. To the extent that such external financing is shorter term than that many developing country governments are able to get in global debt markets, the overall debt structure of countries tends to become shorter term–and therefore riskier. Indeed, the rollover of external corporate debt is viewed as the major problem facing many emerging economies today. Third, many of these markets are not very liquid. This problem has actually become more acute during the recent market downswing. Fourth, although local bond issues did attract foreign investors, they were largely or at least partly lured by the generalized expectations of exchange rate appreciation that tended to prevail in many parts of the developing countries during the recent boom. As the world financial crisis hit, there were large outflows of these funds, and in this sense reliance on these short term portfolio flows did not correct but may have enhanced pro-cyclicality of financing, much as short-term external bank debt did during previous crises.

89. Therefore, although the development of local bond markets is a major advance in developing country financing since the Asian crisis, its promise remains a partly unfulfilled in terms of risk mitigation. It is important for developing country governments, with support from international organizations to correct some of the problems that have been evident and to continue investing in the development of deep and longer-term domestic bond markets.

Innovative Sources of Financing

90. For some time, the difficulty in meeting the UN official assistance target of 0.7 per cent of Gross National Income of developed industrial countries as official development assistance, as well as the need for adequate funding for the provision of global and regional public goods (peace building, fighting global health pandemics, combating climate change and sustaining the global environment more generally) has generated proposals on how to guarantee a more reliable and stable source of financing for these objectives.

91. This debate has led to a heterogeneous family of initiatives. A distinguishing feature of developments in recent years is the fact that the old idea of innovative finance has lead to action, with the Joint Declaration of President Jacques Chirac, President Luiz Inácio Lula da Silva, President Ricardo Lagos and United Nations Secretary-General Kofi Annan in Geneva on January 30, 2004 launching the "Action Against Hunger and Poverty" that in Paris, in 2006 providing the background work for the "Leading Group on Solidarity Levies". The Leading Group now involves close to 60 countries and major international organizations.

92. Some of the initiatives that have been proposed encompass "solidarity levies" or, more generally, taxation for global objectives. Some countries have already decreed solidarity levies on airline tickets but there is a larger set of proposals. There have also been suggestions to auction global natural resources–such as ocean fishing rights and pollution emission permits–for global environmental programs.

93. The receipts from these innovative initiatives could be directed to support developing countries to meet their development objectives, including their contribution to the supply of global public goods, as well as international organizations that are active in guaranteeing the provision of such goods. The existing taxes on airline tickets, for example, are being used to finance international programs to combat malaria, tuberculosis and HIV-AIDS.

94. The suggestion of taxes that could be earmarked for global objectives has a long history. To avert their being perceived as encroachments on participating countries' fiscal sovereignty, it has been agreed that these taxes should be nationally imposed, but internationally coordinated. While universal participation is not indispensable, it would serve the interest of development, as more resources would be raised. Some suggestions aim at both raising funds for global objectives and mitigating a negative externality at the global. Two suggestions deserve special attention: a carbon tax and a levy on financial transactions.

95. Since carbon dioxide is the main contributor to global warming, a tax on its emissions can be defended on environmental efficiency grounds and would also have the advantage of correcting a negative externality in addition to being a significant source of development financing, which according to some estimates could reach as much as $130 billion per year. However, carbon taxes should not be implemented in both developed and developing countries. A uniform global carbon tax, even if introduced gradually, would mean that developing countries will be taxed at several times the rate for industrial countries, as a proportion of their respective GNPs. This would impose a disproportionate burden of adjustment on developing countries, although per capita emissions of greenhouse gases in developing countries are low compared with those in industrial countries. Carbon taxes will also have adverse distributional impacts in developing countries. A high tax on an essential good (e.g. energy, but also food or water) could render it unaffordable by lower income groups. This would not only be regressive, but would also be socially unacceptable and environmentally unpredictable.

96. An alternative to carbon taxes, which is now being used, is the auctioning emissions rights. Emissions trading is one of the Kyoto Protocol mechanisms and has been implemented by means of a European trading scheme which provides for an overall capping of emissions. The mechanism makes pollution with greenhouse gases costly for the emitter who has to acquire emission certificates. In this way, public revenues are generated which

can be used to finance both mitigation and adaptation to climate change in developing countries, thus contributing to "climate justice".

97. Similar mechanisms can be designed to pay for environmental services. Such schemes are operational locally in different areas of the world. They allow for consumers of a given public good to compensate for some of the costs borne by those in charge of producing or preserving it. For instance, downstream users of water can pay those who manage the upstream forest to ensure a sustainable flow of this service into the future. It can be envisaged that similar instruments could pay for the provision of global environmental services, such as the preservation of rainforests.

98. Estimates of the revenues from a currency transaction tax range from $15 to $35 billion. However attractive the tax might be in terms of revenue potential, its implementation is constrained by a number of obstacles. Particularly, the tax base will have to be defined so as to exclude certain transactions that provide very short-term liquidity to markets (e.g., when this tax is applied at the national level, interbank lending is usually exempted) and special treatment for derivatives to avoid double taxation. It will also have to be protected from erosion, for even if all major financial centres participate, there is a risk that smaller centres will attract an increasing volume of activity from those wishing to evade the tax. Finally, strong opposition by a number of stakeholders would have to be overcome.

99. Alternatively, a levy on trade in shares, bonds and derivatives could be introduced. Implementation would be easier than in the case of a currency transaction tax, as a small number of participating countries suffices at the beginning. In later stages, over the counter and currency trading could be included. Large stock exchange centres exhibit positive agglomeration externalities; therefore a small tax would not lead to a flight of trade towards alternative, smaller exchanges.

100. Another set of proposals rely on the use of financing mechanisms. One mechanism that already has a long history of application is swaps of debt for development objectives. It has been recently used in the Debt2Health initiative launched in Berlin in 2007, which converts portions of old debt claims on developing countries into new domestic resources for health. The International Finance Facility was proposed by the UK in 2003 to up-front commitments for future flows of ODA, by issuing bonds backed by public or private sector donors' pledges. The first of these mechanisms, the International Finance Facility for Immunization, is already in place.

101. Public-private sector partnerships can also be used to guarantee certain international objectives. A mechanism of this type is the Advanced Market Commitments proposed by Italy, through which government donors commit funds to guarantee the price of vaccines once they have been developed, provided they meet a number of criteria on effectiveness, cost and availability. This helps encourage pharmaceutical firms to focus on research into neglected diseases which mainly affect poor countries.

102. Emphasis in innovative financing initiatives has also been given to illegal financial flows from developing countries, including those lost by developing countries through tax evasion and other illegal means. It has set up for that purpose a task force on Global

Financial Integrity, under the direction of Norway. The importance of combating tax evasion has already been underscored in Chapter 3.

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Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System

September 21, 2009

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FOREWORD

On June 26, 2009, an extraordinary event occurred: the 192 Member States of the United Nations adopted by consensus a broad and exceptionally substantive statement on the World Financial and Economic Crisis and Its Impact on Development. The analysis and recommendations cover the gamut from short-term mitigation to deep structural change, from crisis response to reform of the global economic and financial architecture. The weight of the document is inclined toward agenda setting; it contains few "deliverables" in the form of actionable decisions, but establishes a bold agenda for policy change and institutional development that is broad in scope and profound in its ambitions. Although it is the product, inevitably, of compromise and calculated ambiguity, the Outcome remains the most comprehensive statement issued by any intergovernmental process on the causes and necessary remedies for our world economic crisis.

The Outcome is also a powerful testament to the potential of the United Nations as a forum not only for deliberation, but for decision-making of the highest order – thinking and acting to define the institutional contours of our common lives. It is the result of heroic efforts by a number of individuals and institutions – diplomats and officials, activists and intellectuals in civil society and social movements, and other academic and independent experts from across the globe. The June Outcome draws upon the intellectual capital accumulated during many years of national and regional crises that culminated, after August 2007, in the largest global economic recession since the Great Depression.

The Outcome also reflects the powerful influence of the Commission of Experts on Reform of the International Financial and Monetary System, which I convened under the leadership of Chairman Joseph Stiglitz, in late November 2008, specifically to assist the Member States of the General Assembly in their deliberations on the world financial and economic crisis. The terms of reference for the Commission were deliberately broad; its focus was shaped by the evolution of the Crisis, by the Commission's own intensive internal deliberations, and through an open, iterative process of dialogue with Member States and other authorities.

Despite its unofficial status, the Commission exerted a powerful pull, its gravitas owing to the reputation and broad representativeness of the Commissioners themselves. The 20 Commissioners came from every region. The cumulative experience that informs their work has to be measured not in decades, but in centuries. They brought to their deliberations a diverse set of lifelong experiences, perspectives, and success as bankers, practitioners, policy-makers and scholars of the first rank. They also brought a willingness to work very hard, and to meet a nearly impossible schedule.

Like the influence of the moon upon the tides, the Commission exercised an enormous influence on the deliberations of the Member States and pulled the debate away from merely superficial concerns and toward the systemic issues whose pernicious impact has become manifest in the present crisis. They helped to embolden thinking by reminding Member States, as they state in the conclusion to this final Report:

> "The crisis is not just a once in a century accident, something that just happened to the economy, something that could not be anticipated, let alone avoided. We believe

> that, to the contrary, the crisis is manmade: It was the result of mistakes by the private sector and misguided and failed policies of the public."

In other words, the Commission members called the UN Member States to take responsibility – but for what, and for and to whom?

Our global economy is broken. This much is widely accepted. But what it is precisely that is broken and needs to be fixed has become a subject of enormous controversy.

In the view adopted by the Commission, and broadly endorsed in the UN Outcome, the crisis we confront is systemic in the deepest sense and has many facets. On this view, the financial crisis that erupted in the United States in September 2009 is the latest and most impactful of several concurrent crises – of food, of water, of energy, and of sustainability – that are tightly interrelated, connected in important ways by an imperious economic perspective that has been implemented, often under duress, across the globe during the last 35 years.

In this perspective, market logic solves nearly all social, economic and political problems. The well-known staples of economic policy complexity such as the need to address economic and non-economic sources of economic instability ("market failure"), the need to account for costs imposed on others and to redress the unfair appropriation of social benefits ("externalities"), the need for public intervention to provide for the conditions and values of sustainable life ("public goods" and "social equity") are all regarded as incidental rather than fundamental issues of economic management.

As the Commission stresses with considerable frequency, the present crisis demonstrates failure at many levels – of theory and philosophy, of institutions, policies and practices, and, less overtly, of ethics and accountability. The essential insight of the report is that our multiple crises are not the result of a failure or failures of the system. Rather, the system itself – its organization and principles, and its distorted and flawed institutional mechanisms – is the *cause* of many these failures.

It is a habit of contemporary speech to refer to the global economy that we have today as "the economy" and, more insidiously, to present it as a natural phenomenon whose putative laws must be regarded with the same deference as the laws of physics. But, as the enclosed report argues cogently, our global economy is but one of many possible economies, and, unlike the laws of physics, we have a political choice to determine when, where, and to what degree the so-called laws of economic behavior should be allowed to hold sway.

An economy is a man-made ecology, or rather the man-made part of our larger ecology of interaction between the man-made and natural worlds. Together the man-made ecology and the natural ecology sustain – or destroy – the conditions of life. It is essential today, as the UN Outcome and this Report both recognize, to view economic and ecological issues as tightly interrelated, and recognize that our global economic system must be adjusted to the requirements of an era in which the risks engendered by centuries of neglect have reached a point of extreme danger and the costs of adjustment must be borne by the present and succeeding generations. The Commission's Report is forceful on this point: "The conjunction of huge unmet global needs, including responding to global

warming and the eradication of poverty, in a world with excess capacity and mass unemployment, is unacceptable."

As the greatest economic philosophers – whose number surely includes Aquinas, Smith, Marx, and Keynes – have all recognized, homo oeconomicus, the acquisitive, emotionally cardboard, and socially atomistic construct of academic economics is a reductio ad absurdum. They did not merely assume that the ethical vocation of human beings should inform their economic decisions and institutions; they insisted on it, and in ways that today are far out of fashion but are also therefore far more necessary today. It is difficult to read this Report and not come to the conclusion that the Commission members share this perspective.

One of the most disappointing aspects of the global response to the present crisis has been the almost complete absence of political accountability. While failure has been broad and abundant, corrective action has been comparatively scarce.

In part, perhaps, this owes to the influence of the concept of the present global economy as natural and therefore subject to natural disasters. But under the circumstances that concept is no more than a rhetorical device, an insidious political strategy, of which there are many, to deflect attention and accountability away from the authors of the policies and designers of the institutions that have failed so miserably.

An alternative, complementary explanation is that there is a deep flaw in our system of global economic governance. According to democratic principles those who are deeply affected by a policy should have a say in their formulation, and those who are responsible for massive failures and injury should be held accountable. Our present system of global economic governance does not meet either of these fundamental tests of democratic governance.

The idea that the world community as a whole should become engaged in sorting through the causes and necessary remedies for the world economic crisis has appeared strange to some nations – mostly those few, unsurprisingly, who occupy the most privileged positions in the current institutional arrangement – and deeply necessary to nearly everyone else.

The idea that the United Nations should provide the forum for such engagement appears to be even more polarizing. Throughout the preparatory process for the June Conference, a studious silence was observed in most Northern countries, except for the large number of articles and stories circulated citing unnamed officials and diplomats who decried the very idea of such a UN process as "a joke" and "a farce." The assertion that the UN lacks competency found frequent expression, most notably in the explanation of vote presented by the U.S. delegate following the adoption of the Outcome: "Our strong view is that the UN does not have the expertise or mandate to serve as a suitable forum or provide direction for meaningful dialogue on a number of issues addressed in the document, such as reserve systems, the international financial institutions, and the international financial architecture."

This view that the United Nations lacks competency to engage on matters of systemic reform received a fatal blow during the intergovernmental consultations (negotiations) that preceded the June Conference. When the lead negotiator for the G77 and China, H.E. Lumumba Di-Aping,

proposed to substitute the words "Member States" for the term "United Nations" to name who would be engaged in the process, this small change of words clarified, and settled, the real issue. For no one dared argue that the Member States of the United Nations lack the competency to discuss and make recommendations on the central institutions of our shared global economy and existence.

The United Nations General Assembly, as the world's only legally constituted and globally inclusive intergovernmental body with a clear mandate on economic affairs, has a special and unique role to play in our global deliberations. In part this is because it offers the only forum in which all nations are free to speak and engage on the basis of sovereign equality, and therefore the only forum where those whose voices are least represented in the councils of global economic governance have to be heard and accommodated not as a matter of courtesy but of right. Here alone does the voice of the Global South ring with equal clarity, and here too is where considerations of equity and justice are therefore more likely to be raised.

In matters of global economic governance, the voice of the General Assembly has an additional claim to uniqueness. Owing to the status of the United Nations as the original authority under whose aegis the core institutions of the current architecture were established, and to the role of the General Assembly in particular as its Carter-defined deliberative and constitutive organ, the UN GA is arguably the most important and necessary, if not by any means exclusive, forum for deliberation of global system reform.

For the better part of the last year, I have recited the mantra of the world social forum: "A better world is possible." I have also drawn inspiration from the life and teachings of Mahatma Gandhi, who once remarked, "First they ignore you, then they make fun of you, then they fight you, then you win." In Gandhi's vital vision, the fight for social and political change is not reducible to a fight between good and evil, but a struggle for Truth, in which each of us must take personal responsibility in a spirit of love and solidarity, even for those who oppose us and may seek to destroy us.

The Report of the Commission of Experts and the June Outcome are both invitations, perhaps even exhortations, to continue our struggle with truth at and through our United Nations. The UN's imperfections, we must accept, are our imperfections; the responsibility to remake it is ours alone.

I wish to take this opportunity to express my deepest gratitude to Professor Stiglitz and all of the Commissioners whose names are recorded herein, as well as Rapporteur Jan Kregel and my personal representatives, Fr. Francois Houtart and Mr. Ali Boukrami – all of whom approached their work with truly extraordinary dedication and sincerity. Ms. Jill Blackford's efficient administration and wise counsel were indispensable, as were the able editing efforts of Mr. Arjun Jayadev and Mr. Frank Schroeder.

The voluntary support of individuals associated with United Nations Department of Economic and Social Affairs, in particular Drs. Manuel Montes and Richard Kozul-Wright, provided important input to my office early on in the development of this project and at critical stages of work.

I also want to thank the members of my staff, senior advisers Dr. Paul Oquist, Dr. Michael T. Clark, Ambassador Byron Blake, Ambassador Nirupam Sen, and Ambassador Alpo Rusi; the Commission

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Several governments and institutions also made financial and other in-kind contributions that made the work of the Commission possible. In particular, I wish to express my appreciation for the support of the governments of Algeria, China, Germany, and the Netherlands, without whose timely commitments of financial and political support, it would have been impossible to adhere to the Commission's very aggressive work schedule. The International Parliamentary Union generously offered its facilities for the second full meeting of the Commission in Geneva in March. I want to thank especially, Mr. Anders B. Johnsson, Secretary General, and Ms. Sally-Anne Sader of the IPU, who made the Commission welcome and the meeting productive.

The personal involvement of Minister for Development Cooperation of the Netherlands, H.E. Mr. Bert Koenders, as a host and as a Special Emissary of the President of the General Assembly to Europe was so extensive and effective that he deserves to be considered an emeritus member of the Commission. Mr. Gerben Planting and Ms. Sanne Helderman of the Netherlands Ministry of Foreign Affairs also made important contributions at critical moments.

Together, all have helped us work our way down from the high clouds of mere possibility in order to map the terrain of the real work that lies ahead. They have also provided an example of selfless commitment and hope that I pray will continue and inspire others to join in.

Miguel d'Escoto Brockmann
President of the 63rd Session of the United Nations General Assembly

CHAPTER 1: INTRODUCTION

The Crisis: Its Origins, Impacts, and the Need for a Global Response

1. The current financial crisis, which began in the United States, then spread to Europe, has now become global. The rapid spread of the financial crisis from a small number of developed countries to engulf the global economy provides tangible evidence that the international trade and financial system needs to be profoundly reformed to meet the needs and changed conditions of the early 21st century. The crisis has exposed fundamental problems, not only in national regulatory systems affecting finance, competition, and corporate governance, but also in the international institutions and arrangements created to ensure financial and economic stability. These institutions have proven unable to prevent the crisis and have been slow to design and implement adequate responses. Indeed, some policies recommended by these institutions have facilitated the spread of the crisis around the world.

2. The crisis emanated from the center and reached the periphery. Developing countries, and especially the poor in these countries, are among the hardest hit victims of a crisis they had no role in making. Even emerging-market economies and least-developed countries that have managed their economies well are suffering declining output and employment. Indeed, those countries that have had the best performance in the recent past and that have been most successful in integrating into the global economy have been among the most badly affected.

3. Past economic crises have had a disproportionate impact on the living standards of the world's poor. Those who are least able to bear these costs will suffer its consequences long after the crisis is over. Infants who suffer from malnutrition will be stunted for life. Children who drop out of school are not likely to return and will never live up to their potential. Future growth and employment prospects may be impaired if small firms are forced into bankruptcy. Economic policies must be particularly sensitive to these hysteresis effects.

4. It is important to recognize that what began as a crisis in the financial sector has now become an economic crisis. But, it is not only an economic crisis, it is also a social crisis. According to the International Labour Organization (ILO), some 200 million workers, mostly in developing economies, will be pushed into poverty if rapid action is not taken to counter the impact of the crisis. Even in some advanced industrial countries, millions of households are faced with the threat of losing their homes, their jobs, and access to health care. Economic insecurity and anxiety are increasing among the elderly as much of their life savings disappear with the collapse of asset prices. The ILO estimates that unemployment in 2009 could increase by some 30 million compared with 2007 and reach almost 60 million if conditions continue to deteriorate.

5. While the crisis began in the financial markets of the advanced industrial countries and then spread to the real economy, in many developing countries, the initial impact of the crisis has been felt in the real sector but is now spreading to (and through) the financial system. Developing countries are being affected through falling export demand and prices, accompanied by reversals of capital flows and reductions in remittances. While developed countries have the fiscal flexibility to respond, to stimulate their economies, to shore up failing financial institutions, to provide credit, and to strengthen social protections, most developing countries have tighter budget constraints, and

resources directed towards offsetting the impact of the crisis must be diverted from development purposes. Money spent to extend social protection may be at the expense of future growth.

6. While it is important to introduce structural changes to adapt the international system to prevent future crises, this cannot be achieved without significant immediate measures to promote recovery from the current crisis. To the extent possible, these measures should promote, or at least be consonant with, the needed long-run structural changes.

7. At the same time, the international community cannot focus exclusively on immediate measures to stimulate the economy if it wishes to achieve a robust and sustainable recovery. This crisis is, in part, a crisis of confidence, and confidence cannot be restored unless steps are taken to begin the more fundamental reforms required, for instance, through improved regulation of the financial system.

8. Any solution—short-term measures to stabilize the current situation and long-term measures to make another recurrence less likely—must be global and must pay due attention to impacts on all countries and all groups within society. In particular, the welfare of developed and developing countries is mutually interdependent in an increasingly integrated world economy. Without a truly inclusive response, recognizing the importance of all countries in the reform process, global economic stability cannot be restored, and economic growth, as well as poverty reduction worldwide, will be threatened.

9. Short-term measures to stabilize the current situation must ensure the protection of the poorest in the least-developed countries, many of whom are in sub-Saharan Africa. As we have noted, the poor countries, and especially the poor within all countries, will bear a heavy burden of adjustment. Long-term measures not only must be designed to make another recurrence less likely, but they also must ensure sustainable financing to strengthen the policy response of developing countries.

10. Any inclusive global response will require the participation of the entire international community. To respond to this need, the President of the General Assembly created the present Commission of Experts to identify measures needed to respond to the crisis and to recommend longer-term reforms, paying explicit attention to the needs of developing countries. Recognizing work by the G-7/8, G-20 and others, the Commission sees its own work as complementary, seeking to focus on the origins of the crisis as well as the impacts of and responses to the crisis on poverty and development.

11. Reform of the international system must have, as its goal, the improved functioning of the world's economic system in support of the global good. This entails simultaneously pursuing long-term objectives, such as sustainable and equitable growth, creation of employment in accordance with the "decent work" concept, responsible use of natural resources, reduction of greenhouse gas emissions, and more immediate concerns, including addressing the challenges posed by the food and financial crises and global poverty. As the world focuses on the exigencies of the moment, longstanding commitments to achievement of the internationally agreed development goals, including the Millennium Development Goals and protecting the world against the threat of climate change, must remain overarching priorities; indeed, both the immediate steps taken in response to the crisis and longer-term global reforms should provide an opportunity to accelerate progress toward meeting these goals. While the world will eventually recover from the global economic crisis, the resolution of other challenges, including those posed by introducing new forms of energy to

counter global warming, eliminating global poverty, and the potential shortage of food and water, will require additional measures. The conjunction of huge unmet global needs, including responding to the challenges of global warming and the eradication of poverty, in a world with excess capacity and mass unemployment is unacceptable.

12. Over ten years ago, at the time of the Asian financial crisis, there was much discussion of the necessity for rapid reform of the global financial architecture if the world were to avoid the occurrence of another major crisis. Little—too little, it is now evident—was done. It is imperative to provide an adequate, immediate response to the current crisis, but also to begin the long-run reforms that will be necessary to create a more stable, prosperous and balanced global economy. The aim must be to avoid future global crises.

13. Both developed and developing countries must recognize that globalization must meet the needs of all citizens of the world. While it promised to help stabilize global financial markets and reduce the scale of domestic economic fluctuations, it failed to do so. Rather, it served to facilitate the spread of contagion from one country to another. A failure in one economy is now leading to a global recession or depression. And unless something is done, and done quickly, those in developing countries are likely to be among the people who suffer most.

14. This report presents an analytical framework for understanding what has gone wrong and what the possible remedies are. It presents both broad perspectives on policies and specific recommendations. This introductory chapter provides an overview of some of the key issues and policy frameworks and perspectives. As noted, the crisis is both a financial crisis and an economic crisis. It has both macroeconomic and microeconomic aspects. It began as a failure in the financial sector, but the problems in that sector were, in part, a result of underlying macroeconomic problems, such as growing global imbalances and growing income inequalities within and between countries. The fact that existing global institutions did little to prevent the crisis, and then delayed developing adequate responses to the crisis, suggests important institutional problems that the international community needs to address. The frequent crises that have accompanied globalization, with problems in one country quickly spilling over and creating problems in others, suggest the need for reform of the international financial system to meet the needs of an increasingly interdependent world economy. The fact that a major impact of these crises has been on the poor and developing countries makes it clear that there are inadequacies in global market and non-market mechanisms for managing financial risks.

15. The current economic crisis should provide an opportunity to reassess global economic arrangements and prevalent economic doctrines. Large changes have occurred in the global economy in recent years, e.g. in the sources of global savings, foreign exchange reserves, and GDP, and these are not fully reflected in our global economic institutions and arrangements. In trying to resolve the problems of the short-run crisis, it is important to seize the opportunity to make deeper reforms that enable the world to enter the 21st Century with a more equitable and stable global financial system, one which could usher in an era of enhanced prosperity for all countries.

The Institutional Responses to the Crisis

16. There have been unprecedented efforts to address the crisis. The stimulus measures introduced by many countries around the world will dampen the impact of the crisis. However, it must be

recognized that there can be no return to the *status quo ante*. It is essential that governments undertake reforms that address the underlying factors that contributed to the current economic crisis if the world is to emerge from the crisis into sustainable, balanced growth. It also is essential if there is to be a quick restoration of confidence. Failure to act quickly to address the global economic downturn and more fundamental problems that gave rise to it would increase the depth and duration of the crisis, making it more difficult and more costly to create a balanced and robust recovery.

17. Most of these longer-term reforms are not just luxuries to be undertaken at leisure once the recovery is assured; they are essential to the recovery itself. Moreover, there is substantial risk that unless work on these more fundamental reforms is undertaken now, momentum for reform will be lost with the recovery. There are strong political forces at play, and those who have benefited from existing arrangements or recent changes will resist fundamental reforms. But allowing these interests to prevail would ensure the recurrence of a crisis. This is one lesson to be learned from the Asian financial crisis of 1997-1998, where relatively quick recovery left the financial system unchanged and helped set the stage for the current crisis.

18. The urgent need to respond to the crisis has been highlighted by the meetings of the heads of government of the Group of 20 in November 2008 in Washington and in April 2009 in London. These have led to commitments to undertake large fiscal expenditure packages, to introduce significant regulatory reforms, and to provide increased assistance to developing countries. These are important initiatives, but more important is the recognition that the global nature of the crisis means that it cannot be resolved by a small group of advanced industrialized countries and instead must be addressed in a more inclusive framework. Moreover, the actions proposed and the processes by which decisions are made and implemented are not ideal.

19. First, and most important, the decisions concerning necessary reforms in global institutional arrangements must be made not by a self-selected group (whether the G-7, G-8, G-10, G-20, or G-24), but by all the countries of the world, working in concert. This inclusive global response will require the participation of the entire international community; it must encompass representatives of the entire planet, the G-192.

20. While proposals from smaller groups will necessarily play an important role in developing a global consensus on key and complex issues, decision-making must reside within international institutions with broad political legitimacy and with adequate representation of both middle-income countries and the least-developed countries. The only institution that has this broad legitimacy today is the United Nations.

21. Better representation and democratic legitimacy would not require the presence of all countries in all deliberations. Working committees, with representative membership chosen by democratic selection mechanisms and with equitable representativeness, could be limited to a size that would ensure effective decision making and yet also ensure that a wide variety of voices and perspectives are taken into account. The fact that all existing democracies have been able to achieve satisfactory solutions to these problems suggests that they are not irresolvable.

Policy Responses to the Crisis

22. Sustainable responses to the crisis require identifying the factors underlying the crisis and the reasons for its rapid spread around the world. There have been policy failures at both the micro- and macro-economic levels. Loose monetary policy, inadequate regulation, and lax supervision interacted to create financial instability. "Reforms" over the past three decades have exposed countries to greater instability and reduced the impact of "automatic" stabilizers. In some countries, social protection has been weakened, with the result that the adverse consequences of major crises, such as the one the world is now facing, have been especially hard on the poor. But any inquiry into the causes and origins of the crisis must go further, examining why these policies were pursued.

23. At the global level, some international institutions continue to recommend policies, such as financial sector deregulation and capital market liberalization, that are now recognized as having contributed to the creation and rapid diffusion of the crisis. The inadequate responses to the last global crisis in 1997-1998 led to a change in policy frameworks within many developing countries that induced them to hold increasing levels of reserves, which contributed to the large global imbalances whose disorderly unwinding was widely feared as an additional source of financial instability.

24. The conduct of monetary policy in the United States has been focused on offsetting the potential negative impact on aggregate demand of the real estate crisis at the end of the 1980s and the collapse of the information technology equity bubble at the beginning of the new millennium. It thus acted to support global aggregate demand and contributed to global imbalances that were also aggravated by increasing income inequality in most countries.

25. In many countries, the focus of monetary policy was on price stability, rather than other factors that might contribute to long-term growth and stability, because it was believed that low inflation was a necessary and (almost) sufficient condition for economic prosperity. It should now be clear that monetary authorities must recognize the consequences of their policy decisions on the stability of asset prices as well as the stability of financial institutions.

26. Part of the reason for inadequate financial regulation was an inadequate appreciation of the limits of the market mechanism—the prevalence of what economists call "market failures." While such failures arise in many markets, they are particularly important in financial markets and can have disproportionately large consequences as they spill over into "real" economic activity.

27. The current crisis reflects problems that go beyond the conduct of monetary policy and regulation of the financial sector; it has exposed broader flaws in the understanding of the functioning of markets. There was a widespread belief that unfettered markets are, on their own, quickly self-correcting and efficient.

28. This suggests that it is necessary to review the policies currently advocated by international institutions—such as the International Monetary Fund, the World Bank, the regional development banks, and the World Trade Organization—as well as many international agreements that are based on these premises.

The Global Crisis Needs a Global Response

29. The current crisis may be considered a manifestation of the impact of real and financial externalities. Most visibly, the failure of markets in the financial sector had substantial negative externalities on real output and employment. But more generally, in a globally integrated world, the actions of any one country have effects on others. Too often, these externalities are not taken into account in national policy decisions. Developed countries, in particular, need to be aware of the consequences of these externalities, and developing countries need frameworks to help protect them from regulatory and macroeconomic failures in the major countries. Ironically, much of the effort to coordinate international economic policy has focused on putting constraints on countries whose behavior is not systemically significant, while doing little about countries whose policies can have systemically significant consequences.

30. Similarly, the importance of externalities is often ignored in the design of countries' policies in response to crises. Presently, there is a risk that countries may undertake insufficient expansionary measures because some of the benefits of their policies (such as deficit-financed expenditures) may accrue to those outside the country. As a result, without global cooperation, countries may spend less than the optimal amount on stimulus packages, as they balance the benefits of the stimulus with the cost of extra debt burdens. Furthermore, they may try to distort their stimulus packages so that more benefits accrue domestically. The net result is that the overall global stimulus impact will be sub-optimal: all may suffer.

31. The introduction of additional protectionist policies to improve domestic conditions at the expense of trading partners also has negative externalities that will impede the recovery from the crisis. Such beggar-thy-neighbor policies contributed to the depth of the Great Depression. Then, countries attempted to augment the impact of expenditure policies through competitive currency devaluations or restraints on trade such as quotas and tariffs. Such moves proved to be counterproductive. In the current situation, explicit moves in this direction, at least of the magnitude and transparency of those that occurred in the Great Depression, may be unlikely. Nonetheless, more subtle versions of such protectionism are already occurring. It is a matter of concern that although the G-20 resolved not to engage in protectionist measures in their meeting in November 2008, by March 2009, nearly all had broken that pledge. Particularly disturbing are protectionist measures directed against developing countries.

32. It has long been recognized that subsidies can be just as disturbing to a free and fair trading system as tariffs. They may also be more detrimental to the creation of a level playing field since rich countries have greater resources to implement them. Measures designed to offset the impact of subsidies implemented in developed countries reduce the availability of already scarce development funds. In the current crisis, developed countries have provided unprecedented subsidies, primarily in the form of financial support for domestic financial and non-financial enterprises that developing countries cannot match in breadth and scale. They also produce a less obvious distortion in that the knowledge that firms in advanced industrial country will be rescued if things go badly gives them a distinct advantage over firms in poorer countries. This highlights the lack of coherence between existing global macroeconomic and financial arrangements, policies, and frameworks and those governing trade. Whether there ever was a level playing field may be debated; that there is no longer one cannot be.

33. Other measures taken in response to the crisis are implicitly protectionist and may have reinforced the natural response of banks to reduce their lending to developing countries. For example, some international banks that have received support from their home governments may have been encouraged to reduce their lending in developing countries to ensure that domestic lending increases. Or banks that have received large amounts of public money may reduce lending even without explicit governmental oversight because of worries about adverse political reactions. This creates a new dimension of financial market protection that exacerbates long-standing asymmetries in the functioning of global financial markets.

34. Unless actions are taken to curb financial market and other forms of implicit and explicit protection and to provide developing countries with compensatory payments to offset the possible distortions that may result from the bailouts, guarantees, and asymmetric expansionary fiscal policies, there is a risk that the global inequalities which contributed to the crisis will increase.

35. A lack of resources is a major impediment to the introduction of strong stimulus packages in developing countries. This report thus calls for a substantial increase in resources available to developing countries, not just to undertake stimulus measures, but to cope with the negative impact of the crisis. Funding to shore up their banking systems, provide credit, including trade credit, and strengthen social protection should be provided, and developing countries should have expanded scope to implement policies that will allow appropriate counter-cyclical policies and to design other structural policies consonant with their needs, objectives, and situation.

Reforming international economic institutions

36. It is apparent that the conditionalities often imposed by international financial institutions in their support of developing countries were counterproductive. The demand that countries implement short-run pro-cyclical policies has exacerbated downturns, while long-run structural policies exposed countries to greater risk and undermined social protection. It is important to design reforms that prevent, or at least reduce the likelihood of, such counterproductive policies in the future. Part of the answer is to be found in the reform of the governance of international economic institutions.

Some Basic Principles

37. In addressing the crisis, several other basic principles—besides, for instance, acting with all due speed, recognizing the necessity to offset new forms of externalities, and avoiding financial and other types of protectionism—should guide the responses of the international community.

Restoring balance between market and government

38. The crisis is, in part, a result of excessive deregulation of financial markets. Restoring the global economy to health will require restoring to the state the appropriate role of regulator of financial markets. In addition, the externalities associated with both the global economic crisis and the global climate crisis can only be addressed by restoring government to its appropriate role in providing collective action at the national and the global levels.

Greater transparency and accountability

39. Greater transparency in responding to the crisis is necessary. More generally, democratic principles, including inclusive participation in decision-making, should be strengthened and respected. Regrettably, in responding to the crisis, many governments have undertaken non-transparent actions and relied heavily on central banks, with only limited democratic accountability. Some central banks with only limited direct accountability have introduced measures—without parliamentary or congressional approval—in support of financial institutions that have exposed taxpayers to massive risks.

Short-run actions consistent with long-run visions

40. In taking policy actions, it is imperative that governments not exacerbate the current crisis through actions that have adverse impacts on other countries or result in structural changes that increase future instability or reduce future growth. For example, in some countries, the response to the crisis created by excessive risk undertaken by financial institutions that were too big to fail has resulted in bank consolidation, which increases such risks in the future.

Assessing distributive impacts

41. Any economic policy, including those responding to crises, has large distributive consequences, both within and between countries, and policy makers need to be attentive to those consequences. As noted, previous financial and economic crises have had particularly adverse effects on poverty, but the strategies employed to address them have sometimes resulted in exacerbating income and wealth inequalities. Bank bailouts and restructurings have played a particularly important role in these adverse redistributions of income and wealth. For example, the unprecedented lowering of interest rates may have been the correct macroeconomic response to the crisis, but it has produced a sharp reduction in the incomes of retirees who did not gamble on risky securities and invested prudently in short- or medium-term government securities. In the East Asian crisis, by contrast, high interest rates were imposed as a condition for international assistance. Small businesses that found themselves unable to bear the burden of debt were forced into bankruptcy.

Avoiding an increase in global imbalances and asymmetries

42. There are large inequalities in the global economy and large asymmetries in the global economic framework. It is important that the measures introduced to respond to this crisis seek to reduce, not exacerbate, these inequalities and asymmetries. For instance, in a crisis counter-cyclical policies are pursued by developed countries, while most developing countries pursue pro-cyclical policies. As noted, this is a result of both the limited availability of resources to engage in counter-cyclical policies, and the restrictions on "policy space" resulting from conditions imposed on countries seeking assistance from international institutions. But even if all countries apply similar policies, the policies can have asymmetric effects: guarantees provided to financial institutions in developed countries cannot be effectively matched by developing countries. These asymmetries, especially in the absence of adequate mechanisms for transferring and mitigating risk, impose high costs on developing countries, increasing volatility and reducing growth.

Distribution and incidence of risk

43. All economic policies involve risks and uncertainties, but under different economic policies, different groups may bear the brunt of this risk. An aggressive stimulus policy may, for instance, increase the risk of inflation from over-stimulation, and those with long-term investments with fixed nominal returns (such as bondholders) may suffer. A weak stimulus may lead to prolonged unemployment, with workers suffering.

Irreversibilities (hysteresis effects)

44. Policies need to be sensitive to non-linearities and problems of irreversibilities. Some policy mistakes are easy to correct, others are not. It may be easier to damp down demand in an economy that faces a risk of overheating than to resuscitate a dying economy, just as it may be easier to dampen nascent inflation than to tame hyperinflation. Reversing policies that have led to the bankruptcy of a firm cannot bring it back to life. An economy may be able to absorb small shocks, but large shocks can have disproportionately adverse effects. These simple maxims of risk management need to be borne in mind in designing responses to the crisis.

Intellectual diversity

45. While much of the support for globalization and the changes in economic policy (e.g. in deregulation) over the past quarter century may have been driven by particular interests, it was also premised on economic doctrines whose theoretical foundations and empirical bases were, at best, questionable. Modern economic theory has brought into question many of the ideas underlying market fundamentalism, including the notion that unregulated markets lead to efficient outcomes or that markets are self-regulating and stable. The current economic crisis has raised further questions concerning these doctrines and has highlighted the relevance of alternative theories and ideas. Any approach to addressing the current economic crisis and preventing future episodes must be robust, in the sense that the conclusions and policy prescriptions cannot rely on economic doctrines in which there is, or should be, limited confidence. Some international institutions have advocated notions of competitive pluralism, encouraging the creation of a marketplace of ideas, while others have tried to enforce a single-minded adherence to a particular ideology that the crisis has shown to be inadequate. Strengthening the diversity of ideas may contribute both to global stability and to a strengthening of democracy.

46. The crisis also highlights that the standard policy nostrums—that countries should have sound macroeconomic policies, strong governance, transparency, and good institutions—may be less than helpful. Countries that held themselves out as models of best practices have been shown to have had deeply flawed macroeconomic policies and institutions and to have suffered from major shortfalls in transparency.

Impact on developing countries

47. The crisis is likely to extract a particularly high toll on developing countries for four reasons.

48. First, the citizens of these countries have fewer resources with which to cope with a crisis of this magnitude.

49. Secondly, they already suffer from a lack of automatic stabilizers due to the embryonic nature of their fiscal and social protection systems.

50. Third, the limited ability to borrow in international financial markets may impose constraints on their ability to pursue counter-cyclical fiscal and monetary policies. Many countries are forced, for instance, to pursue pro-cyclical fiscal policies because tax revenues decline in a downturn and they cannot find adequate financing for existing, let alone expanded, government expenditures. In this crisis especially, many firms and countries will face credit constraints and higher borrowing costs because capital flows to developing countries are likely to be markedly lower and risk premiums have increased substantially. To retain foreign investors, countries may be tempted to raise interest rates, with adverse effects on the real economy. But as in the East Asian and global financial crises, such interest rate increases may not have the desired stabilizing impact and may instead reduce economic growth and, as the economy slows, erode confidence and cause capital outflows. It is possible that the risk-adjusted interest rate may even fall as the nominal interest rate is increased.

51. Fourth, these ever-present threats have been exacerbated by financial market integration. Countries that have fully opened their capital accounts, have engaged in financial market liberalization, and have relied on private finance from international capital markets are among those likely to be most adversely affected. Many countries have come to rely on foreign banks, some from countries that were poorly regulated and followed inappropriate macroeconomic policies and that now find their capital badly impaired. These institutions are now repatriating capital, with adverse effects on developing countries. The difficulty is compounded by the fact that many developing countries have entered into free trade agreements (FTAs), bilateral investment treaties (BITs) and World Trade Organization commitments that enshrine the policies of market fundamentalism noted above and further limit their ability to regulate financial institutions and instruments, manage capital flows, or protect themselves from the effects of financial market protectionism.

52. In the past, those developing countries that have accessed IMF financing have been constrained by international financial institutions to adopt restrictive policies in times of slow growth or even recession. Such pro-cyclical policies are counterproductive, since one of the purposes of assistance should be to enable developing countries to stabilize their economies. But in the current global crisis it is not just the developing countries that are forced to adopt such policies that suffer; the entire global economy suffers. International responses require all countries to engage in expansionary policies—*including developing countries*. The purpose of IMF assistance should be, in part, to enable the developing countries to participate in this global effort. Even without these artificially imposed constraints, the natural market constraints referred to earlier may impede developing countries, even those receiving assistance, from having counter-cyclical policies as strong as would be desirable.

53. The legacy of past imposition of pro-cyclical policies may itself exert a depressing effect on developing countries today, unless there are strong and clear signals of a marked change in the policy regime. These countries may have to pay higher risk premiums in the current crisis as market participants know that they are likely to face a deeper and longer downturn than they would have had they been allowed to pursue more counter-cyclical policies. Unfortunately, the signals are mixed: constraints on implementing counter-cyclical policies have become apparent in the current crisis in the conditions attached to IMF programs in several countries.

54. More broadly, developing country dependence on IMF financing has constricted policy space for counter-cyclical policy. Concerns about future imposition of these constraints have contributed

to several countries building reserves and global imbalances. Unless the policy regime is changed, incentives for further build-up of reserves could increase, impairing the ability of the global economy to emerge quickly from the global economic crisis.

55. If appropriate measures are not taken quickly by the international community, developing countries may, in fact, be hurt rather than helped by the responses of developed countries to the crisis. In the short- and medium-term, it is necessary that developing countries undertake a variety of counter-cyclical policies—including social protection measures, infrastructure development, and credit guarantees—and it is imperative that developed countries provide them with appropriate assistance and policy space to do this. Such measures may also ensure fair global competition.

56. The major focus of this report is on short-term measures and the longer-term reforms of the international financial system that support the developing countries and their aspirations for development. As noted above, developing countries will bear the greatest costs of the crisis but do not have the resources necessary to deal with its negative impacts. Measures are needed very quickly to avoid further deepening of the crisis in emerging and developing countries, including restoring and expanding social protection and reducing the pro-cyclical features of economic policy. Delay will mean that the eventual cost of dealing with the problem will be higher, and the length and depth of the downturn will be greater, with more innocent victims losing their jobs, with more small—and even large—businesses forced into bankruptcy, and with public finances increasingly put in jeopardy. The consequences of our current failures may be felt for decades to come.

57. This report presents its analysis and recommendations in the following four chapters. Chapter 2 deals with the macro issues and perspectives lying behind the crisis and the measures that need to be taken to overcome it. Chapter 3 deals with the causes of instability in the financial system in particular and impact on the overall economic system, as well as those measures that should be taken to ensure financial stability at the level of individual financial institutions and at the systemic level. In Chapter 4 the report assesses the adequacy of existing international institutions, how they should be reformed, and new institutions that could be created to make the system more stable and better able to serve the needs of developing countries. Finally, Chapter 5 deals with International Financial Innovations, those measures that might be introduced to what is called the international financial architecture to meet the needs of the globalized world of the 21st Century.

CHAPTER 2: MACROECONOMIC ISSUES AND PERSPECTIVES

1. While the current economic crisis is global in its causes and ramifications, the responses to the crisis have been decided and implemented at the national level. Little attention has been given to the global externalities and spillovers that arise out of those uncoordinated decisions. The challenge raised by the crisis is to design a framework and roadmap for a coordinated, global response that recognizes the differing constraints facing individual countries, particularly the most vulnerable developing countries.

2. Coordination is essential to the success of the different actions currently being implemented by governments in response to the crisis because the impact of individual policies will depend on actions undertaken by other countries. It is important that national governments recognize that their policies will be more effective in protecting their citizens from the crisis if they are internationally coordinated.

3. Failure to coordinate policies can lead to growing global imbalances and increased exchange rate and asset price volatility, which will impair a return to robust and sustainable growth. Protectionist measures introduced in response to the crisis would impede the speed of global recovery

4. National policies introduced in response to the crisis may have unintended and unforeseen protectionist effects. While measures such as guarantees and bailouts may not be intended to provide trade protection, they may nonetheless create advantages restricted to domestic firms. Thus, it is important to design measures that protect domestic residents without increasing trade protection. It is also necessary to find ways of extending social protection without such protectionism. One major lesson of the Great Depression is that certain forms of protection are likely to be counterproductive. In current conditions, the effects of protectionism may be even worse because of the increased global integration of trade and production.

5. Developing countries and other emerging markets are more exposed to these adverse effects. A globally "balanced" response to the crisis will require both coordination of national recovery programs and, because many developing countries do not have the requisite resources, a substantial increase in official assistance to developing countries.

6. The objectives of national and international policy should be a quick recovery and protection of vulnerable populations, who are likely to be the most adversely affected, and in ways that promote equitable, democratic, environmentally and socially sustainable development. It should, at the same time, facilitate the necessary restructuring of national economies and the global economic system.

Sources of the Crisis

7. There have been many failures behind the current financial crisis. Chapter 3 of this report analyzes regulatory failures in developed country financial systems and management of risk. But macroeconomic failures were part of other failures. It is important to understand these interrelationships in order to design policies that will allow the global economy to emerge from the crisis with more robust growth and to make recurrence of crisis less likely.

8. The sub-prime mortgage crisis, which led to a wider crisis in credit markets, was partly caused by an "excess" supply of liquidity in global capital markets and the failures of the central banks in the United States and some other advanced industrial countries to act to restrain liquidity and dampen the speculative increases in housing and other asset prices. While lax financial regulation may have contributed to the particular *form* taken by the crisis, the magnitude of this excess liquidity, and other associated factors, made further difficulties likely.

9. While problems initially appeared in the financial sector, the origins of the problem were deeper and cannot be addressed *simply* by repairing the "plumbing" of the financial sector. For example, the rise of income inequalities discussed below and inadequacies in competition policy and corporate governance, discussed in Chapter 3, were of major significance.

10. Focusing attention on public policy failures should not, however, divert attention from underlying market failures. Financial markets mismanaged risk and misallocated capital. Had markets done what they should have, the availability of capital at low cost could have led to large increases in productivity, rather than further impoverishing lower income Americans.

11. The similarities between this crisis and several other financial and economic crises, including the Great Depression, suggest that economic policies have not fully taken into account the lessons of those crises. Part of the reason for this lies in economic doctrines that became fashionable in some quarters during the last three decades.

12. As the international community frames an immediate response to the crisis, it would be a mistake to forget this broader context. The present chapter thus focuses on macroeconomics—both the underlying macroeconomic problems and the necessary macroeconomic policy responses that will make for a speedy recovery and make recurrence of the crisis less likely.

Role of economic doctrines

13. Part of the explanation of the current crisis may be found in the underlying economic fundamentals. Another is in the economic theories that motivated the financial and economic policies that produced the crisis. A more detailed discussion of the impact of these economic doctrines on regulatory policy is found in Chapter 3. These same economic doctrines—the belief that economic agents are rational, that governments are inherently less informed and less motivated by sound economic principles and therefore their interventions are likely to distort market allocations, and that markets are efficient and stable, with a strong ability to absorb shocks—also affected macroeconomic policies.

14. One of the most important lessons of the Great Depression was that markets are not self-correcting and that government intervention is required at the macroeconomic level to ensure recovery and a return to full employment. In the aftermath of the Great Depression, governments introduced policies that provided automatic stabilizers for aggregate demand and implemented discretionary policy frameworks to reduce economic instability. But as the Great Depression and earlier panics and crises faded from memory, confidence in the self-stabilizing nature of the market returned.

15. The fact that the world recovered so quickly from financial crises such as the East Asian crisis of 1997-1998 and the global liquidity crisis of August 1998 induced false confidence in the self-correcting nature of market processes. While the recovery was due to public policies, it was credited to market processes. More generally, the historical role of government intervention in recovery and stability was forgotten.

Changes in the global economy

16. The level of international economic interdependence may also have contributed to an increase in vulnerability of the global economic system to external shocks that produce larger negative impacts on global aggregate demand.

17. In some countries, the weakening of social protection and the reduced progressivity of income tax systems weakened the automatic stabilizers. In some countries, structural changes within the market had similar consequences. Too often in national policy discourse, and even in some theoretical discussion, globalization was used as a pretext for ostensibly competitive reductions in social protection, creating a global race to the bottom.

18. Constraints imposed in the European Union by the Stability and Growth Pact and concerns in other countries about the size of fiscal deficits and national debt may impair the use of counter-cyclical fiscal policies to respond effectively to shocks, including the extra-ordinary shock the world faces today.

19. The expansion in lending associated with new risk management practices, deregulation, and accommodating monetary policy allowed consumption to grow more rapidly than incomes. However, this support for aggregate demand in the face of rising income and wealth inequality came at the costs of increasing household indebtedness to unsustainable levels. Moreover, policies in many developing countries aimed at reducing external constraints led to ever-increasing global imbalances. In some of these countries these policies and the trade surplus to which they led were a defense against international financial volatility.

Growing inequality as a source of the crisis

20. Although economic globalization has supported rapid increases in GDP, the real increases in societal wealth were smaller because of growing environmental damage, which took a significant but largely overlooked toll. Globalization has also produced increased volatility in incomes and increasing income inequality. It has been associated with increasing inequality of income not only within developing countries but also among developing countries and between developed and many developing countries. Inequality has also increased within developed countries. When combined with changes in financial markets, this growth in inequality has had important consequences for the evolution and resolution of the crisis.

21. It is now recognized that in most advanced industrial countries, median wages stagnated during the last quarter century, while income inequalities surged in favor of the upper quintiles of the income distribution. In effect, money was transferred from those who would have spent to meet basic needs to those who had far more than they could easily spend, thus weakening aggregate effective demand.

22. There were many forces contributing to this growth in inequality, including asymmetric globalization, especially that facilitated the greater ease of the movement of capital than of labor, the weakening of labor unions, deficiencies in corporate governance, and a breakdown of social conventions which resulted in greater disparities in compensation between top executives and other workers. Finally, it was believed that increasing after-tax remuneration and providing other economic incentives, like non-monetary benefits, would increase savings, labor supply, investment, and thus growth. These problems were exacerbated by the reduction of progressivity in tax structures in some countries. In most OECD countries, the tax rate for the highest tax bracket has been reduced by more than 10 percentage points on average.

23. The negative impact of stagnant real incomes and rising income inequality on aggregate demand was largely offset by financial innovation in risk management and lax monetary policy that increased the ability of households to finance consumption by borrowing, especially in the United States and some other developed countries such as the United Kingdom. On the other hand the search for yield by the higher income classes to invest their increased incomes supported the formation of asset bubbles. But increasing household indebtedness was not sustainable. Or rather, what was perceived to be sustainable was dependent on artificially inflated asset prices that created the illusion that household wealth was increasing at a faster pace than their debt. The support for the bubble thus depended on expansionary monetary policy together with financial sector innovation leading to ever-increasing asset prices that allowed the households virtually unlimited access to credit.

24. It is possible to argue that the increase in public debt in some OECD countries was partly the consequence of the evolution of the distribution of income. In some advanced countries such as those in the European Union, social protection systems that provided partial compensation for stagnating income in a context of high unemployment were financed through increased public deficits and public debt.

25. In countries where the social protection system is much weaker (e.g., the US), increased household borrowing may have postponed a decline in living standards and consumption in tandem with the decline in real wages.

26. The 2001 and 2003 tax cuts in the United States provided little stimulus to the economy but had a negative impact on government deficit and debt, reducing the room for fiscal policy measures to deal with rising unemployment and placing a greater burden on monetary policy.

27. The Iraq War and other events that helped increase the price of oil had a further depressing effect on countries that import energy, including the U.S. The magnitude of the increase in energy prices was exacerbated by financial speculation. This change in the price of energy, accompanied by government support of the production of bio fuels, contributed to higher food prices. The sharp increase in energy prices thus directly and indirectly brought further reductions in purchasing power in many countries. Since a large fraction of low income households' budgets are spent on energy and food this further increased income inequality. Moreover the transfer of income, from those who suffered from these price increases to those who benefited, weakened global aggregate demand and contributed to the global imbalances that played an important role in the crisis.

28. While the negative impact of income inequality and energy, commodity, and food inflation on global aggregate demand was thus temporarily offset by mounting private and public debt, it should be clear that this was not sustainable. But those responsible for macroeconomic management, including the monetary authorities, failed to recognize this and to take appropriate actions.

29. Policy responses designed to ensure a robust and sustainable recovery from this crisis must address the question of how growing inequality of income and wealth might be reversed. Should the trend towards reducing the progressivity of the fiscal system be reversed? Capital mobility in the absence of tax harmonization among countries has contributed to tax competition, undermining the ability of governments to impose taxes on capital. Should some harmonization of business taxation throughout the world be advocated? Are there ways of directing public attention to inequality—which in turn might translate into public action? Should, for instance, changes in inequality in each country become public knowledge through a yearly parliamentary debate?

30. One thing seems to be certain: the use of fiscal advantages to attract foreign investors that has become common with the globalization of production is not sustainable for at least two reasons. The first is that it contributes directly to the rise in inequality through a regressive redistribution of income; the second is the indirect rise of inequality that results from the reduced capacity of governments to provide public goods to the population.

Global imbalances and imbalances in global aggregate demand

31. Part of the reason the United States was able to sustain an expanding external deficit was the decision of many emerging market countries in Asia and Latin America to respond to the financial crises in the 1990s by adopting policies to strengthen their external balances. As some other emerging market countries chose deliberately an export-led growth strategy, the resulting increase in foreign exchange reserves, along with the increasing reserves accruing to oil-producing countries from higher oil prices, were invested in official dollar assets and provided the financial counterpart to the rising US external deficits.

32. The apparently unending increase in what came to be known as global imbalances raised concerns that they were unsustainable and that their disorderly reversal might generate a global financial disruption or exchange rate crisis. But those responsible for global macroeconomic management did not take appropriate action.

33. There were several reasons why many emerging markets strengthened their external accounts, so much so that foreign reserves had grown to $4.5 trillion by October 2008. The first was to prepare a defense against instability due to volatile external financial flows. Countries with insufficient reserves had paid high economic and political costs in the East Asia and global liquidity crises at the end of the previous decade. The loss of economic sovereignty associated with the imposition of pro-cyclical macroeconomic conditionality (as well as other forms of conditionality) as part of International Monetary Fund support programs has also been a source of particular concern to many countries. In addition, some countries had adopted exchange rate stabilization as part of their policies to ensure external balance and stability; some of these countries built up substantial reserves as a result of attempts to prevent exchange rate appreciation, with its adverse effects on economic development (as discussed further in Chapter 5).

34. Moreover, many developing countries, especially those deriving export incomes from the sale of primary commodities, benefited from rising prices due to rising global growth that accompanied the credit expansion before the crisis. Speculative activity in recent years may also have contributed to rising prices. But, this beneficial trend in prices was also accompanied by increased volatility. Many countries reacted by increasing their prudential reserves during periods of rising prices. These reserves have provided a useful cushion as prices have declined after the outbreak of the crisis.

35. The collapse of the U.S. mortgage market and the accompanying decline in house prices have produced a sharp increase in household saving and a decline in investment in the US. Other countries had real estate bubbles which also collapsed, with similar consequences. These difficulties in the real estate sector precipitated problems in financial markets, discussed more extensively in the next Chapter. The problems of bad lending were aggravated by high leverage and other risky behavior, as well as by a lack of transparency. The resulting collapse of credit reinforced the underlying weakening of aggregate consumption, leading to a rapid decline in global aggregate demand. Declines in final demand as well as increasing cost and decreasing availability of credit led to inventory adjustments which accelerated downward movement in global GDP. But it is important to note that while the inventory adjustments may have aggravated the crisis, they are not part of the underlying cause. Thus, the downturn will not end even when these inventory adjustments are completed; there will be no automatic economic recovery.

36. Indeed, unless there is a coordinated policy response to this crisis that supports global demand, it is possible that the problem of global imbalances may be exacerbated. With countries facing the threat of high volatility in export earnings and global financial flows, it is rational for countries to increase precautionary savings to protect against future potential calamities. While it is rational for individual countries to "insure" against another crisis through the build-up of external surpluses and foreign reserves, doing so weakens global aggregate demand. The absence of alternative means for self-protection may not only impair a robust and sustainable recovery, but also lead, in the long run, to further instability. The implication is that a reform of the Global Reserve Currency System that provides an acceptable means of risk mitigation is imperative. Proposals for how this may be done are made in Chapter 5.

37. It is important that the international community address not only the issue of risk mitigation but also the underlying sources of volatility and the mechanisms by which a financial crisis in one country gives contagion to others. Commodity price speculation, as already noted, probably contributed to the magnitude of price volatility. Reforms in the global financial system, particularly capital and financial market liberalization, have facilitated international contagion and thereby increased the risk of volatility originating from abroad.

Instability and built-in destabilizers

38. Another major source of concern is the limited ability of the economic system to respond to shocks. As noted above, economic systems may have become more unstable as a result of weakening both public and private automatic stabilizers through the reduced progressivity of tax structures, weakening of safety nets, greater wage flexibility, and the movement from defined-benefit to defined-contribution schemes for workers' retirement accounts. New bank regulations, including mark-to-market accounting, may actually have created built-in destabilizers.

39. An important part of the response to the crisis should therefore be the strengthening of the automatic stabilizers and, more broadly, the adoption of policies that not only reduce the shocks to which economies are exposed but that also dampen the impacts. Strengthening automatic stabilizers will also contribute to the long-term sustainability of growth by reducing the risk associated with income volatility. Chapter 3 discusses one important reform: counter-cyclical capital adequacy and provisioning standards.

40. Unmanaged flexible exchange rate regimes may expose developing countries to high levels of volatility, especially when combined with certain monetary policies. Countries that raised their interest rates in response to high food and energy prices saw large appreciations of their currency; this has now been followed by large depreciations. Such volatility exacts a heavy toll on developing countries.

International Responses: Fiscal Policy

The need for and the nature of a globally coordinated response

41. This crisis is different from the financial crisis of 1997-1998. Then, the affected countries used exchange rate adjustments and other policies to export their way out of the crisis. In a global crisis affecting all countries, this solution is not possible. It is thus imperative that all countries take strong, coordinated actions to stimulate their economies.

42. There will be some temptation for countries, especially those with small, open economies, to avoid taking action and benefiting from the expansion that will result from stimulus policies introduced in other countries. As countries balance the trade-off of the benefits of expansion against the costs of increased debt-financed government spending, the risk is that they will undertake insufficient action (when viewed from a global perspective) and, as a result, the global stimulus will be deficient. If all countries think in this way, the global downturn will be more prolonged. Furthermore, when the recovery occurs, it will be more fragile because of an unsustainable distribution of public debts among countries. Hence rapid and sustainable recovery depends on there being no free riders.

43. Moreover, countries will look for those forms of expenditure that have the largest domestic multipliers. What is at stake is illustrated by the fact that national expenditure multipliers are generally believed to be around 1.5, due to leakages of demand abroad through increased imports. But from a global perspective, there can be no such leakages (though multipliers will still be limited by savings), so that multipliers for a coordinated global expansion are, in reality, much larger.

44. The implication is that a global crisis requires a global stimulus—it is much like a global public good. The desirable level of the global stimulus is greater than the level that would be implemented by each country thinking only of itself. Moreover, if every country attempts to maximize the domestic impact of its stimulus policies (for example by limiting expenditure on imports), the domestic and the global effectiveness of the policies, measured by the expansionary impact per dollar spent, will be reduced.

45. Similarly, there will be a temptation in many countries to maximize the domestic impact of their stimulus policy expenditures by introducing protectionist measures that limit leakages of demand

into imports from foreign countries. Such measures are more likely to be introduced if countries perceive that others are free riding on their efforts. While these measures may be introduced with the best of intentions, to maximize social protection, they may not respect equal treatment trade principles and, when imitated by others, are likely to be counterproductive. The fact that so many countries have already introduced such protectionist measures should be viewed as a cause of concern. But even measures not designed to have protectionist effects may do so, as noted below. These protectionist measures, both when they are intentional and when they are unintentional, can be particularly harmful to developing countries.

46. There would be additional benefits from a globally coordinated fiscal response if significant proportions of these expenditures are directed at addressing global problems.

The need for stronger social protection

47. Social protection is not only an instrument of social justice but also a major tool of economic stabilization. Well-designed social protection systems make the economy more resilient to shocks by increasing the size of automatic stabilizers. Social protection systems have two components. The first is insurance against risks. It enables smoothing of disposable income, while the enhanced security is of value in its own right. The second component is progressive redistribution, to avoid exclusion and to prevent individuals from being trapped in poverty. Social mobility ("giving to my children better opportunities than I had") is one of the engines of growth and prosperity. But social mobility is all the more likely when "counters are reset," at least partially, at each generation. One of the roles of social systems is a transfer of resources that helps reduce inequalities of initial conditions for each new generation.

48. Besides its role as "insurance" against income and consumption fluctuations, especially for poorer households, social spending has a more direct impact. Increasing the supply of public goods would free part of the income that is now saved for precautionary purposes and make it available for spending, including investment in both physical infrastructure and human resources. In other words, social spending could "crowd in" private investment and raise the economy's current and future growth rates while decreasing its volatility.

Monetary Policy and Restructuring Financial Markets

49. It is equally important that monetary policy be coordinated across countries. In the absence of coordination there may be large, costly, and destabilizing exchange rate movements. But it may be difficult to achieve the necessary level of coordination, given different circumstances and views of the role and objectives of monetary policy. Conventional monetary policy measures to combat the crisis appear to have been exhausted in several major countries. Interest rates in the U.S. and some other countries cannot go much lower. This is one reason why most of the burden of the economic policy response to the crisis must now fall on the shoulders of fiscal policy.

50. Monetary policy operates by increasing the availability of money and credit and easing the terms at which credit is available. Credit availability is mediated mostly through the banking and financial system. Providing more liquidity to financial institutions may not, however, lead to more lending. A kind of liquidity trap can arise in circumstances such as those the world is facing today. Banks that have seen large erosions in their net worth and that face the prospect of high default rates on

existing risky loans are not disposed to increase lending. There may, of course, be overreaction: an episode of excessive risk taking may be followed by an episode of excessive precaution. If that is the case, governments may need to take a more active role in absorbing some of the risk of lending. Chapter 5 discusses some ways in which this may be done.

51. It is thus probable that traditional monetary policy, by itself, will have only limited effects in resuscitating the global economy; a reduction in interest rates will have an insufficient impact on aggregate demand unless there is an expectation of increased levels of activity and profits.

52. Monetary policy has traditionally focused on the overnight interest rate at which banks borrow from each other or from the central bank at the discount window. The spread between the policy interest rate and the interest rate at which firms or households can borrow in the medium and long-term is an endogenous variable which may actually increase as the policy rate falls. This may be because of changed inflationary expectations or because other changes in the economy result in heightened risk perceptions for lenders. It is possible for monetary authorities to influence longer-term interest rates for government securities and private sector liabilities by opening the discount window to them or by buying them outright through open market purchases. However, this would require the central banks to assume risks beyond those that they have assumed in normal times through their lender-of-last-resort function. It is important that when central banks assume such risks they estimate the future actuarial cost carefully and, to the extent possible, that those costs are reflected in the public domain.

53. When policy intervention involves the purchase of the liabilities of particular private sector issuers, this may be equivalent to an implicit subsidy on the financing costs for that sector. If it is restricted to some very large firms, it may place other, especially small and medium-sized firms, at a disadvantage.

54. In the interests of transparency and accountability, since the costs of these actions may have an impact on resource allocation as well as on the balance sheet and the receipts of the national treasury, it is desirable that these decisions be ratified by parliament. This does not imply that central bank independence should be limited. It is the simple recognition that central bank operations that have fiscal consequences should be subject to the same surveillance as treasury operations.

55. At the same time, it needs to be recognized that traditional prudential policies may also have significant impacts on credit availability and the terms on which it is available. There is a fundamental difference between prudential policies affecting a single bank and those that affect an entire banking system. The introduction of prudential regulations, such as increasing collateral requirements in response to financial difficulties has, in the past, produced excessive credit contraction. While getting the balance right is extraordinarily difficult, central bankers need to be attentive to the macroeconomic consequences of prudential policies. On the other hand, if a policy of forbearance is adopted, it must be accompanied by increased supervision to offset the possibility of moral hazard leading to excessive risk-taking and fraudulent behavior.

56. In some economies, both conventional and unconventional monetary policies are actively being used to prevent a deepening of the financial crisis and its harmful impacts on employment and income. Part of this is in response to the fact that capital markets have proved inefficient, and these policies are a direct response to such inefficiencies. Nevertheless, as a result of the actions of central

banks, there is concern among some observers about high rates of inflation in the short to medium-term. While trade-offs between preventing downturns and causing inflation will differ from country to country, at the current juncture, there is a need for global coordination of expansionary policy. In the future, when the current severe crisis appears mitigated, governments and central banks will have to make the difficult decision as to whether and how to retract liquidity. This will certainly depend on the particular context of the country and will require careful balancing of the risks of a return to recession versus accelerating inflation. However, in present conditions the balance of risks appears to be clearly on the side of deflation rather than inflation.

Bailouts

57. Bailouts of financial and non-financial institutions have become a distinguishing feature of the macroeconomic policy responses to this crisis. They have changed expectations of the future development of global financial markets. The efficiency of the bailouts will affect the pace of recovery, the level of the national debt, and the ability of a country to pursue a broader range of objectives. One important goal of the bailouts should be to facilitate a restructuring of the financial sector in ways that enhance economic stability and growth. Bailout decisions must be made with the future design of the financial structure in mind. The financial system of the future must avoid the structural flaws revealed in the recent crisis. In many countries, the financial system had grown too large; it had ceased to be a means to an end and had become an end in itself. The bailouts must be designed to facilitate the restructuring of the financial system, strengthening its capacity to perform its basic functions, including providing finance for small and medium sized enterprises.

58. The primary concern in this report is the impact of these policies on developing countries and the impact of badly structured bailouts in diverting capital resources from developing countries, impeding their long-term growth prospects. For developing countries especially, the new global financial system should provide better risk management than in the past and provide a more stable source of funding, including funding for small and medium-sized enterprises. In the past, the global financial system has exacerbated economic fluctuations in many developing countries by providing funds in a pro-cyclical manner. It also diverted funds away from lending to small and medium-sized enterprises and forced developing countries to bear a large fraction of the risks they face, including those associated with exchange rate and interest rate fluctuations.

59. In assessing the policies introduced in response to the crisis, distinctions needs to be made among the various impacts on the economy. The primary focus of any bailout is to restore credit flows to the real economy and to contribute to macroeconomic recovery. However, there are distributional impacts of a bailout, and its design will affect stakeholders—equity shareholders, bondholders, workers, firms and households seeking credit—in different ways. There is concern that in some countries there has been excessive focus on saving bankers, bank shareholders, and bondholders instead of on protecting taxpayers and greater focus on saving financial institutions than on resuming credit flows.

60. One result is that the bailouts have been more costly than they might otherwise have been; another is that the bailouts have been viewed to be very unfair. A third result is that there has been a massive redistribution of wealth from ordinary taxpayers to those bailed out. A bank at risk of being unable to meet its obligations to depositors can be restructured by forcing unsecured debt holders to restructure their claims, diminishing debt and converting the residual into equity. Alternatively,

taxpayers can finance a bailout. The latter approach, by subsidizing bondholders who did not have explicit guarantees, may serve to strengthen problems of moral hazard in the future, undermining incentives of those providing credit to engage in due diligence. Because resources are scarce, and the national debt will be larger as a result of a taxpayer financed bailout than it otherwise would have been, there will be less to spend on a stimulus package, on social protection, or on public investments. The perception that the bailouts have been unfair may impede future actions to resuscitate the financial system or to undertake other actions necessary to address the crisis. The fact that the bailouts have, in many cases, been slow to restart lending is of particular concern because if this continues, prospects of a robust recovery are diminished.

61. Finally, the perception that the bailouts have been unfair may be corrosive to the reputation of the government with longer-term adverse effects. A demoralized body politic that does not believe that government representatives can implement desired change equitably may choose in the future to elect officials who reflect their pessimistic views of the capacity of the public sector to play a constructive role. This would diminish society's capacity to achieve collective responses to many challenges not well-handled by private markets alone.

62. Given that the focus should be on restarting lending, governments should expand their strategies to include additional options such as the establishment of a new bank or banks operating without the bad debts of the failed institutions and the provision of (partial) guarantees for new lending. The terms on which any newly established banking institution should be provided support should not give the new bank a competitive advantage over existing banks that have not required additional funding. It makes more sense to focus more attention and resources on future growth than on dealing with the mistakes of the past.

63. In transferring assets and liabilities between the public and private sector, particular attention needs to be given to the prices paid. Overpaying the private sector for a particular asset or bundle of assets represents an unwarranted transfer to the firm at the expense of the taxpayers and an inefficient use of public funds. Preventing such transfers is, however, difficult, given that one feature of this crisis is the failure of markets to function properly in setting accurate prices. In such a situation, minimizing the scope for unwarranted transfers from the public to the private sector should be one objective of public policy. Similarly, in providing equity injections to banks, it is important that the value of the shares obtained be commensurate with the funds provided. This has not been the case in some countries.

64. There is a strong presumption that government should set rules to protect taxpayers and to ensure that financial firms play by the rules. These rules entail reorganization when bank capital falls below certain levels. Banks that are too big to fail are not too big to be financially reorganized. Financial reorganizations that shift some of the costs from shareholders and bondholders to taxpayers not only represent an inefficient use of public money but also lead to future moral hazard problems as noted above. Public subsidies to the financial sector lead to distorted resource allocations. The fact that there have been repeated bailouts of the financial sector suggests failures in their ability to assess creditworthiness and systemic problems that must be addressed, both as part of the bailout and of the long-term strategies for preventing future crises. More discussion of these issues is found in Chapter 3.

65. Six principles should guide bailout design. They should: (a) restore capital adequacy; (b) impose minimal burdens on the public sector budget; (c) establish proper governance/incentive structures; (d) reduce—and certainly not exacerbate—existing problems in the financial system; (e) be viewed as fair to all stakeholders; and (f) be designed to rekindle lending. In some bailout plans, most of the capital has been supplied by the government, while the government has little or no role in management or governance. A failure to align ownership and control almost inevitably gives rise to incentive problems, some of which have been manifest in recent bailouts, where attempts at recapitalization have been partially undone as the banks have paid out large amounts in bonuses and dividends.

66. Moreover, some bailouts of financial firms in the wealthiest economies have exacerbated the problems arising from institutions that are "too big to fail." The bailouts have provided money to large failing institutions without penalizing them for their misallocation of resources. Moreover, this encourages further consolidation, thereby increasing systemic risk in the future.

67. Such consolidation strengthens a market structure deeply infused with moral hazard and prone to repeated bouts of excessive risk taking. The mere fact of the vulnerability of the real economy to spillovers from the financial crisis informs the expectations of risk takers. Confidence in their ability to secure bailouts has been greatest among the very politically influential chief executives of large, highly leveraged institutions. The international community (through the G-20, Financial Stability Board, and Bank for International Settlements Committees, among others) must give more substantial consideration to the long-term consequences of too big to fail institutions if they are to design sound public policies for the world economy using the lessons of this crisis. Excessive deference to the wishes of large institutions for particular regulatory designs has been, and will continue to be, part of the problem rather than part of the solution to this very damaging experience.

68. The variety of forms of subsidies to the banking system (including direct subsidies and guarantees) is costly, distorts resource allocations, can distort incentives going forward (the moral hazard problem noted earlier), and creates an unlevel playing field in finance among countries, to the disadvantage especially of those developing countries that cannot afford such subsidies. This is true even if such assistance is viewed to be necessary to stabilize the financial system. Some guarantees may even impede the resolution of bad debts, especially when banking systems allow impaired assets not to be marked to market. Some governments may have undertaken less transparent and less efficient methods of assistance to hide the long-run costs from their taxpayers. The potential future costs of all such assistance should be recognized on government budgets at the time the guarantees are provided.

69. The use of guarantees may also serve to impair the credit quality of the sovereign debt of the country providing the guarantee when the balance sheets of impaired financial institutions are very large in relation to the size of the economy. The credibility and effectiveness of these guarantees may also be called into question in such cases.

70. Providing more money to financial institutions that supply credit to small and medium-sized enterprises may be viewed as more effective in rekindling lending than giving money to those financial institutions that were more engaged in trading and speculation. In any case, any strategy for

restructuring the financial system needs to focus on the functions which the financial system should be providing and take due account of the repeated failures in recent decades.

The Role of Central Banks

71. Several aspects of the conduct of monetary and credit policies contributed directly to the crisis. The deregulatory pressures of the last two decades as well as the successful management of recent financial crises, which led to a larger appetite for and a lower price of risk, were central to the breakdown of the financial system. Regulators leaning against these currents faced substantial pressure. These issues are discussed more extensively in Chapter 3. This section focuses on central bank monetary policies and the aspects of central bank governance that may affect their conduct of monetary policy. Certain widely held beliefs about the appropriate role for central banks and the appropriate design of their policies may have contributed to these problems.

72. There has been widespread belief that price stability was necessary and (nearly) sufficient for economic growth and financial stability. However, success in stabilizing goods prices was often accompanied by inflation in asset prices. Decisions to focus on price behavior in the real sector (i.e. on consumer prices) led central banks to ignore the broader impact of financial innovations on risk and liquidity management in financial markets. Thus, while price stability was achieved, central banks did not prevent, and may even have contributed to, the gravest financial turmoil since the Great Depression. In particular, it is clear that the economic cost of this financial fragility was much greater than the economic costs that might have resulted from the slight distortions in resource allocation caused by the relatively modest price misalignments that can arise with uncoordinated price changes in the presence of low to moderate inflation.

73. Underlying these failures was perhaps an excessive reliance on a particular set of models making unrealistic assumptions concerning rational behavior that ignored key aspects of the economy, including the importance of information asymmetries, the diversity of economic agents, and the behavior of banking institutions. They focused on the efficiencies arising from the diversification of risk associated with securitization while ignoring the problems of information asymmetry to which securitization gave rise.

74. In the period before the outbreak of the crisis, inflation spread from financial asset prices to petroleum, food, and other commodities, partly as a result of their becoming financial asset classes subject to financial investment and speculation. While it became impossible for central banks to ignore the impact of asset price inflation on goods inflation, the appropriate policy response was not clear. This was the case in particular for central banks following (consumer price) inflation targeting.

75. Countries that judiciously intervened in their foreign exchange markets and capital markets have fared better than those that did not. Risk absorption mechanisms, especially in developing countries, both in the public and in the private sector are not well developed, and the capacity of firms and households is limited because of low levels of wealth available to absorb shocks of these magnitudes and the lack of development of financial institutions to transfer risks from those less able to bear them to those more able to do so. Those central banks that used the full flexibility implicit in an inflation-targeting approach may also have fared better than those that took a more rigid approach.

76. One of the lessons of this experience is that monetary policy decisions should be sensitive to the source of inflation. Increasing interest rates to counter the rising prices of tradable goods in an open economy or increasing government-administered prices is unlikely to have much direct impact on inflation. In some developing countries, these sources of inflation can constitute three-fourths or more of GDP. Hence, attempting to rein in inflation by raising interest rates in these cases imposes a high cost on the economy, and especially on interest sensitive non-traded sectors, without providing the desired stabilization of prices.

77. The recent food and energy crisis also highlighted the problem of the choice of the appropriate target for monetary policy dedicated to price stability. Some central banks have focused on "core inflation," a measure of goods price inflation that excludes the volatile energy and food sectors. But in developing countries this measure of inflation excludes the prices that have the highest impact on household purchasing power and are thus most important in influencing inflationary expectations.

78. Monetary authorities should, at the same time, be sensitive to the consequences of asset price bubbles and other factors that might affect financial stability and thus economic stability and growth.

79. Another lesson to emerge from this crisis is that the definitions of national and global macroeconomic stability need to be broadened. It is clear that central banks need to assess the impact of their policies on aspects of stability other than just price stability. In particular, the stability of the real economy and the financial system should also be taken into account. Macroeconomic policy has, of course, broader goals, including growth and employment.

80. But because these objectives will also be influenced by the behavior of the real economy, including incomes and employment, better coordination of fiscal and monetary policy as well as social policy is required.

81. While high, accelerating levels of inflation impede expansion and have costs that are inequitably distributed across the population, there is little evidence that moderate, non-accelerating levels of inflation have similar consequences. Moreover, history suggests that deflation represents just as great a threat to economic prosperity as inflation. A gently rising price level can have the merit of speeding up the efficiency of the market process in reallocating resources, especially in the presence of downward wage and price rigidities.

Risks and Policy Trade-offs

82. Monetary policy has tended to focus exclusively on the stability of prices of real goods and services. Many central bankers claim that asset price stability is either not their responsibility or they do not have the capacity or instruments to control asset prices. Certain central bank governors, for instance, have claimed that they could not ascertain whether there was a speculative element present in market prices or whether there was a bubble, but that even had they been able to do so, they only had one instrument, the interest rate, to deal with two objectives. Using tight interest rates to dampen asset price inflation would have caused an unnecessary sacrifice of real output.

83. While one cannot ascertain the presence of a speculative bubble with certainty, there are indicators that suggest the likelihood of its presence. But nothing in economics is certain. If policy

decisions were restricted to those actions with certain consequences, no decision would ever be taken. Economic policy is always conducted with uncertainty, and part of the art and science of policymaking is to assess and balance the risks. It is clear that many central banks erred due to their adherence to erroneous economic creeds which held that misallocation of resources would automatically self-correct with minimal dislocations to the economy.

Multiple instruments

84. It is also important to note that central banks do have a number of additional policy instruments at their disposal, such as margin requirements, which—together with other regulatory restrictions discussed in Chapter 3—could have been used to dampen speculative activity in asset markets. It is also not the case that each institution in an economy should use only one instrument and be responsible for only one objective. Such assignments are only viewed as optimal in highly simplified models with little policy value. In a complex economy with considerable interdependence, there are often trade-offs and synergies, requiring multiple instruments to achieve multiple targets. This also needs a high degree of co-ordination among various institutions.

Changing structure of the financial sector

85. The large interventions in financial markets by central banks raise a number of other difficult issues, some of which are discussed below. One overriding issue is the effects of large changes in financial markets in recent decades, such as the growth of securitization, the increasing use of leverage, and the decline in the role of relationship banking. Some failings of the financial system may be related to these changes. Another issue is that government intervention will have an effect on the future evolution of the structure of the financial sector. Governments and central banks need to take decisions that they believe will be most effective in generating the benefits that can be derived from a well-performing financial sector—and that will insulate the real economy from the risks to which it has been exposed as a result of the malfunctioning of the financial sector.

Governance

86. The large role that some central banks have been taking in direct lending to financial institutions raises further questions about the governance of central banks when they are engaged in a quasi-fiscal role. In such a circumstance, is independence from political interference still required by the need to gain "policy credibility?" As already noted, many interventions by central banks have a fiscal character: implicit subsidies and taxes, unfunded or contingent liabilities, etc. While in the past these quasi-fiscal operations were limited and their effect on public finance was more or less regular, they have grown enormously in number and magnitude in the current crisis. The problem is that when central banks engage in quasi-fiscal activity, conventional measures of fiscal activity—such as the deficit of the central government—become misleading indicators of the size or impact of fiscal policy. Therefore, these activities with fiscal implications must be closely coordinated with governments.

Multiple and New Objectives

87. Beyond the immediate issues currently being addressed by most countries—stimulating their economies and restarting the flow of credit—there are some basic problems that have to be

addressed, such as, in particular, redressing national inequalities and global imbalances. The policies currently being introduced to deal with the economic crisis may exacerbate national inequalities and global imbalances.

The need for economic restructuring

88. In addition to the problems confronting the global economy described above, many countries face problems in economic restructuring. Rapid increases in productivity in manufacturing, combined with globalization, have translated into rapid improvements in competitiveness in developing countries, which have resulted in rapid changes in comparative advantage across developed and developing countries which in turn have led to changes in the international division of labor. Such adjustments are always very costly and painful, especially when there is high unemployment, where countries provide insufficient adjustment assistance to their citizens or where many citizens have seen large fractions of their wealth, which might have provided a buffer against such changes, disappear. High interest rates and lack of availability of credit—problems facing many developing countries—hinder adjustments and increase the difficulties of economic restructuring. It is important, of course, to avoid the adverse consequences of dysfunctional, under-regulated financial markets, which can lead to overcapacity and fail to allocate capital to high-productivity uses. (Greater availability of capital at low interest rates provides such dysfunctional financial markets greater opportunities to misallocate resources.)

89. There is also a need to restructure the global economy to meet the challenges of global warming. Providing clear price signals concerning the economic costs associated with global warming would create strong incentives for the private sector, both for households to change consumption patterns and for firms to change production technologies. Restructuring the capital stock would provide large demands for investment that could be a major stimulus for the economy. There may also be a need for government to assist in financing these investments in resource conservation and environmental protection, and so long as markets fail to price these scarce environmental resources appropriately, government subsidies may be required to get efficient resource allocations.

Impacts on Developing Countries

90. Measures are very quickly needed to avoid further deepening of the crisis in emerging markets and other developing countries. These include restoring and expanding social protection and reducing the pro-cyclical features of the economic system. Delay will mean that the eventual cost of dealing with the problem will be higher, and the length and depth of the downturn will be greater, with more innocent victims losing their jobs, with more small, medium and even large businesses forced into bankruptcy.

Why developing countries are being hurt so badly

91. These ever-present threats have been exacerbated by financial market integration. Many countries have come to rely on foreign banks. Some foreign banks from countries that had inadequate regulation and followed inappropriate macroeconomic policies find their capital badly impaired. They are now repatriating capital with adverse effects on developing countries. The difficulty is compounded by the fact that many developing countries have entered into (North-South) free trade agreements (FTAs), bilateral investment treaties (BITs), and World Trade

Organization (WTO) commitments that prevent them from regulating the operations of financial institutions and instruments or capital flows.

92. For example, if a developing country decides to nationalize some services such as banking, this can require compensation if the sector has been liberalized under the WTO GATS Financial Services Agreements (FSA) or under an FTA or BIT. When these agreements and commitments are enforced, developing countries have to pay compensation or suffer the imposition of tariffs on their exports to the complainant if they do not or cannot comply.

The role of protectionism

93. These adverse effects of financial globalization have been further exacerbated by a new wave of financial protectionism. Governments that have provided large amounts of capital to their banks—either under recapitalization programs or by central banks providing liquidity in unusual ways, with attendant risks to the public finances—understandably expect increased domestic lending. The irony is that this kind of financial protectionism does not seem to be subject to sanctions.

94. Certain policy measures taken by developed countries have exacerbated these problems further. Credit guarantees have contributed to the reversal of capital flows. Even if developing countries believed it was desirable and appropriate for governments to provide guarantees of the depth and breadth provided by some advanced industrial countries, their guarantees would be less credible. Symmetric policies can have asymmetric effects. Credit guarantees are clearly a violation of the spirit of the "level playing field" in international trade that the international community has attempted to construct over the past half century. Most countries providing such extended guarantees have made no attempt to ensure that those receiving these guarantees pay for them on an actuarially fair basis. In the absence of such full payment, such guarantees represent a major subsidy.

95. Market forces and resource constraints may also limit the ability of developing countries to pursue counter-cyclical fiscal policies. They may not have sufficient domestic resources, and when they turn to global markets to finance the deficits required to manage counter-cyclical fiscal policies, they may find international markets either unwilling to lend or willing to lend only at very high interest rates. This is one of the reasons that some developing countries have resorted to policies to reduce external constraints and have built up large reserves (see Chapter 5 for a more extensive discussion of these issues).

96. Market inequities have been exacerbated by government distortions in another way. There have been massive bailouts not only of financial institutions, but also, increasingly, of firms in other sectors of the economy. Most developing countries do not have the resources to match these support measures. Again, this problem may be aggravated if the developing country is party to an international agreement (FTA or BIT). In that case, the agreement would in effect require that if a country wants to support domestic companies facing difficulties, it should provide equal treatment to foreign companies. Here, too, the apparently symmetrical treatment which appears in the agreement can have deeply asymmetrical effects. It would be very difficult for a developing country to bail out a large foreign company, in view of its limited resources, and this could represent an impediment to providing assistance to local companies.

97. The same consideration applies to public procurement policy. But here again, there is an asymmetry. There are multilateral procurement agreements among developed countries, but relatively few between developed and less developed countries. Hence, if a developed country adopts a "buy national" policy with an exception for WTO commitments, the effect is to discriminate against purchases from developing countries that do not have such commitments.

98. In addition, many developing countries have been required by international financial institutions to adopt restrictive policies in times of slow growth or even recession. These policies are markedly different from the counter-cyclical policies adopted by the advanced industrial countries and increase the risks faced by investors in developing countries relative to those in developed countries. In the current crisis, the asymmetry in IMF policy stances has become apparent in several countries. Even the EU is imposing pro-cyclical policies on the enlargement countries, including wage and expenditure reductions in the public sector.

99. More broadly, developing country dependence on IMF financing has constricted their ability to adopt counter-cyclical policies and other counter-cyclical measures and may impede their willingness to turn to international financial institutions in a timely way, resulting in costly delays.

100. If strict measures against protectionism are not taken quickly by the international community, developing countries will suffer from the attempts by developed countries to protect themselves from the crisis. In the short and medium term, counter-cyclical policies, social protection measures, infrastructure development, and credit guarantees are indispensable for developing countries and may enhance global fairness.

Developing Countries and Funding

101. Developing countries will need substantial funding in addition to that provided by traditional sources of development assistance to participate effectively in a coordinated global stimulus. They will also need funds to protect their most vulnerable individuals, to provide trade finance and finance to corporations whose sources of international credit may have dried up, and to bolster domestic financial institutions weakened both by the withdrawal of funds and by the precipitous collapse of export earnings. Developing countries also need low-conditionality financing to compensate them for the adverse effects of the intentional and unintentional protectionist measures of the developed countries. (Indeed, additional funding would be required just to offset the imbalances and inequities created by the massive stimulus and bailout measures introduced in the advanced industrial countries.) Current funding available to help developing countries meet the many shocks to which they are regularly exposed, including the volatility in commodity prices, is insufficient.

102. Sources of funding for developing countries that could be activated quickly and are not subject to inappropriate conditionality are necessary. As in developed countries, substantial portions of this stimulus spending could be directed to environmental measures, especially climate change adaptation, in part fulfilling developed country commitments under the United Nations Framework Convention on Climate Change (UNFCCC).

103. Failure to maintain the levels of official assistance and to provide this needed additional assistance will have long-term effects. There will be an increase in poverty and malnutrition, and the

education of many young people will be interrupted, with life-long effects. The sense of global social solidarity will be impaired, making agreement on key global issues, such as responding to the challenges of climate change, more difficult. Failure to provide such assistance can even impair the global recovery.

104. We welcome the decisions of Member States to complete the issuance of Special Drawing Rights (SDRs) approved by the IMF Board in September 1997 through the proposed Fourth Amendment of the Articles of Agreement to double cumulative SDR allocations to SDR 42.8 billion. The issue of additional SDRs could be essential in support of the counter-cyclical financing needs of developing countries. There are a number of possible mechanisms to facilitate the transfer of SDRs to developing countries for this purpose. They are discussed more fully in Chapter 5. Chapter 5 also discusses proposals to provide such emissions on a more regular basis.

105. In addition, regional efforts to augment liquidity should be supported. For instance, extension of liquidity support under the Chiang Mai initiative without the requirement of an active IMF program should be given immediate consideration. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighboring countries.

106. These further sources of funding should be in addition to traditional official development assistance. More broadly, developed countries must make a renewed effort to meet the commitments made in the 2000 Millennium Declaration, the 2002 Monterrey Consensus, the 2005 Global Summit, and the 2008 Doha Declaration.

107. In thinking about additional funding, it is important to distinguish between support for counter-cyclical macroeconomic policies and longer-term development financing, though increases in the latter can have important counter-cyclical effects. Traditionally, the World Bank and the regional and sub-regional development banks have played the central role in development lending, while the IMF has played a more important role in managing crises. Some studies have emphasized that the IMF should not play a central role in development assistance. But, what role should it play in the provision of credit in the current crisis, and what role should credit itself play?

Grants and concessional lending

108. At the beginning of the decade, there was considerable concern about the excessive debt burdens of developing countries. In addressing this crisis, it is important to avoid a build-up of unsustainable debt or debt that would crowd out developmental efforts. Thus, the bulk of assistance to the least developed countries should take the form of transfers rather than loans. There is concern that the initiatives announced by the G-20 in London largely involve additional provision of credit.

109. A potential source of funding for such assistance would be a commitment by the developed countries to devote 1 percent of any stimulus package to direct expenditures in developing countries. (There is a similar proposal on the part of the World Bank, which we support.)

110. The international community should give consideration to accelerated spending accompanied by an early replenishment of International Development Association (IDA) funding. Without an

early replenishment, the poorest developing countries may be reluctant to accelerate spending, lest there be inadequate resources available in subsequent years.

111. The assistance that we call for in this chapter should be viewed as in addition to existing commitments. The advanced industrial countries should fulfill their existing commitments to provide official development assistance.

Social protection funds

112. Over the longer run, the international community should consider establishing a special facility to provide support for those countries creating strong systems of social protection. While such systems may be largely self-funded, it will take time to build up the required reserves, and the international community should consider back-stopping these efforts. Such commitments might have important incentive effects in inducing the creation of such systems, which would also serve to help stabilize the global economic system through their automatic stabilizers.

Comprehensive involvement

113. The magnitude of the necessary support could be increased by involving multiple sources of funds, including regional development banks, the IMF, the World Bank, and, possibly, a newly created credit facility to be described below.

Harmonization

114. While it is essential to continue the important work of harmonization of official development assistance, it is also important that harmonization, especially of counter-cyclical lending, does not lead to concerted imposition of pro-cyclical conditionalities. This is important given the need for countries to quickly undertake measures to stimulate activity, protect the vulnerable, and maintain the flow of credit.

New credit facility

115. The reluctance of many countries to accept assistance from certain institutions and of some potential lenders to provide funds to certain institutions constitutes an impediment that may not be fully addressed by the reforms likely to be made in the short-run. This reluctance may be especially understandable in the light of the current crisis, because some of these institutions pushed policies on to developing countries that are now recognized to have contributed to the crisis and its rapid spread. The availability of alternative mechanisms of disbursement might not only accelerate the flow of funds but also make it less likely that they will be accompanied by pro-cyclical conditionality, either *de jure* or *de facto*.

116. It is thus imperative that during the recovery phase of the crisis, developing countries should have access to additional sources of external funding, including credit and liquidity facilities for social protection, infrastructure investment, and environmental interventions, for government support, for support of developing country financial systems, and for corporate borrowing. Without such support, the global crisis may grow worse, and long-term global cooperation will be impeded.

117. Existing facilities presently do not meet these needs for several reasons. First, the current system does not provide an efficient mechanism for mobilizing funds available in countries that have accumulated large reserves. It would be beneficial for all participants in the global economy if savings from emerging markets could be utilized in support of developing countries. Government agencies in some emerging market countries that have reserves are reluctant to provide funds to existing multilateral institutions because these countries are under-represented in their governance structures and the policy advice and conditionalities provided by these institutions are considered inappropriate for the needs of developing countries.

118. Given the urgent need for rapid response, a new credit facility might be established under the umbrella of existing institutions administered under more representative governance arrangements, or through the creation of new international economic institutions or facilities. Such a new credit facility could draw upon the administrative expertise of existing institutions and could be created rapidly. Its governance would reflect more recent thinking concerning appropriate voice and representation, ensuring greater say not only for those countries providing the funds but also for recipient countries. The governance structure of this facility could be more modular, with regional groupings (for example, the Inter American Development Bank, the Asian Development Bank, the African Development Bank and others) charged with its operations. The introduction of alternative voting arrangements, including double majority voting, should be given serious consideration. Given the limited remit of the IMF's new flexible credit line and the relatively minimal conditionality related to the usage of funds, it may be easier to achieve agreement on the details of governance.

119. The new funding facilities should be designed with the intention of attracting funds from countries that have accumulated large international non-borrowed reserves. These funding commitments could be backed by guarantees provided by advanced industrial countries. They could be leveraged by borrowing in global financial markets.

120. With regard to the utilization of the funds, there are different (complementary) options. First, there is an urgent need for balance-of-payment and budget financing, with the objective of increasing developing countries' capacities for counter-cyclical fiscal expenditures. Second, the funds could be used for key investments where some of the emerging markets have a particular interest, such as developing agriculture in African countries, including their capacity to export, thus contributing to food security in other regions, for example in Asian and Arab countries. Another possibility is to use those funds to help developing countries finance guarantees for trade credit or for the debt of their corporations, forestalling the risk of a run on these corporations.

121. Special consideration should be given to timely environmental investments addressing problems of climate change. The facility could adopt climate change principles to ensure that the short-run focus of this spending is consistent with longer-term development strategies.

Concluding Remarks

122. As the world addresses the exigencies posed by this crisis through stimulus packages, monetary and credit policies, and bailouts and guarantees, the international community should not lose sight of remedies for the underlying causes of the crisis and of the other major crises which the world faces—including the food, energy, and climate change crises and the debt crises that have confronted so many poor countries in recent years—nor should it ignore the other major challenges

it faces, including the reduction of poverty and inequality. Policies that address the underlying causes are more likely to ensure a robust and quick recovery and to reduce the vulnerability of the global economy to another crisis.

123. National economic systems which give rise to high levels of inequality pose problems, not only for social and political sustainability but also for economic sustainability, i.e., excessive increases of household and public debt. They may also contribute to an insufficiency of global aggregate demand.

124. We have noted that responses undertaken by some countries may have exacerbated some of the underlying problems. As noted elsewhere, bank consolidation increases the risk of creating more institutions that are too big to fail, one of the problems contributing to this crisis and making us vulnerable to another. Similarly, poorly designed bailouts may lead to increased inequality. Moreover, unless policies are well designed, there is a risk that national and government debts will be increased unnecessarily, constraining policy space for the future.

125. The failure of certain national economies to engage in appropriate restructurings and the failure to provide adequate assistance to developing countries without inappropriate conditionalities may contribute to the global imbalances, another major contributing factor to this crisis. Inadequate international responses may (as in the crisis of 1997-1998) contribute to the demand for increased reserves, which in turn may contribute both to global imbalances and to a global insufficiency of aggregate demand.

126. Of particular concern is that the poorest countries not get themselves into another debt trap, which is why it is of such importance that additional grant funding be provided. In this chapter, we discussed several sources of funding; Chapter 5 discusses several other innovative sources of finance.

127. Reforms instituted in the last quarter century have put too little emphasis on the properties of an economic system that contributes to *real* stability—properties which reduce its exposure to risk and which enhance its ability to respond to s*hocks*. Capital and financial market liberalization has exposed countries to more risk, and, in this crisis, has facilitated the rapid spread of the crisis around the world. We have noted that insufficient attention has been paid to strengthening the built-in stabilizers; in some cases, there have been built-in destablilizers. The next chapter discusses some of the necessary reforms in these areas that can enhance stability. In this chapter, we have noted that there are reforms (like enhanced public and private social insurance systems and more progressive taxation) which simultaneously may address problems of inequality and enhance the stability of the economic system.

128. It is also of crucial importance that the crisis response should fully take into account the need for transforming the present mode of growth by trying to slow down the overexploitation of natural resources, in particular of those contributing to global warming. This may imply a change in consumer habits to support environmental sustainability. In this respect, investment in new environment and energy technologies, to address adaptation to and mitigation of climate change, is a formidable opportunity for counter-cyclical stimulus. "New environment and energy technologies" (NE^2T) include all technologies able to lower the energy and emissions content of our standard of living, technologies leading to the production of energy from renewable resources, and technologies

helping to preserve, repair, and improve ecosystems. For developing countries, the full incremental costs of these investments, justified by their global benefit, should be financed by industrialized countries and transferred to developing countries in exchange for commitments on climate change and biodiversity. Such resource commitments have already been made as part of earlier international environmental conventions, but substantial additional resources to fulfill those commitments have yet to be provided. The imperative to address this question is enhanced by the fact that while developed countries are, by far, the biggest global polluters up to now, some emerging market economies could soon become the biggest global polluters. It is thus rational to make large investments today to develop those technologies and to make them available freely to developing and emerging countries through technological transfer. Climate change and biodiversity are quintessential global public goods. Supporting developing countries in their own efforts to address climate change and preserve biodiversity should be seen as part of the solution, and of the way the international community can ensure that these global objectives are effectively addressed.

129. More generally, the need to retrofit the global economy for the exigencies of global warming can provide an important source of aggregate demand (if accompanied by appropriate regulatory policies and policies on the pricing of carbon and if accompanied by adequate finance) to help pull the economy out of the current global economic downturn.

130. To date, there has been little effort to coordinate international responses to the crisis. Reactions in almost all countries have been simply to launch national recovery programs. These programs have been nationally designed with almost no coordination among countries, even in the Euro area. Traditional thinking, derived from crises arising in a single country, entails identifying areas in which domestic multipliers are high. But that kind of approach may lead to recovery programs that are far from optimal not only in magnitude but in design, delivering less global stimulus relative to the size of the increase in total spending or indebtedness. Moreover, underlying problems, like global imbalances, may not only not be addressed but may also be exacerbated. There is a special need for surplus countries to take strong actions. Moreover, macroeconomic coordination would avoid the risk of self-defeating beggar-thy-neighbor strategies aimed at increasing exports while attempting to decrease imports, or increasing credit available to home country firms at the expense of credit available elsewhere. These new forms of protectionism can be as detrimental to the global economic system as the old and more unfair to developing countries. Protectionism through subsidies and guarantees are particularly disturbing, since developing countries cannot match the subsidies and guarantees given by developed countries.

131. Because countries are at different phases of their business cycles, and different countries have different automatic stabilizers and de-stabilizers, mechanisms for coordinating macroeconomic policy and evaluating relative contributions will be difficult. Moreover, different countries have different circumstances—for instance, different inherited debt burdens—suggesting different capacities to implement counter-cyclical policies. Developing countries, in particular, have greater external dependence and vulnerability to external cycles and much weaker capacity to undertake counter-cyclical policies.

132. Still, if governments bear in mind that what is important is not just their liabilities (the national debt) but their national balance sheet (their assets as well), and if they direct much of the stimulus to investments (in infrastructure, technology, and human capital), then the stimulus spending can leave

the country in a stronger position and can be sustained for a longer period of time. This is especially important given that this crisis may be an extended one.

133. A cross-cutting issue is the need for significant improvements in regulatory cooperation. Regulatory and tax arbitrage distort capital allocation and undermine government efforts at reinvigorating their economies that have been the subject of this chapter. This is the subject of the next.

CHAPTER 3: REFORMING GLOBAL REGULATION TO ENHANCE GLOBAL ECONOMIC STABILITY

Introduction: The Economic Crisis and the Failure of Financial Market Regulation

1. This global economic recession is the worst since the Great Depression. It originated in the financial sector in the United States and some other advanced industrial countries. The financial sector is supposed to manage risk, allocate capital, and mobilize savings, all at the lowest possible transaction costs. In many countries, including the U.S., the financial system failed to perform these vital functions and yet absorbed large amounts of society's resources, including some of its more capable individuals. Mistakes in the financial sector have imposed large costs on taxpayers. This is not the first time that the failure of financial markets to perform these essential functions has led to severe losses of wealth and an economic recession. Indeed, financial crises and bailouts are a regular feature of the market economy.

2. Furthermore, in recent years, the size and scale of financial market activity in relation to the underlying economy has led some to question whether unfettered free markets had promoted finance, the servant, to the position of master of the economy and, more broadly, society. As noted earlier, in many countries financial markets had become ends in themselves rather than a means to a more productive economy. The measure of success of financial policy should not be the rate of growth or the size of the financial sector as a share of GDP. Indeed, an excessively large financial sector relative to the GDP of a medium to large economy should be a cause of concern to those interested in long-term economic growth because financial crises are often associated with unsustainable growth of the financial sector.

3. Since capital is more scarce in developing countries, mistakes in risk management and capital allocation impose heavier burdens on them. The large diversion of some of their most talented individuals to finance is also particularly costly. So too are the consequences of a failure of their financial systems to mobilize savings and the unnecessarily large transactions costs, including an inefficient and costly payments mechanism.

4. As noted above, these failures have been particularly costly for developing countries. Without foreign assistance they may not be able to implement the stimulus packages necessary for recovery. This crisis will leave a heavy legacy of debt on even the wealthiest of countries, including the United States, but for many already overly indebted developing countries, the burdens of rescuing the financial sector failure can be even greater. Resources committed to recapitalize financial institutions might have been better spent in promoting growth, including investments in education, health, infrastructure, and technology.

5. Even in countries that were desperately in need of mobilizing savings, financial markets encouraged consumption. Had the financial sector in richer countries, such as the U.S., performed their critical function of allocating the ample supply of low cost funds to productive uses, the world economy might now be facing a boom rather than today's economic crisis.

6. While in many countries financial markets did not perform the roles that they should have and diverted scarce resources from other sectors where they might have been more socially productive,

there have been other adverse social consequences. Compensation schemes in financial markets resulted in huge societal inequalities, and the economic disruptions to which dysfunctional financial markets gave rise imposed especial burdens on the poor and less well-educated.

7. There is an extensive literature explaining the reasons for the pervasive and persistent failure of financial institutions. In spite of the widespread presumption in favor of private markets, research over the last three decades has shown that they do not in general produce efficient outcomes when information is imperfect and especially when information asymmetries mean that different individuals will have different information. Such information imperfections are particularly pervasive in financial markets. Moreover, in financial markets, private incentives, both at the level of the organization and the individual decision-maker, are often not aligned with social returns. While this crisis has made evident that there are large disparities in all countries, they may be of particular significance in developing economies.

8. Because of the pervasive and persistent "failure" of financial institutions to perform their essential roles, they are regulated by governments. The quarter century following World War II is noteworthy for its absence of financial crises, and this is almost surely the result of the more stringent regulatory regime of the New Deal and similar regulations in the rest of the world that were imposed in the aftermath of the Great Depression.

9. However, the current crisis comes on the heels of a period of time when many political leaders and economists espoused deregulation. They argued either that the inherent efficiency of unfettered financial markets would contribute to the overall efficiency of the economy or at least that "lighter" regulation would improve economic performance. These claims put little emphasis on the notion of market imperfections and externalities. While earlier economic episodes as well as modern economic theory should have led to skepticism, the sheer magnitude and pervasiveness of this crisis is a profound refutation of that vision (which is sometimes referred to as free-market fundamentalism or neoliberalism).

10. There is now a consensus that inadequate regulations and regulatory institutions, some of which failed even to implement effectively those regulations that existed, contributed to this crisis. While "blame" should rest on the financial sector, government failed to protect the market from itself and to protect society from the kinds of excesses that have repeatedly imposed high costs on taxpayers, workers, homeowners, and retirees.

Regulation, rationality, and self-regulation

11. The doctrines that supported deregulation were predicated on the assumption that sophisticated market participants were rational and had rational expectations. They were considered to view market prices as the best available signals for the allocation of resources. Indeed, the standard view went even further and argued that unfettered markets would result in optimum economic efficiency. Under these assumptions only self-regulation was appropriate. The only role for government regulation was protection for small investors who might not be fully informed. Rationality was presumed to result from the fact that those who were "irrational" would suffer losses and thus be excluded from the market through bankruptcy.

12. But this standard view ignored key advances in economics in the last quarter century—and especially results relating to the inefficiency of markets when it is recognized that information is

always imperfect and asymmetric. Such informational asymmetries are also an inherent characteristic of financial markets. Theoretical arguments have been bolstered by a wealth of historical experience and econometric evidence suggesting: (a) that markets are generally not self-correcting; (b) that financial markets in particular are usually characterized by "market failures;" and (c) that failures in financial markets have systemic consequences for the economy.

13. The assumption of rationality is thus even more questionable in financial markets. There is, indeed, a long historical experience of crises in financial markets, with dire consequences for output and employment. The large externalities associated with failure of financial institutions means that other institutions may be affected by this process. That is why banks that have failed in their minimal task of credit assessment have been repeatedly rescued. But even if all market participants are rational and there is no systemically significant financial institution, regulation is necessary because of external effects arising out of correlated behavior. Put simply, the traditional (pre-crisis) remit of financial regulation was just too narrow.

14. To a large extent, the views of those political leaders that espoused deregulation were supported by economic models based on these flawed ideas. The models used to describe the economic process and the underlying (often implicit) assumptions have, of course, long been the subject of controversy. This extraordinarily costly crisis provides an opportune time to reopen these debates and to learn from recent experience about market and political processes as well as the desirable regulatory regime. In particular, views about the efficiency (or failures) of market processes will affect views about the appropriate regulatory regime—as will perspectives about the capacity of governments to correct market failures.

15. The recent experience should not only greatly invigorate debate but also lend support to those who questioned the models of competition and efficient markets with well-informed individuals and firms (typically with rational expectations) that justified the deregulatory policies.

The resurgence of an understanding of the need for regulation

16. The current crisis may thus be considered a direct consequence of these ideas which supported the elimination of many regulations that had enhanced the ability of markets to function efficiently. Some of the regulations had been adopted in the aftermath of the Great Depression. They should have been adapted to the evolving markets, not eliminated. Moreover, the changing economy—the creation of new financial instruments—required new regulations. Even when adequate regulations were in place, many regulators didn't believe in the need for regulation and, not surprisingly, did not enforce it effectively. The crisis highlights the imperative for regulations and a regulatory structure reflecting the changing economy and strengthened supervision of the entire financial system

17. As the Congressional Oversight Panel of the financial bailout package (the TARP) in the United States concludes in its report on regulatory reform: "But at the root, the regulatory failure that gave rise to the current crisis was one of philosophy more than structure."[1] Had there been a greater appreciation of the role of regulation, the United States could have implemented an effective set of regulations within existing regulatory institutions. Still, reforms in regulatory institutions may be

[1] Congressional Oversight Panel, "Special Report on Regulatory Reform. Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability," Washington, D.C., January 2009, available at http://cop.senate.gov/reports/library/report-012909-cop.cfm

called for to prevent the capture of the regulatory process by those whose interests (and philosophy) argue against the need for strong regulation.

18. To illustrate, at a very simple level, why regulation is necessary, consider a situation where the failure of large, complex financial institution can do great harm to the economy and in which policy makers will act to mitigate the consequences for the real economy—a bailout. It is easy to see that, without adequate regulation, private incentives to take risk are not those that are socially optimal. Ex ante, there are two possibilities (regulation, no regulation) and ex post two possibilities (bailout, no bailout).

	Bailout	No Bailout
Regulation	A	B
No Regulation	C	D

19. A *true* adherent of a free market would seek to impose a regime of no regulation and no bailouts—position D in the matrix. Let us assume for the purpose of the argument that the social payoff that would result from the choice of D might be larger than in any of the other regimes, even though in reality it may not be. D represents an optimal system design as long as no financial institution is large enough that its failure would impose sufficient harm to the real economy to induce the authorities to break the pledge of no bailouts. In fact, in all countries there are sufficiently large financial institutions that the entire right column is simply not credible since there is no way that the government can commit itself not to bail out a big bank. Thus, the real choice for society is between positions A and C. The management of large financial institutions knows this ex ante. Given that in the future any financial crisis will elicit a bailout, only the imposition of regulations (Regime A) can restrain financial institutions from exploiting the misalignment of social and private incentives. In Regime B, banks would undertake *excessive risk* given their belief that the position of no bailout is not sustainable and that any losses will be covered by a government bailout. This simple logic has become powerfully obvious in the recent crisis. To repeat, given that governments cannot commit themselves not to bail out large banks, economic efficiency requires that they be regulated and that position A is the only viable solution.

20. This example illustrates a situation where the private incentives of the financial institution do not coincide with those of society more generally. Such a situation can arise even when no single financial institution is too large to fail. If a number of smaller institutions exhibit correlated behavior, their actions can give rise to a systemic problem requiring a government bailout, and again, their incentives will not be appropriately aligned with those of society.

21. In fact, the current crisis opens up debates not only on how to use regulatory policy to align private and social incentives for firms but also how to align managerial incentives within the large financial institutions to reduce the incentives for decision-makers within those firms to take risks that are borne by the firm as a whole, the owners of the resources they manage, and society at large.

22. These problems are referred to in the economics literature as "agency" issues because they deal with the difficulties that arise when agents have objectives that differ from those of the individuals *on whose behalf* they are empowered to act. For example, the savings of workers held in pension funds is invested by portfolio managers who act as agents. But the welfare of the managers may not be perfectly aligned with those of the workers. Indeed, managers seldom attempt to induce the firms to

act in ways that are consonant with the interests of the worker; more frequently, they focus on very short-term returns.

23. Thus, modern economies are marked by a long chain of agency problems: the 19th Century model of capitalism, in which the owner managed his own firm, is increasingly rare, particularly in advanced industrial societies. While perfect alignment of interests is impossible, the current crisis has illustrated the magnitude of their disparity and heightened the need for regulations which bring them more closely in alignment.

Regulatory structures and institutions

24. While there is a clear case for government regulation of financial markets, governments often fail to adopt the appropriate regulatory structures. The incentives faced by public officials, regulators, and elected officials, and the role of money in politics are important antidotes to romantic notions of the efficacy of regulation to correct for market failures.

25. Even when appropriate regulations are adopted, they may not be effectively enforced. Regulators may be 'captured' by those that they are supposed to regulate. Even expertise can be captured, as experts are themselves motivated by considerations of power, prestigious awards, and compensation. The design of regulatory institutions should take into account these risks.

26. Before the crisis there was a heated debate between those who favored regulation based on "principle" and based on "rules." The former were concerned that banks would use rules as goalposts that would allow them to circumvent basic banking principles, while the latter were concerned about the possibility of regulatory capture. But the crisis overwhelmed both rule-based and principle-based regulatory systems, suggesting that this dichotomy was not as important as it may have appeared. Both principles that set out the objectives of regulation and rules that try to apply these principles appear to be required.

27. While ideas matter, so do interests: the current regulatory regime may have been affected more by the influence of certain special interests than the merits of theoretical arguments. These special interests may, in particular, have found those ideas that supported their positions particularly appealing and did what they could to promote them.

28. Ensuring global financial stability to support economic stability is a global public good. In a world of financial and economic integration, a failure in the financial system of one large country (or even a moderately sized one) can exert large negative externalities on others. This was brought home in the 1997-1998 global financial crisis as fears of "contagion" became widespread. Such contagion was, indeed, evident as the crisis in East Asia led to problems in Russia, and the crisis in Russia spread in turn to Brazil. But the present crisis has made these "cross-border spillovers" particularly evident, as the failure of the U.S. to regulate its financial markets adequately has had global consequences. That is why a discussion of regulation is not just a matter that can or should be left to national authorities. There has to be global coordination. It is also why the subject is one of the principle concerns of this report.

29. This chapter sets forth some general principles of financial sector regulation and some reforms needed to bring existing national and international regulatory practices in line with these principles. It makes certain key distinctions between micro-regulation aimed at the behavior of particular

financial institutions and macroeconomic regulations directed at the systemic stability of the financial system and enhancing macroeconomic stability. While the general principles of regulation and the purpose and functions of particular aspects of regulation need to be specified, the particular institutional framework and implementation of these regulations should be tailored to the circumstances of each domain.

30. This chapter also lays out key issues in the design of *financial policy*—that is, government interventions in the financial sector. Most of the discussion focuses on regulation, but financial policy goes beyond regulation. It may include creating incentives for the provision of credit to certain underserved groups or creating institutions that focus on long-term development impacts rather than the short-term capital gains that have been the central focus of so much of the financial market. It includes providing incentives for catalyzing the creation of financial institutions or instruments that help meet social needs—mortgages that help individuals manage the risks of home ownership better, student loans with lower transaction costs, banking the un-banked, or insuring the uninsured. In short, it entails all interventions other than the attempt by government to make *private* financial institutions behave better, that is, more in accord with general principles of efficiency, for instance, by better alignment of social and private benefits.

31. Therefore, banking regulation needs to be seen as part of financial market regulation, and financial market regulation needs to be seen more broadly as part of overall financial policy. There are several important forms of financial market regulation: (i) protecting consumers and investors (rules against fraud, market manipulation, misrepresentation of products, and laws promoting competition); (ii) ensuring the safety and soundness of individual institutions; (iii) ensuring competition; (iv) ensuring systemic stability; (v) promoting deep financial development, particularly long-term finance; and (vi) ensuring access to finance. Ensuring systemic stability goes beyond ensuring the safety and soundness of individual institutions. Such regulations can support and safeguard confidence in the financial system as a whole and enhance financial and economic stability. While they may not be able to prevent crises such as the current one, they can make them less frequent and less severe. Promoting macroeconomic stability goes beyond avoiding crises; it entails the expansion of credit when the economy is in a downturn and the curtailment of credit when inflation threatens.

32. Similarly, financial market regulation has multiple objectives: (i) promoting financial market stability; (ii) enhancing macroeconomic stability and growth; (iii) promoting the efficiency of the allocation of scarce capital; (iv) promoting equity; and (v) protecting the public finances which have borne the financial consequences of regulatory failures.

33. Governments need to be aware of the relationships among the various forms of regulation and regulatory institutions and the relationship between regulations and other instruments of government policy, all of which are aimed at ensuring that financial markets perform their vital role in support of all members of society.

34. Many areas of government policy such as competition policy and corporate governance are as relevant to the financial sector as they are to other sectors. Indeed, some of the worst failures of the financial system may be traced to failures in these two areas.

35. There may be trade-offs: a less competitive financial system may be more stable but less efficient and give rise to greater social inequities. But there are also important complementarities.

The financial system's failure is in part a result of predatory lending; better and better enforcement of investor protection would have resulted in a more stable financial system.

36. But regulations are not costless. As always, there must be balance between costs and benefits. Today, the global economy is paying a very high price for inadequate and inappropriate regulations as well as a failure to effectively enforce those that did exist. Clearly, regulators in the main financial centers of the world failed to get the balance right, and their failures have imposed heavy costs on the global economy. The additional costs of better regulation are dwarfed by the costs imposed on society by the failure to regulate.

37. One of the often-alleged costs of tighter regulation is that it might slow the pace of innovation. There is little evidence that the innovations in the financial sector in recent years have enhanced the overall performance of the economy, though to be sure it may have increased the profits of the sector. Much of the innovative effort of the sector was directed at circumventing regulations, taxes, and accounting standards; other innovations increased revenues generated through higher transactions costs. These "innovations" had a negative social return.

38. Only a small fraction of the U.S. financial sector, the venture capital firms, was directed at promoting innovation in the productive sector. This part of the financial sector is now under strain. More generally, there is a risk that financial markets will emerge from the crisis with a financial system that is less well-equipped to meet the future needs of our society. It may, for instance, be less competitive. The need for appropriate regulations may be even greater now than it was in the past.

39. The rest of this chapter discusses at greater length some of the general principles of financial market regulation. It first focuses on transparency and incentives and macro- and micro-regulation, respectively. It then discusses financial market restructuring and regulatory institutions. While most of the issues discussed to this point relate to national financial systems, the chapter then examines global regulation and the problems that are posed by cross-border capital flows. It concludes with the presentation of a broader range of issues in financial policy that go beyond regulation.

The Purposes and General Principles of Financial Regulation

40. Firms operating in the financial sector are regulated over and above other firms for two principal reasons. This section reviews the justifications for regulation and the possible types of regulation appropriate to these institutions.

Consumer and investor protection

41. The first reason is that consumers of financial products require additional protection from those provided for other products because their performance cannot easily be tested before, at, or shortly after the point of purchase. As already noted, monitoring banks and their ability to fulfill their contractual promises is a public good. The present crisis has highlighted, in addition, the need to protect many individuals from predatory lending practices, where financial institutions took advantage of those who were ill-equipped to make judgments concerning the risks associated with the financial products that were sold. But even relatively well-informed individuals cannot assess the riskiness of the complex financial products being sold or the appropriateness of these products to their circumstances. Issues of consumer and investor protection are discussed at greater length

later in this chapter.

Externalities and Regulation

42. The second reason is that financial markets are particularly prone to exhibit externalities. This crisis has shown how the failures of the financial system have imposed costs on others, such as taxpayers, homeowners, and workers, who were not directly party to the excessive risk-taking. Indeed, the failures affected the world economy at large, plunging the world into its worst peacetime recession since the 1930s. Whenever there are externalities, there is a divergence between private incentives and social returns, and the magnitude of the disparity in this present case clearly calls for strong government action.

43. Financial markets are characterized by imperfect information, and as already noted, markets with imperfect information are often characterized by serious inefficiencies requiring government intervention. Such information imperfections give rise to significant externalities and externality-like effects.

The special role of banks

44. The role that banks (institutions licensed and regulated for deposit-taking and other banking operations with access to liquidity from central banks) play in a credit economy is unique and quite different from the role played by non-banks such as traditional investment bank broker-dealers, mutual funds, insurance companies, and hedge funds. The crisis has also highlighted that bank access to central bank liquidity and provision of liquidity to the rest of the economy played a critical role in the transmission of the boom.

45. The distinctive role of banks is in part related to their role in the payments mechanism. This distinction provides a basis for recommendations to regulate the activities of core banking activities (deposits from individuals and loans to companies) more heavily than non-bank institutions, while making regulation more comprehensive across the national and international financial system.

46. The distinctive role of banks was obscured in the run-up to this crisis. Some financial institutions engaged in the creation of arms-length off-balance-sheet entities, such as special investment vehicles, that engaged in banking-like activities without being subject to regulation or access to central bank support or deposit insurance. This "shadow banking system" took on an increasingly important role in providing credit, and some aspects of the credit crunch were related to failures in these shadow banks.

47. In addition, the banking system became intertwined with other financial institutions in ways that meant that the failure of these other financial institutions (AIG) could put at risk the banking system.

48. The failure to effectively regulate these interlinkages as well as other aspects of the risk position of banks has resulted in taxpayers becoming unintended bearers of the residual risk of a failure of the financial institutions that had provided explicit or implicit guarantees to the shadow banking system. Not only does this result in excessive risk taking, but it also distorts the financial market structure, since there are large implicit subsidies associated with such guarantees.

Externalities and the failure of self-regulation

49. Because of the externalities that play such a large role in motivating regulation, it should have been clear that the self-regulation that was promoted so forcefully in the deregulation movement that preceded the crisis made little sense. Self-regulation in the presence of externalities is an oxymoron.

Network linkages and externalities

50. The nature of the credit economy is such that the lending by one bank often serves as a deposit at another, and this deposit may be used to provide collateral for borrowing at a third. An essential part of banking is that banks lend to banks, and so a failure of one can lead to a cascade of failures. This means that the behavior of individual banking institutions can have systemic influence in a way that a failure of, say, a shoe shop may not. The failure of a single bank can bring down the entire financial system, either directly or as a result of a general loss of confidence in all banks, leading to a freeze in inter-bank markets. At other times, this discussion might appear merely academic, but the credit crunch has underscored the systemic nature of bank failures and the role of confidence and trust.

The key role of trust and confidence and the role of regulation

51. Confidence and trust is essential because an individual turns over his capital to a financial institution with the promise that he will get it back, with an expected return, at a later date. But these promises are often broken. Moreover, it is costly for individuals to ascertain whether a particular bank will be able to fulfill this promise. The complexity of modern finance has made this increasingly difficult, but many financial institutions in the run-up to this crisis deliberately tried to obfuscate their financial position (both from regulators and investors). When those who have entrusted their money to a particular financial institution lose confidence, they will pull their money out, and the financial institution may collapse. Many financial institutions have given good reason that they should not be trusted.

52. Government regulation can play a key role in the restoration and maintenance of trust and confidence in financial institutions. Some one hundred years ago, Americans lost trust in the safety of their meat packing industry; trust was only restored with government regulation. The failure of self-regulation and the rating agencies provides further bases for a strong role of government regulation in current circumstances.

Regulation and monitoring: information as a Public Good

53. Moreover, information is a public good. There is no marginal cost of an additional individual using a particular piece of information, including information about the credit worthiness of a bank. When public goods are privately provided, there will typically be an undersupply and/or large inefficiencies, as barriers are created to the enjoyment of something for which the marginal cost is low (zero). This provides another rationale for public monitoring of financial institutions.

54. Moreover, most individuals lack the technical competence to evaluate the financial position of a bank. Indeed, even the regulators and the rating agencies, which were presumed to have specialized competence, failed to do a good job. These problems are compounded by failures in the "rating

agency market," described more extensively below, making reliance on such private assessments problematic at best.

Transparency and Incentives

55. While all regulation is designed to induce private firms to alter their behavior to bring it more into line with the interests of society as a whole, it is often difficult for government (regulators) to control behavior directly or even to ascertain what appropriate behavior entails. For instance, while everyone agrees that banks should not engage in excessively risky behavior, what does that entail? Modern regulation is predicated on a multi-prong approach that includes direct restrictions on behavior as well as restrictions affecting the determinants of behavior. The most important determinants are incentives and competition. If markets are to exercise discipline, they must have access to good information, which implies transparency, and there must be effective competition. There were significant deficiencies in both competition and transparency in the run up to this crisis (and these conditions still prevail).

Transparency

56. Good information is required for the efficient functioning of the market economy. Part of the failure of this crisis is a failure of information. The financial sector demonstrated its ability to use creative accounting to obscure information. If market participants do not know the risks undertaken by banks or other publicly listed companies, it is difficult to assess appropriately the value of shares and bonds. This means that capital may not be allocated efficiently. Transparency is important for markets to exercise discipline by producing efficient prices. How can the decision to buy or sell a bank's shares and bonds be determined accurately if the risks to which it is exposed are not known? Regulatory reforms must deal adequately with these issues of transparency.

57. But while stronger transparency is necessary for a better functioning financial system, this not enough. It is unlikely that, in aggregate, the excessive lending and borrowing that helped fuel the present crisis would have been substantially reduced if there had been greater transparency. Nor would full disclosure make the accurate appraisal of the risks of very complex financial products possible. The lack of transparency is often a symptom of deeper market failures that produces incentives to limit information, and these deeper market failures may have other manifestations. Moreover, lack of transparency is only one of several market failures.

58. There is now widespread agreement that private markets do not necessarily provide optimal incentives for transparency. There may even be incentives for providing distorted information, e.g. incentives associated with executive compensation schemes based on stock options. Regulatory arbitrage also provides incentives to reduce transparency. The creation of off-balance sheet vehicles that caused so much difficulty in the current crisis was the result of such arbitrage. Regulations should not only insure greater transparency, they should also improve incentives for transparency. Thus, requirements for expensing of stock options or increasing capital adequacy requirements for those banks that pay executives through stock options reduce the incentives to use them.

59. Mark-to-market accounting was introduced to increase transparency. But some have argued that its inappropriate application to all assets contributes to market volatility. The problem is not with mark-to-market accounting but with how the information provided is used by firms, markets, and

regulators. The adverse effects of mark-to-market accounting could be offset by countercyclical capital adequacy requirements and provisioning described below. It would be a major retreat from transparency to move away from mark-to-market accounting.

60. However, the regulatory system should reward financial institutions with long-term funding of liabilities. In this regard, mark-to-funding could be more useful than mark-to-market accounting and in some cases even more relevant. Life insurance firms, for instance, with long-term liabilities but with assets matching those liabilities should not be placed at a disadvantage. But this is what would happen with mark-to-market accounting if liquidity risk spreads rose and the long-term assets in which they had invested fell in value. It would be inefficient to match each asset with its funding, but pools of assets could be matched with pools of funding. One difficulty in a mark-to-funding approach would be determining the maturity of funding. Life insurance policies might normally be held to maturity, but the contract provides a liquidity option—owners can borrow against them. They also have a cash value. Demand deposits are normally held for a long time, but in a panic, they can be withdrawn overnight.

61. Accounting standards should make information as transparent as possible for shareholders and bondholders. This might require changing existing standards. For example, while dynamic, counter-cyclical provisioning is desirable, accounting standards boards are not currently well disposed to such proposals. They prefer event-based to statistical accounting, even though statistical techniques may be the best means for providing reliable estimates of future losses.

62. While mark-to-market value accounting may not be appropriate for the risk management of some institutions, it is important to recognize that failure to apply it may induce other perverse incentives, particularly during crises. Banks may have an incentive to engage in excessive risk taking—assets that go down in price may be kept while those that go up in price may be sold. The result is to increase the divergence between market values and "book" values. This incentive has been compounded by recent actions to, in effect, suspend mark-to-market accounting in the crash, having promoted it in the boom.

63. Transparency regulations have to be comprehensive. Otherwise there is a risk that transactions which market participants do not want to disclose fully will be channeled through the less transparent vehicle. As noted below, this is a concern with recent proposals that do not require full transparency in over-the-counter trading in derivatives such as credit default swaps. Giving banks and firms a choice of using either not-fully-disclosed over-the-counter stock options or fully disclosed exchange-traded options might encourage less transparency. (Regulation of derivatives is discussed more fully below.)

64. Moreover, without such comprehensiveness, it will be difficult for those who wish to use the information to assess its relevance. In the global financial crisis of 1997-1998, many developing countries argued that without transparency requirements imposed on hedge funds' holdings of their liabilities, it would be difficult for them to ascertain their risk exposure. While other market participants might make full disclosure, it would be difficult for these countries, or other market participants, to ascertain the adequacy of their foreign exchange reserves without full and comprehensive disclosure.

65. Regulations should also be directed at affecting incentives for transparency (or lack of

transparency). Compensation systems relying heavily on stock market performance provide strong incentives for the provision of distorted information. This provides a further argument for restricting the form of compensation (in addition to those discussed more extensively below). More generally, there are managerial incentives to reducing transparency, especially in economies with inadequate corporate governance. Reduced transparency may reduce the threat of a take-over and may enhance the ability of executives to enhance their compensation.

66. Economic theory suggests that transparency may actually lead to more volatility. But even if this proves to be the case, most of the time the benefits of transparency outweigh the costs, and so there should be a strong presumption for greater transparency. Without good information, resources cannot be efficiently allocated, and lack of transparency can too easily contribute to exploitation and corruption.

67. Just as accounting standards should allow for as much information and transparency as possible, the same should be the case for the promulgation and implementation of regulations. While supervisors are, in principle, free to ask for information from private actors, the public dissemination of any findings needs to be carefully handled. The supervisor should have an obligation to put transactions involving public money in the public domain but perhaps with a lag, if there are concerns about market sensitivity. If proprietary information issues restrict full disclosure of firm-level data, there should be full disclosure of aggregate data.

68. Transparency should be encouraged whenever a financial rescue plan is being undertaken. In the current scenario, the manner in which financial rescues/bailouts are being conducted is often opaque and uncertain. As a result, a great deal of confusion has been sown about the principles underlying the financial restructuring that is occurring and about the process by which the terms are determined. This has contributed to market uncertainty. While in the past, a simple adage—"save the banks, not the bankers"—has been followed, in the current crisis this important distinction has been blurred in some countries. Clear principles need to be in place that recognize that, while banks may be systematically important, this is not the case for all elements of their capital structures. An expedient resolution—through recapitalization, (temporary) nationalization, and/or super (or expedited) "Chapter 11" bankruptcy (conservatorship)—could restore the credit intermediation process in the most rapid and transparent manner possible.

Incentives

69. Incentives are thus key to an efficient and effective operation of the financial system. Regulators need to make sure that the incentives of financial institutions and those of management are compatible with the social objectives of the financial system. It will never be possible to monitor and regulate all the practices that expose banks and the economy to excessive risk. It is therefore imperative to get incentives right. It is clear that private rewards have not been linked to social returns. This means that there are perverse incentives that produce adverse outcomes.

70. The fact that so many firms have adopted incentive structures that served shareholders and other stakeholders well in the short-run but so poorly in the long-run is suggestive of serious and pervasive failures in corporate governance. Weaknesses in corporate governance in both developed and developing countries have long been recognized, but not enough has been done. While such problems exist in all sectors, they may have more dire consequences in the financial sector. This

crisis should provide an opportunity to revisit these issues.

71. The payment of large bonuses to top executives of banks that have had record losses shows that "incentive pay" was not closely related to performance—something that statistical studies have also confirmed. One long-recognized problem is that current incentive structures encourage excessive risk-taking and short-sighted behavior. Not only did such incentive structures play an important role in the run up to the crisis, but they have also impeded attempts to resolve it. Methods to remedy these problems include requiring incentive compensation schemes to be based on long-term performance and implementation of a requirement that firms pay higher capital charges if their remuneration schemes are not designed to limit excessive risk-taking. Stock options should be reported as a form of remuneration—expensed and valued at the time of issue or of re-setting stock option strike prices. In any case, payment through stock options can provide particularly perverse incentives because it encourages deceptive accounting practices that contribute to (temporarily) high stock prices. Using indicators other than the performance of share prices could create incentive schemes more commensurate with social objectives, e.g. by rewarding achievements in corporate social responsibility.

72. When banks become too big to fail, they have perverse incentives for excessive risk-taking. Problems are even worse if a financial institution is judged to be too big to be financially resolved (at least in times of a crisis). It is imperative that governments impose strong antitrust policies with criteria stronger than just market power. (See the discussion below.)

73. Regulators should be particularly attentive to conflicts of interest. For instance, investment bank analysts' views affect markets, and those views may be influenced by the positions they hold. There can also be conflicts of interest between the roles of financial institutions as commercial banks and as investment banks. Similarly, credit rating agencies were paid by those whose creditworthiness they were supposed to evaluate. Disclosure is an important first step.

74. The privately owned, government-sponsored enterprise (GSE), such as Fannie Mae and Freddie Mac, in which the government either provides conditional funding or guarantees to a firm with private shareholders and independent management given wide latitude, may be a particularly hard model to design in a way that avoids potential conflicts between managerial interests in maximizing their own returns, returns to shareholders, and the overall public interest.

Regulation and Innovation

75. One alleged potential cost of regulation is to reduce the scope and speed of financial innovation. But much of the recent innovation in the financial system has sought to increase the short-run profitability of the financial sector rather than to increase the ability of financial markets to better perform their essential functions of managing risk and allocating capital. In addition, innovation has engendered financial instability. Indeed, from the point of view of the economy as a whole, some innovations had a clearly negative impact. It is important to design regulatory structures that encourage economic and socially productive innovations and to place adequate constraints on socially dubious innovation; good regulation may actually enhance the scope for positive innovation.

76. In some cases, a slight delay in introducing an innovation in order to ascertain better whether it

makes a positive or negative contributions to the economy or to determine its suitability for particular purposes would have little cost but would produce substantial benefits by ensuring that inappropriate products are not marketed or sold to those for whom they are inappropriate.

77. In fact, just as financial market failures noted above led to excessive risk taking, short-sighted behavior, and exploitation of financially unsophisticated individuals, it also led to "innovations" that were not necessarily welfare-enhancing from the perspective of society. At the same time, few incentives were provided for innovations that would have been welfare enhancing.

78. An outsized financial sector, often acting non-competitively, impeded innovations such as an efficient electronic payment system based on modern communications technology. Innovations that would have led to more stable mortgage markets or other innovations that would have enabled households and countries to manage the critical risks they face, including the risks associated with home ownership, were not introduced because they challenged the vested interests of large institutions. The failure to produce mortgages that enabled even average Americans to manage the risk of home ownership better is now having disastrous global consequences.

79. The financial sector also failed to introduce products such as GDP-linked or commodity price-linked bonds that might help manage seemingly important risks. Government attempts to introduce these products have been resisted because they do not generate sufficient fee income for private participants. The longstanding problem of the failure of financial markets to transfer risk from those in the developing countries who are less able to bear the risk of interest-rate and exchange-rate volatility to those in the developed countries who are more able to bear these risks has also remained unresolved.

80. Unregulated market forces have provided incentives not only for under-production of innovative financial products that support social goals but also for the creation of an abundance of financial products with little relevance to meeting social goals. There were incentives to exploit those who were financially unsophisticated and incentives to maximize transactions costs (e.g. in repeated refinancing of homes, excessive trading, or "churning"). By curtailing such socially unproductive innovation, better regulation may actually lead to more innovation that enhances societal well being. Some of the areas in which innovation is badly needed are described below.

81. Government financial policy can also play an important catalytic role in the development of financial markets. Private financial markets have failed to make innovations that address many of the critical needs associated with ordinary citizens. In some cases, after the potential of such markets has been established, the private sector can take over. These innovations are important, both domestically and internationally, e.g. in improving the distribution of risk-bearing between developed and less developed countries.

Boundaries of Financial Regulation

82. Traditionally, regulation has been differentiated by institutional form: deposit-taking banks are regulated in a different way from non-banks. Insurance products are regulated by insurance regulators, but derivatives such as credit default swaps that have similar properties to insurance are unregulated. This represents the legacy of the past rather than an analytical approach to regulation and is vulnerable to regulatory arbitrage and in need of adjustment. Regulation needs to be comprehensive, with boundaries determined by the economic functions of financial institutions,

not by what they are called or where they may be located.

83. Coverage should extend to all relevant institutions and instruments. The coherence of different regulatory frameworks needs to be considered when attempting to delineate the boundaries of regulation. Regulatory authorities need to coordinate seamless coverage across national and international capital markets, securities markets, and deposit-takers. If regulation is not comprehensive and coherent, there is likely to be regulatory arbitrage with activity gravitating to the least regulated markets or to jurisdictions where regulations are most favorable. Comprehensive regulatory systems need to give priority to systemically important activities, institutions, and instruments. These should be subject to oversight, even if the intensity of regulation differs among them on the basis of their systemic importance.

84. However, there is no guarantee that all the practices that expose the financial sector and the economy to excessive risk can be properly monitored and regulated. As a result, regulation will have to put special emphasis on setting the right incentives (including strengthening financial responsibility so that failures in risk management are less likely to have adverse effects on others) in order to restrain excessively risky activities and to reduce the scope for adverse consequences.

85. At the international level, comprehensive coverage should eliminate the exposure of national financial systems to the possibility that some states might fail to implement effective regulation. At the same time, care should be taken that regulatory standards should not be an anti-competitive ploy by developed financial centers to maintain their positions attained in part through previous periods of regulatory and tax competition. (See below for further discussion).

86. More broadly, regulators also need to give special attention to financial institutions where governments are bearing implicit risk, either because of a bailout that may be necessary to protect the economy against systemic risk or because of the provision of (implicit or explicit) deposit insurance. The recent experience should make clear that any institution may have systemic significance. Indeed, the fact that some institutions were too big to be financially restructured has meant that protection has been provided not only to the institution but also to shareholders and other creditors. This suggests an even higher level of scrutiny for such institutions. There should be clear principles to determine what is considered systemically important, such as leverage, size, exposure to retail investors, and/or degree of correlation with other activities. Regulators must have comprehensive authority. There also needs to be a clear assessment of whether the concept of "too big to be financially resolved" has any validity, and if so, what the principles are that determine whether an institution is too big to be financially resolved. Regulation must occur continuously, on a day-to-day basis, while at the same time ensuring long-term consistency.

Micro-prudential vs. Macro-prudential Regulation

87. Micro-prudential regulation, geared towards consumer protection, should apply to all financial institutions, with particular attention given to protection of unsophisticated "vulnerable" consumers. Macro-prudential regulation should be focused on key components of systemic risk: leverage, the failure of large, inter-connected institutions, and systemically important behavior and instruments and their interactions with the economic cycle. Both macro- and micro-prudential regulation should pay particular attention to potential risks undertaken by the government through implicit or explicit deposit insurance. Financial institutions that play a central role in the payments system thus need to be more intensely regulated through, for example, restrictions on risk-taking or

capital adequacy standards. Some argue that imposing differential regulations may distort the financial system because of the implicit subsidies to such institutions on which appropriate regulations are not imposed. Restricting banks from engaging in certain risky activities does not mean that these risk services will not be provided; it simply means that they will be provided without the implicit subsidy associated with the risk of a government bailout. (See the discussion below.)

88. Macro-prudential regulation aims at reducing the pro-cyclicality of finance and its effects on the real economy. It does so by explicitly incorporating the effects of macroeconomic variables (growth, exchange rate, and interest rate movements) on financial risk, avoiding in particular the accumulation of systemic risks and changing crucial regulatory variables in a counter-cyclical fashion to discourage lending booms and prevent credit crunches.

89. Recessions that follow the sequence of lending booms and banking crises are often more severe and long lasting than recessions which originate in the real sector. This provides special impetus for regulation to be directed toward reducing the scope for financial market failures that are closely linked to economy-wide boom-bust cycles. Successful financial regulation should therefore not only ensure the safety and soundness of particular institutions but also enhance the stability of the macro economy.

90. Regulations should therefore focus more on those institutions most likely to have systemic consequences, which means those with the greatest leverage and size. But the experiences of this and previous crises suggest that it is difficult to tell which financial institutions will have systemic consequences, so that it is imperative to maintain some oversight over all activities, institutions, and instruments. Macro-prudential regulation must thus go beyond banking institutions. This is particularly important given the tendency, and incentives, for financial market participants to engage in regulatory arbitrage through activities that have led to the creation of what has come to be called the "shadow banking system," which has a parallel in the creation of a "shadow insurance system." There should also be a special focus on aspects of the financial sector most likely to have significant consequences for the real economy. This entails protecting the payments system and ensuring the flow of credit.

91. Instruments should be regulated where their use might be harmful to vulnerable consumers or pose systemic risks to the economy or to the taxpayer. This could be achieved through a Financial Products Safety Commission to ascertain the safety and appropriate use of various financial instruments and practices for retail consumers. Alternatively, governments could create, within their existing regulatory structures, corresponding bodies that focus on consumer protection. It is important to recognize that seemingly safe instruments can have damaging consequences when their use changes, e.g., instruments used for hedging and insurance can also be used for speculation. Safety of financial products should thus be assessed not only in terms of their appropriateness in meeting the needs and objectives of retail consumers but also in terms of their impact on systemic behavior. Safety should be continuously reviewed with respect to prevailing practice and the consequences for product "safety." While great care should be taken in approving products for use by vulnerable consumers, all consumers need some protection. Many of the products marketed by American financial institutions were so complicated and complex that not even their creators seemed to be fully apprised of their risk properties.

92. Regulation must be dynamic, since instruments that initially appear to be safe can become

dangerous with changing or growing use. Other instruments might initially appear to be excessively risky for some uses, but as their risk or complexity becomes understood and appropriate offsetting measures are devised, or as their safety is demonstrated in less regulated markets, they might be approved for specific uses in more regulated markets. A key part of supervision is the continuous monitoring and consideration of all instruments, institutions, markets, and behavior, with much more intense supervision and oversight of those with greater systemic importance.

93. Moreover, financial institutions will try to circumvent regulations. Regulators have to be especially attentive to the ever-present attempts at regulatory arbitrage and circumvention, including through the creation of arms-length special purpose vehicles. By definition, regulations reduce profits because they restrict potentially profitable actions. The fact that regulations are circumvented is no more an argument for abandoning regulation than the fact that tax laws are often circumvented is an argument for abandoning taxation. The fact that firms are always inventing ways of circumventing regulations means that governments have to view regulation as a dynamic process and provides an argument for legal frameworks that give regulators wide latitude to respond to the public interest.

Ring-fencing

94. While there may be a case for differential regulation of financial market participants based on their sophistication, ability to bear risk, and the consequences that might arise from failure, it should also be recognized that in financial markets it is difficult to erect hermetically sealed barriers between the highly regulated actors posing systemic risks and those who do not. For instance, credit interlinkages are likely to remain. As a result, depending on the depth of a financial crisis, regulators may feel forced to rescue risky interlinked players in order to protect the interests of vulnerable participants and to avoid adverse systemic consequences. Typically, though, it is more "fiscally efficient" to directly bailout those who must be bailed out because of their direct systemic importance.

95. In order to prevent problems in the unregulated sector from spreading to the regulated sector when the government does not tightly regulate all financial institutions, the less regulated sector must be ring-fenced at least to some extent, with sensible controls on the extent of interaction with the more regulated sector. Governments need to be aware of the danger of contagion from one part of the financial system to others. Thus, the better and more comprehensive regulation, the more integrated (less segmented) the financial system can be.

96. The advantages of diversification provided by a large integrated firm or market may be more than offset by the risks of contagion, as a problem in one part of the economy spreads. This appears to be the case in the present crisis, especially in real estate. Had mortgages been centered in a specialized set of institutions, problems might have been contained, as they were in the U.S. savings-and-loan crisis in the 1980s.

97. Moreover, allowing highly risky activities to be undertaken within a regulated depository institution creates an unlevel playing field as a result of the potential subsidies that arise in the case of failure. Such distortions have been particularly evident in this crisis. In addition, they put the public finances at risk. (These issues are discussed further below.)

MACRO-PRUDENTIAL REGULATION

98. As pointed out above, the basic aim of macro-prudential regulation is to improve the stability of the macro economy, and particular at reducing the pro-cyclicality of finance and its effects on the real economy. The basic instrument is counter-cyclical regulation, but policies aimed at increasing the diversity of financial agents can also increase the stability of the system. A final set of issues relate to the management of the pro-cyclical pattern of capital flows that affect developing countries in particular and the role that capital account regulations can play to increase financial stability. They are considered later in the chapter, in relation to international issues.

Counter-cyclical Regulations

99. There is a long history of credit cycles, of which the current crisis is an example. In the boom, risk premiums decline and credit expands, largely based on collateral whose value increases with the expansion of credit. In the present crisis, as the rate of increase in real estate prices accelerated and the likelihood of a collapse increased, banks and other lenders lowered lending standards. There is by now ample evidence of this repeated pattern, suggesting that regulators should move more quickly to "lean against the wind." Counter-cyclical regulation can be an important part of economic strategies aimed at stabilizing the economy.

100. Existing capital adequacy regulations have actually had an adverse effect on stability and act in a pro-cyclical manner. When the economy goes into a downturn and banking institutions lack adequate provisions (reserves) for the risks they have assumed during the boom, bank capital declines due to the associated losses, and the bank is either forced to raise new capital at an unfavorable time or to cut back on lending. Too often, the only option is the latter. If many institutions are in a similar position, the result will be a credit crunch that reinforces the economic downturn.

101. Time-varying capital adequacy and provisioning requirements that rise and fall with the business cycle provide the best instrument of countercyclical macro-prudential regulation. These countercyclical capital adequacy and provisioning requirements can be based on simple rules which call, for instance, for an increase in capital requirements as the rate of growth of the assets of a bank increases or the rate of growth of a particular risky class of assets increases. Provisioning requirements automatically ensure that the bank sets aside more funds as it lends more. These regulations operate, in particular, as "speed bumps" that help dampen credit booms, reducing the likelihood that they will be followed by busts. As pointed out in the analysis of cross-border flows below, capital account regulations aimed at reducing capital inflows during booms can play a similar role in countries subject to pro-cyclical capital flows.

102. Variable risk weights used to ascertain appropriate capital adequacy standards can have strong incentive effects. Regulators need to be aware of distortions in capital allocation when provisioning and capital adequacy requirements do not accord well with actuarial risks What is required is intense supervision and constant revaluation of the regulations. Maximum overall capital asset ratios should be imposed as a complement to accounting rules that adequately measure the associated risks through statistical accounting techniques that better estimate possible future losses than traditional accounting methods.

103. With current accounting practices which do not allow for statistical provisions, counter-cyclical capital adequacy requirements should be the preferred instrument. If statistical provisions are allowed, they may be preferable, as they follow the traditional principle that provisions should cover expected losses while capital should be able to cover unexpected events. This could be done, as the Spanish system introduced in 2000, by forcing financial institutions to make provisions equivalent to the expected losses of from different groups of loans through a full business cycle, based on past experience. This principle also recognizes that the risk is incurred when loan disbursements are made, not when a loan is not paid (or expected not to be paid). In practice, however, counter-cyclical capital and provisioning requirements could be used as complements, as loan losses always have an unexpected component. Liquidity requirements can play an additional complementary role, particularly if they are also subject to counter-cyclical rules.

104. Regulation, and especially macro-prudential regulation, can have as important an effect on lending as open market operations or other central bank interventions. As an example of how macro-prudential and micro-prudential regulation could be combined, regulators and central banks might jointly agree to an annual rate of expansion in bank lending and to bands around that rate, above which a bank would be required to increase its capital adequacy or provisioning levels and below which it would be allowed to reduce those levels. The bands themselves might be adjusted in a way to help stabilize the economy.

105. If time-varying capital adequacy requirements had been in place, the magnitude of the previous boom and its inevitable crash would have been moderated. However, relating macro-prudential regulation to the rate of growth of bank lending would further enhance the temptation for banks to hide their own lending in associated off-balance sheet vehicles, like conduits and Special Investment Vehicles (SIVs). Regulators must prevent this by treating all such arms-length vehicles on a consolidated basis.

106. A series of micro-prudential regulations can also have macro-prudential effects. For instance, during booms, increasing the loan-to-value ratios for mortgages and requiring larger monthly payments of outstanding credit card debts will help reduce an excessive growth of these types of lending. Provisioning standards could also be raised for sectors experiencing credit booms. And, as pointed out below, managing the currency mismatches of lending can also provide an essential tool to reduce credit risks in countries facing pro-cyclical capital flows.

The advantages of diversification

107. Regulation should be more focused on the capacity of the financial system as a whole to bear and allocate risks and where this is best done rather than solely on measures of individual firm risks. Risk is not just about assets; it is about how the assets are funded and how they are used. Regulation of systemic risks needs to include an assessment of funding liquidity.

108. Financial liquidity and stability requires diversity of action and opinion. If all firms respond in the same way (e.g. trying to sell the same asset at the same time), markets may exhibit extreme volatility. It is important that regulators do what they can to preserve natural diversity, especially in the face of enhanced transparency, common accounting standards, and the increasing comprehensiveness of regulation.

109. The benefit of diversity is another argument in favor of a return to more specialized, simpler institutions and the segmentation of markets, perhaps with a return to the "public utility" aspect of banking for core deposit-taking institutions and regulatory segmentation of institutions into areas such as retail banking, long-term savings institutions, and wholesale investment banking. Each function could then be regulated to discourage it from holding risks it does not have a natural capacity to hold and manage.[2] Alternatively, specific regulations tailored to the different financial activities undertaken within a universal banking structure, or the subsidiaries of a bank holding company, could be introduced to equivalent effect.

110. The virtue of differentiated regulatory structures and standards for different kinds of financial institutions has to be offset against the risks of regulatory arbitrage. There needs to be systemic oversight over the entire financial system to make sure that there is not extensive regulatory arbitrage.

MICRO-PRUDENTIAL REGULATORY ISSUES

Restricting Excessively Risky Practices

111. It is clear that the banks have engaged in excessively risky practices. They have had excessive leverage and traded in highly risky credit default swaps without adequate assessment of counterparty risk. Trading in subprime mortgages and complex securities based on these mortgages exposed banks to risks that they did not fully assess.

112. This crisis illustrates the risks of excessive leverage, which yields high returns to equity when markets are going up but exposes them to huge losses when markets are declining. If a financial institution has a 30 to 1 leverage, just a 3% decline in asset prices wipes out all the value of the owners' equity.

113. Unrealistic market expectations of returns to equity, often in the range of 20 per cent per annum, typify the market pressures that existed before the crisis. Such returns can only be achieved if there is: (a) lack of competition or (b) excessive risk taking. Such returns in the financial sector should be the subject of intensive scrutiny and supervision. If they are a result of insufficient competition, strong antitrust actions need to be undertaken (see below). If they are the result of excessive risk-taking based on the expectation of a government guarantee, then they should be directly proscribed by the regulator.

114. The extent of the risk associated with any particular action may depend on the state of the business cycle. The same loan-to-value ratio in a bubble poses greater risk than in more normal

[2] In the United States, the regulatory segmentation introduced by the Glass-Steagall Banking Act of 1933 was progressively eroded from 1980 to 2000 and formally abandoned with the Gramm-Leach-Bliley (GLB) Financial Modernization Act of 1999. Under GLB, banks and other financial institutions were permitted to commingle banking, insurance, and securities activities within a holding company structure. At the time, the promoters of such legislation emphasized the benefits of diversification and ability to compete with foreign institutions that were permitted to combine these activities in one institution. Little concern was voiced about conflicts of interest among the various dimensions of the business, or about the commingling of risky activities with the core activities of the payment system and deposit protection. The Group of 30, under the leadership of Paul A. Volcker, in its January 2009 report *Financial Reform: A Framework for Financial Stability*, has called for establishing "new constraints on the type and scope of their risk-taking activities" for those institutions that carry the major responsibility for maintaining the financial infrastructure.

times. This provides a further rationale (besides economic stability) for counter-cyclical capital adequacy and/or provisioning requirements discussed in the previous section.

115. Regulators should not, however, rely just on capital adequacy standards, even cyclically and risk-adjusted capital adequacy standards. One reason is that such restrictions may, in fact, induce greater risk taking, because while the firm may have more "wealth" at risk, there is a diminution in the franchise value of the bank as an ongoing concern, so there is less to lose in a bet that threatens the bank's survival.

116. Regulators also need to be attentive to managerial incentives and who bears the risks of failure. This is especially so in the current crisis when the government may have provided large fractions of the capital of a bank, but governments have chosen not to exercise adequate control. While the capital provided by the government enhances the bank's buffer against shocks, the impact on incentives may be far less, as bank executives focus their attention on private shareholders or even on the consequences to themselves. Thus, when the U.S. government provided more funds in the form of preferred shares, banks used the money in part to fund bonuses, share buy backs, and dividends, even though such actions significantly increased the risk of future problems.

117. Risk adjustments can also discriminate against developing countries and contribute to systemic instability. Under the Basel I accord, short-term lending was treated as less risky than long-term lending. Lending to developing countries, even those that seemed to have a record of economic stability, was treated as riskier than lending to more developed countries. These adjustments resulted in extensive reliance on short-term lending to developing countries contributing to the crisis of 1997-1998.

118. Governments, especially in developing countries, may want to consider other restrictions such as quantitative restrictions and/or higher provisions on the fraction of bank portfolios that can be allocated to certain sectors prone to speculative activity, such as real estate. This may not only lead to greater stability but also ensure greater financing for infrastructure or employment-related investments on a longer-term basis.

119. Countries that allow banks to own equity shares may experience greater volatility because a sudden decrease in stock prices can induce a credit contraction. Specific, appropriate regulation should thus be exercised if banks invest in equity shares.

120. Some problems in earlier crises were a result of foreign exchange mismatches. Regulations should place strict limits on uncovered foreign exchange exposures. Attention should be paid to indirect foreign exchange exposure, that is, loans to firms that have foreign exchange exposures. Since such exposure is cyclically related, such regulations may play an important role in macro-economic instability, and can be viewed as part of macro-prudential regulation.

121. Similarly, there should be restrictions on engaging in swaps and other insurance and derivative products other than to hedge or mitigate existing risks. Banks, with their implicit or explicit government guarantees, should be prevented from activities that may significantly increase their individual and systemic risks.

122. Countries that allowed the balance sheets of domestic banks to grow beyond the size of their economy will have difficulty in meeting guarantees should the banks fail, or can only do so at great

cost to the rest of society. It is thus necessary that either: (i) a global deposit insurance fund be created, funded by fees on banks or a tax on all cross-border deposits and backed by the governments of the depositors or (ii) depositors in foreign banks not explicitly insured by the host country recognize that those deposits are not insured. The provision by the host country of deposit insurance should only extend to separately capitalized subsidiaries of foreign banks, with strong restrictions on the pay-out of capital to the holding company and close oversight by host country regulators.

Regulating Securities Markets

123. Banks are only one part of the modern financial system, and many non-bank operations in the securities market have contributed to the current crisis. Excessive volatility in securities markets can have adverse effects throughout the financial system.

124. Securitization held open the promise of risk-diversification and access to new sources of funding. But it also opened up new information asymmetries and avenues of inappropriate behavior by investors who did not possess the ability to bear the risks or could not evaluate them appropriately since they did not have the relevant knowledge of the underlying assets available to the originators. Markets, regulators, and the models used by bankers, credit rating agencies, and investors to assess risks overestimated the benefits of risk diversification and underestimated the costs of the information asymmetries and herd behavior by investors.

125. Securitization has also presented new problems for debt restructuring that were already evident in the response to problems that arose earlier in the debt crises of the late 20th Century. It was far easier to restructure the sovereign debts in the Latin American crises of the 1980s than in the East Asian and Latin American crises of the late 1990s and early years of this decade. In the present crisis, restructuring has been made more difficult by explicit restrictions imposed by the securities that were issued (presumably to give more confidence in these securities). Further problems have been created by complicated conflicts of interest: where the interests of service providers, nominally responsible for the restructuring, may not coincide with those of mortgage holders; where there are conflicts of interest between those who hold first and second mortgages; and where the service providers are often owned by those who hold the second mortgage There are large social costs associated with these difficulties in restructuring that become particularly acute in an economic crisis and which parties promoting securitization may not fully internalize.

126. Originators of securities should be required to hold a stake of at least 10 per cent in each securities issue they underwrite. While this might reduce the capacity for future securitization, it would also substantially reduce the potential for systemic risks associated with structured products and would encourage higher underwriting and lending standards.

Regulation of Credit Derivatives and Swaps

127. Since the default of a large corporation can have far greater monetary implications than the size of any of its outstanding liabilities, it may be prudent for lenders to hedge the risk of default of the company affecting its suppliers, dealers, pensioners, stores local to the employees, etc., so that the outstanding value of credit default swaps (CDS) may be larger than the liability of the direct creditors. However, there are systemic implications of a large CDS market, especially where there is

no centralized clearing house or regulated exchange trading. As the AIG episode illustrated, a failure of one institution can have a cascade of effects, and it may be very difficult to evaluate fully the nature of counterparty risk.

128. Hence regulatory agencies should be authorized to require any CDS transactions (singly or in total) that it considers to be of systemic importance to comply with a range of requirements, including registration, centralized clearing, and, where appropriate to the risks being taken, margin and capital requirements.

129. When there is extensive exposure to over-the-counter (OTC) CDSs, as noted above, the effective exercise of market discipline requires the disclosure of net positions so that the market can evaluate the nature of the counterparty risk. Revelation of gross exposures will not suffice, in particular because details of contracts may mean that positions are not really fully netted out. Thus, while the regulator should have a preference for exchange-traded instruments relative to OTC instruments, if the latter are approved, there should be adequate transparency in the form of mandated and regular reporting to the regulator, and aggregate information should be put in the public domain as determined by the regulator.

130. Comprehensive regulation entails ensuring that equivalent instruments be treated with equivalent regulation. Thus, for example, to the extent that a CDS is equivalent to an insurance contract, it should be subject to equivalent regulation.

Investor Protection and Access

Predatory lending and usury

131. Regulating predatory lending is primarily a matter of consumer/investor protection, but, as this crisis has shown, it is also a matter of risk management. The elimination of usury restrictions has been advocated on the grounds that it encourages risk taking. But it may have resulted in excessive risk-taking and the abuse of ill-informed borrowers. The excessive returns garnered by such lenders have contributed to the bloating of the financial sector.

132. The subprime mortgage market provided examples of predatory lending, but there have been other abusive practices as well. Regulators need to be attentive to the variety of forms that circumvention can take, e.g. through rent-to-own and payday loans.[3]

133. Recent years have seen particular abuses in regulations covering the use of credit cards. Such practices have flourished, in part because of anti-competitive behavior, which has helped generate above market returns. Moreover, abusive lending practices lead to high returns to lending and have contributed to a build-up of excessive household debt. The misery of the ill-informed borrower is compounded by the recourse by lenders to recovery agents who use unregulated and often illicit means of loan recovery. Some governments have introduced measures to discourage such predatory practices, such as making abusive credit contracts unenforceable.

[3] Rent-to-own provides household goods for a low weekly or monthly self-renewing lease payment without any down payment or credit check. The lease provides the option to purchase the goods. Payday loans are cash advances made at extremely high interest rates that are secured by the borrower's personal check to the lender, covered on the next payday with the borrower’s next paycheck.

134. Even when lending practices may not be predatory, mortgage and other financial products may impose excessive risk or costs on borrowers. An important function of a Financial Products Safety Commission or a similar body within a broader regulatory structure is to assess the safety and appropriateness of financial products for individuals in different circumstances.

Access regulation

135. Financial regulation can and should be used to affect lending patterns where social and private returns may differ. It can help direct lending into socially desirable areas and discourage lending where private benefits exceed social costs.

136. For instance, many countries have enacted regulations to prevent racial and ethnic discrimination and have passed legislation to encourage lending to underserved groups. In some countries, mandates for lending to underserved segments have played an important role and have even proven profitable in the long-term. While pressure has been exerted on developing countries to eliminate such requirements, the U.S. Community Reinvestment Act is actually a successful example of such practices. Because information is at the heart of banking, requirements that banks open up branches in underserved parts of a country can also be an important instrument of development. Negative and positive "priority" lending may be most effective when broad based, leaving the private sector with the strongest incentives to find the best commercial opportunities within those constraints.

137. Regulations affecting the direction of lending can also be used for macro-prudential reasons. While lending to the real estate sector can have a number of social benefits, it is also a common source of excessive lending and asset market bubbles. Consequently, limits to real estate-related lending, such as loan-to-value limits on mortgage lending, should be instituted. These limits should be counter-cyclical, rising in a boom and falling in a crash.

138. Restricting lending, e.g. to the real estate sector, may also be an important instrument in encouraging lending to other sectors. Such restrictions may enhance stability, development, and job creation. This is an arena in which regulatory tools should be accompanied by other instruments of financial policy. (See the discussion in below.)

Regulating Competition

139. Competition policy (antitrust) is one area of government regulation that applies to all sectors of the economy—including the financial sector—but inadequacies in such regulation may be particularly manifest, and costly, in the financial sector.

140. Failure to enforce effective antitrust policies has led to excessive concentration in the financial sector. Lack of competition is evident in supra-normal profits, in excessive fees, in other anti-competitive practices, and most importantly in this context, in banks that have grown too big to fail.

141. Even more worrisome is the claim by some governments that certain banks are too big to be financially restructured (or "resolved") (TBTR). The argument is put forward that any resolution entailing losses to shareholders or bondholders would cause such massive market disturbance

and/or impair the ability of banks to raise capital in the future that the costs exceed the benefits. In such cases, taxpayers must pick up a much larger part of the cost of financial restructuring. They provide money that otherwise should have come from shareholders or bondholders. Financial restructurings may be close to zero-sum games, implying that if the losses of shareholders and bondholders are reduced, the losses to taxpayers are increased by a corresponding amount.

142. Not only will such institutions face distorted incentives towards excessive risk-taking since they know that the government will bear the costs of large losses, but the implicit subsidy given to these institutions also produces market distortions. Under current arrangements, knowing that they are too big to fail or to be financially resolved, large banks have an unwarranted competitive advantage over smaller banks because of the implicit insurance.

143. One of the original motivations for antitrust laws was a concern for excessive concentration of political power. The ability of the financial sector to obtain favorable laws and regulations, at great cost to the rest of society, and to obtain large bailouts and to do so repeatedly, combined with evidence of large campaign contributions and heavy lobbying, suggests cause for concern.

144. While the increase in market concentration may be a natural consequence of the winnowing out of firms in the context of a major economic downturn, the problem has been exacerbated by the way some governments have managed bailouts. Disproportionate amounts have gone to large and dominant firms. In providing bailout funds, the impact on the competitive structure of the financial sector should be an important criterion.

Too-big-to-be-resolved financial institutions

145. When faced with the challenge of restructuring large multifaceted institutions on the verge of insolvency, public officials have chosen deliberate forbearance on the grounds that public control of these institutions (through nationalization or intervention—in the latter case, putting them into conservatorship, in U.S. terminology) and/or inducing a financial restructuring that entailed a loss to shareholders or bondholders, even those that are not secured, would produce catastrophic disruption of financial markets and the real economy. Some have suggested that the sheer size and complexity of these institutions means that changing organizational forms would start a run on other institutions heavily intertwined with the behemoth institutions on the threshold of insolvency.

146. Whether or not these arguments are valid, if governments adopt this principle, it means in essence that society is faced with a policy regime where officials claim they cannot protect government finances and taxpayers from the excesses of the TBTR firms. A strategy of allowing a financial institution to embed itself so deeply into the fabric of the economy that it cannot be permitted to be resolved puts society in a position of great fiscal danger. It no longer has control of the scale of fiscal losses that can be imposed upon it by financial institutions' managers.

147. This puts the management of TBTR institutions in a very powerful position incompatible with wider social goals. The problems are far worse than with too big to fail (TBTF) institutions. In some countries, even at present, the scale of these institutions has reached such a magnitude that the value of guarantees on liabilities is drawn into question.

148. The TBTR regime goes beyond TBTF, where critical functions of restructured institutions have to be preserved. These can be preserved while making shareholders and bondholders bear the

costs of their mistakes (though in some cases, their mistakes are so large that the government may be required to provide additional funding to maintain the firm as an ongoing institution). A TBTR regime implies that management and creditors are immune from the consequences of their actions or inaction—particularly in relation to risk management. There is insufficient market discipline, since TBTR status removes risk from creditors, giving these institutions an advantage that enables them to further increase their size. A policy regime such as this is not consistent with a market economy that performs its social functions well in the longer term.

149. Standard antitrust policies should be implemented, but the usual metrics for excessive economic concentration (share of the top four firms in the market, or the ability to determine market prices) may not be totally adequate in the context of financial markets. These criteria may need to be supplemented by an assessment of whether the financial institution is at risk of being too big to fail or too big to be financially restructured. Such large institutions should be broken up and limited in size so that they are not too big to fail and certainly not too big to be financially resolved. There is little evidence of significant economies of scale or scope, at least of sufficient magnitude, to warrant the risks imposed on the economy and the public finances.

150. But such measures need to be supplemented by financial sector regulatory measures. Any large bank that is not broken up should have stronger capital adequacy requirements than other banks and face more stringent restrictions in each of the areas discussed so far (e.g., on the admissible set of incentive structures, on transparency, and on the kinds of risks that they can undertake, such as lower leverage). Because of the greater cost to government of problems in these institutions, they should also face increased premiums for deposit insurance.

Regulating Other Players

151. Financial markets have become more complex over time. Finance is provided by banks and through securities markets. There are a host of other actors, some of whom have played an important role in the current crisis and have become the subject of extensive controversy. In particular, there are two non-traditional groups of financial institutions that require special attention: rating agencies and sovereign wealth funds.

Rating agencies

152. Credit rating agencies (CRAs) were supposed to play a key role in financial markets by reducing information asymmetries between issuers and investors. Their role has expanded with financial globalization and received additional importance in Basel II, which incorporates the CRAs' ratings into the rules for assessing credit risk.

153. However, the role of rating agencies in the present crisis has been subject to serious criticism due to the generous ratings given to complex financial instruments backed by subprime mortgages. The risk assessments of rating agencies have been highly pro-cyclical and tend to react to the realization of risks rather than to risk build-up, in relation to both sovereign and corporate risk. The risk models of CRAs rely, to a large extent, on market-determined variables like equity prices and credit spreads, thus exacerbating pro-cyclicality.

154. Since CRAs are paid by those they are asked to evaluate, they are subject to a clear conflict of interest that has undermined confidence. Moreover, the provision of consulting services to their

clients presents another conflict of interest similar to that forbidden to accounting firms in the United States. It is no less problematic in the case of rating agencies, and these should be forbidden.

155. This is not the first instance of wide-spread failures of the CRAs. Their failures were widely noted in the 1997-1998 financial crisis, and it is widely thought that the late and marked downgrades to below investment grade in many cases contributed greatly to the depth of the crisis.

156. Inaccurate assessments may have other adverse effects beyond exacerbating cyclical fluctuations. As assessments of creditworthiness by CRAs came to be viewed as authoritative in financial markets, such ratings often adversely affected financing for developing countries. Indeed, they may have contributed to the fact that there appears to be "excess" returns to a diversified portfolio of sovereign bonds, i.e. such bonds are underpriced.

157. In spite of the fact that CRAs play such a large role in financial markets, they are essentially unregulated. While greater oversight is required, there is no set of reforms that have received general support and which would convincingly resolve the problem. One reform, designed to remove the conflict of interest, would impose a charge on all security issues to be used to finance one or more ratings.

158. Greater transparency in the way that rating agencies discuss and present their analyses, clarifying assumptions made and the sensitivity of the results to these assumptions, should enhance the functioning of financial markets. In addition, rating agencies should be required to provide information concerning their overall past performance, and/or an independent government agency should provide such information, which would enhance "positive" competition among rating agencies. Rating agencies should be forced to abandon their obscure and non-comparable rating systems and provide a quantitative assessment of the probability of default. The accuracy of these forecasts can then be assessed.

159. Part of the problem is caused by the small oligopoly market structure of the credit rating agencies, which means that ratings failures do not lead to significant market discipline. Many investors, and hence borrowers, are required by their investment by-laws to obtain a rating from each of the main agencies. It may be necessary, therefore, for the government to impose discipline by penalizing rating failures, e.g. losing the "accreditation" for a certain period of time after evidence of systematic and significant failures in assessment. But even this remedy has problems. Since ratings are correlated, there is a chance that all agencies will lose their accreditation at the same time. Knowing that it would be hard to enforce such a policy in such a circumstance may encourage rating agencies to maintain ratings that are similar to each other.

160. Given the difficulties of resolving the problems posed by CRAs, it is important that regulators and others charged with risk management reduce their reliance on external ratings. Rating agencies proved to be no less pro-cyclical than market prices, and their use by regulators has added to the pro-cyclicality of bank lending.

161. Problems with individual ratings need to be viewed in the broader context of the provision of information in the financial sector. In the Enron and WorldCom scandals, conflicts of interest in the stock and bond research and ratings provided by analysts paid by investment banks drew extensive criticism. In the recent food and energy crises, information provided by some investment banks may have simultaneously enriched those providing the information and contributed to those

crises. While the reforms concerning analysts' pay were a move in the right direction, they do not go far enough. There should be disclosure at least to the regulator (as is already the case in some countries) of the positions of investment banks and others capable of "moving" markets, to at least identify potential conflicts of interest.

Sovereign wealth funds

162. Earlier conventional wisdom argued that ownership did not matter, so long as it was not the government of the country in whose domain the assets resided. Developing countries were urged to privatize state-owned assets, paying little attention to the identity of the buyer, even if, in some cases, it was a foreign government or government-owned firm. It seemed permissible for a foreign government to own a country's assets but not the country's own government. As entities owned and controlled by foreign governments have taken more active roles in purchasing assets in developed countries, these views have evolved, creating uncertainty over the rules of the game. Whatever rules are devised and agreed upon should be universally and fairly applied.

163. There may be particular industries or sectors where ownership matters. Governments should agree on these sectors and make them public. If national security provides a rationale for ownership restrictions in one country, there should be a presumption that it provides a rationale for similar limitations on ownership in other countries. If ownership matters, one should be as concerned by aberrant private sector behavior as by that of a government-owned enterprise. Indeed, some have suggested that governments may be more responsible investors than private investors, precisely because of the greater degree of public accountability expected.

164. Some have suggested that a special code of conduct be imposed on sovereign wealth funds, including provisions relating to transparency and disclosure, including disclosure of the sovereign wealth fund's business model. Others have argued this is just window dressing on the part of countries that want the funds but realize the political sensitivities: almost any action can be cloaked within a business rationale. While transparency and disclosure may be helpful, it is unlikely that it would solve the problem. So too with a broader voluntary code of conduct.

165. Any conditions or requirements imposed on sovereign wealth funds should be symmetrically imposed on private-sector investors. The point is reinforced by the growing blurring of the line between private and public investors, with the bulk of the capital of many Western banks now being provided by governments.

166. Moreover, restrictions on sovereign wealth funds may be relatively meaningless, so long as there is no comprehensive disclosure of ownership. Ownership stakes could be mediated through third parties (such as hedge funds) without disclosure. If governments are concerned about ownership, there has to be appropriately comprehensive disclosure.

167. If there are certain behaviors of the foreign owner that are a source of concern, those behaviors should be restricted, whether on the part of private or government entities. Worries about their behavior are thus symptomatic of a lack of confidence in the overall regulatory regime. Countries should identify the inadequacies in their regulatory structures and seek to remedy them.

FINANCIAL RESTRUCTURING

168. All governments need to have adequate legal frameworks to deal with situations where firms cannot meet their obligations to creditors (i.e. bankruptcy). Such laws need to balance the rights and interests of creditors and debtors and the consequences for economic efficiency, both ex ante (i.e. the impact on incentives to assess credit worthiness) and ex post (i.e. the impact on incentives on the part of debtors to comply with their obligations, of creditors to monitor effectively, and of both sides to enter into timely renegotiations when problems arise). They should create a framework for fair negotiation among the parties involved, leading to rapid and efficient bankruptcy proceedings if such negotiations fail. It is better to have clarity about such matters prior to the signing of contracts so that parties know more fully their rights and responsibilities.

169. Some countries, such as the U.S., have corporate bankruptcy provisions that allow for speedy resolution, giving firms a fresh start in the belief that it is in the broader interests of society to maintain jobs and the firm as an ongoing concern. Keeping a family in their house is equally important, as is giving families overburdened with debt a fresh start. Governments should consider passing a "homeowners Chapter 11" (analogous to Chapter 11 in the U.S. bankruptcy code for corporations).

170. The bankruptcy of large numbers of firms in the midst of a crisis presents special challenges. Delays in resolution have large externalities, giving rise to adverse macro-economic effects. Furthermore, many countries do not have adequate resources to deal with such massive problems, which are complicated by high levels of interdependency (i.e. assessing the net worth of one firm for purposes of bankruptcy may depend on the resolution of the debts for other firms). Governments need to consider passing a "super Chapter 11" to facilitate expedited restructuring in the event of a systemic crisis where there are large numbers of defaults such as occurred in several developing countries after their financial crises.

171. Banks and other financial institutions present special problems for debt restructuring because of the stake of the government, through implicit and explicit deposit insurance, because of the externalities that may result from the failure of such institutions, and because the government does not want to wait until the institution has no capacity to repay creditors. Doing so can give rise to especially large adverse incentive effects, e.g. "gambling on resurrection." It is necessary for governments to have a legal framework for prompting corrective action, including intervening in such institutions (placing them into a conservatorship) and other discretionary powers of resolution.

172. In the current crisis, some governments claimed that they did not have legal authority to deal effectively with institutions whose failure might pose systemic risk. It is clear not only that any such institutions should be highly regulated but also that there need to be effective mechanisms for financial restructuring. Such mechanisms should apply to any financial institution judged to have the potential to cause systemic consequences, including financial services holding companies, investment banks, and insurance companies. Foreign firms operating within a country that have systemic consequences present special challenges, and there is accordingly a strong argument to require domestic incorporation. (These arguments are in addition to the other arguments, discussed below.) Such mechanisms need to recognize the rights not only of shareholders and bondholders but also those likely to be adversely affected by a failure of the institution.

173. Converting long-term debt holders into shareholders increases the financial viability of the bank and should enhance market confidence, not weaken it. There is very limited if any evidence that, in the process of conservatorship, shareholders' loss of value will generate market disturbance.

174. Of course, a disorderly process of bankruptcy in which the integrity of the payments mechanism is not protected can give rise to large externalities. Government powers of resolution should extend to allowing a quick restructuring of the large financial institutions, which would facilitate the maintenance of the integrity of the payments system but allow, for instance, an associated real estate or hedge fund within the institution to go into bankruptcy.

175. The need for using such powers of resolution will be reduced if governments adopt strategies to limit the absolute size of financial institutions. In addition, extensive examination of large institutions on an ongoing basis can prepare officials for controlled restructuring. There is not a basis for allowing these large institutions any degree of opacity *vis-à-vis* regulators, who must always be prepared for the contingency of a resolution.

Incentives, guarantees insurance, and bail-outs

176. Guarantees and insurance (implicit and explicit) distort incentives since they are designed to eliminate the risk of loss; the higher potential gain from more risky behavior accrues to the recipient of the guarantee, while the larger losses are absorbed by the guarantor. Concern about these distortions has been increased by the massive increase in government guarantees in the present crisis.

177. The recent bailouts have also raised issues of conflicts of interest and divergences between the interests of firm managers and of those providing capital. The provision of capital by some governments without exercising control over how the capital is used exacerbates the usual incentive problems that arise when there is a separation between ownership and control. The much criticized behavior of banks taking money intended to recapitalize them and paying it out in bonuses and dividends instead is explicable in terms of the differences in interests between those making the decisions (the bank officers) and the public providing the money. The risks should have been apparent (see the discussion in Chapter 2).

178. Some governments have used guarantees and insurance as part of bailout packages that lacked sufficient transparency concerning the risk of loss; it has not always been clear that governments have been adequately compensated for the risk borne by the public. Such non-transparency should always be discouraged, but some of these programs may be particularly costly in this crisis because they create perverse incentives on the part of banks to restructure mortgages.

179. However, in times of economic crisis, guarantees and insurance may be part of a government's crisis response in order to stimulate counter-cyclical economic activity and to prevent runs on banks. In some cases, issuing government guarantees may even be a strategy to attract individuals to make investments (or to induce banks to finance investments) with relatively high risk but with highly positive long-term economic, social or ecological effects. However, there is some presumption that providing guarantees for new loans or creating new lending facilities may be a more effective way of stimulating such investments than buying non-performing assets from banks or even providing new funds to existing banks for recapitalization. Adverse incentive effects can be mitigated by providing only partial insurance guarantees.

180. While the main mandate of central banks is to provide liquidity, when this involves accepting risky assets as collateral on a non-recourse basis, it amounts to an insurance policy on the losses associated with these assets. When insurance premiums on such guarantees and insurance are not set at the appropriate level, they represent a non-transparent transfer, and such non-transparent transfers on the part of central banks and governments should be discouraged. Typically, such guarantees, bailouts, and insurance represent a large transfer of wealth from ordinary individuals to those who are, on average, better off. If there are particular groups that might be adversely affected by a financial restructuring and deserve to be protected, it is far better to target assistance to such parties. The non-transparent bailouts, guarantees, and insurance undermine confidence in government and central banks, strengthen the case against an independent central bank (see the discussion above), and may create a political backlash, hampering government's ability to deal with the present crisis if it proves to be as long lasting as some believe it may.

REGULATORY INSTITUTIONS

Regulatory failure

181. It is not enough to have good regulations; they have to be enforced. The failures in this crisis are not just a failure of regulation but of regulatory institutions that did not always effectively implement or enforce the regulations. In this crisis, the regulatory performance of many central banks has been far from stellar. They did not adequately enforce and implement the regulations at their disposal, and they did not alert governments to the need for additional regulatory authority or restructuring authority when existing authority was not adequate.

182. All human institutions are fallible, and it may happen again, especially if those who are appointed to oversee the regulatory system do not believe that regulation has a role or are not fully sympathetic with the roles that it should play.

183. At the same time, it is clear that regulatory structures can be designed in ways that reduce the scope for the failure of regulatory institutions. Regulators may be under pressure during a boom. While the regulator is supposed "to take away the punch bowl just before the party gets going," pressures are often brought to bear to continue the party, since so many are making so much money doing so. Specious arguments are brought forward—such as the impossibility of identifying a bubble until it breaks. This is true, but it is possible to ascertain an increasing probability of a bubble as prices relative to incomes attain historically high or even unprecedented levels.

184. Another specious argument is that regulators or central banks do not have instruments with which to deflate a bubble. The instruments available—increasing margin requirements in the case of a stock market bubble or decreasing loan-to-value ratios in the case of a real estate bubble—have been analyzed elsewhere in this report.

185. Still a third specious argument that was put forward before the crisis is that it is less expensive to repair the damage caused by the breaking of a bubble than to dampen the bubble itself. The current crisis has clearly shown that this is not the case.

186. In light of this pressure, it may be necessary for part of the regulatory structure to be "hard wired," limiting the discretion available to regulators and supervisors. Counter-cyclical provisioning

and capital adequacy requirements of the kind discussed in previous sections should be rule-based, while adjustments to regulation due to evolution of financial practices and innovation will require monitoring and discretion in adjusting regulations as appropriate.

Capture and voice

187. Regulatory institutions have to be created with recognition of the risks of capture by the interests and perspectives of those being regulated, and they must ensure that the users of finance—such as small and medium-sized businesses, pensioners, consumers, and perhaps other stakeholders—are given voice. For instance, pensioners who are likely to see their hard-earned pension funds disappear as a result of poor regulation should have a stronger voice in regulatory structures. Those who benefit from the continuation of a bubble often have excessive influence on the regulatory institutions as presently constituted.

188. The creation of a specific financial regulator (with appropriate governance structures) whose mandate is to ascertain the safety and appropriate use of various financial products may reduce the likelihood of regulatory capture.

Regulation and political processes

189. Regulation is part of the political process; failures in public governance contribute to failures in regulatory design. When the political process is unduly influenced by campaign contributions and other forms of lobbying by the financial sector, failures in the design of financial regulations become more likely. In some countries, "revolving doors" that allow individuals easy movement between jobs in government and the private sector and other pecuniary and non-pecuniary considerations present problems compromising the integrity, adequacy, and appropriateness of financial regulation, supervision, and enforcement.

190. Regulatory design needs to be able to resist attempts by the industry to influence regulators and to divert them from their core responsibilities of consumer and investor protection and systemic stability. Much can be done to design regulatory systems that have built-in resistance to capture, such as reliance on simple and transparent rules regarding the regulation of instruments that are potentially of systemic significance. The design of regulatory governance can also reduce the scope for capture, ensuring that those who are likely to be hurt by a failure of regulation rather than those who benefit from weak regulation dominate the regulatory process.

191. "Regulatory capture" occurs not just through financial contributions but also through ideas. Many of the ideas that persuaded regulators to limit regulation simultaneously enhanced the profits of the financial sector. "Revolving doors" not only provide perverse incentives but also facilitate this form of capture. Governments should put in place strong restrictions on revolving doors. Today, there are experts in finance and economics that neither work for nor are indebted to the financial sector, and greater reliance should be placed on them. More generally, those from the financial sector, even though they are familiar with industry practices and perspectives, often do not understand the systemic consequences of policies and even less the implications for the broader economy. Reliance on experts from the financial sector may, as a result, lead governments to have an excessively "partial equilibrium" approach to policy. This crisis can be seen, in part, as a result of excessive attention being given to these forms of expertise.

Personnel

192. Many regulatory bodies face difficulties in attracting qualified personnel: the battle between the regulator and the regulated might seem to be unfair from the start, given the high salaries paid in the private financial sector. But the skills and talents necessary for creating new products and circumventing existing regulations and accounting standards are different from those required for assessing the safety and soundness of financial institutions or the safety and efficacy of particular financial products. Nonetheless, it may be desirable, or even necessary, to link the salaries of the regulators to those in the financial sector, paid for by a financial sector tax.

Regulatory structure

193. Much of the discussion over regulatory design has focused on the problem of assignments of responsibilities, e.g. should there be a single regulatory authority for the entire financial sector? Old models of regulatory structure have been failing because different institutions have been providing services formerly associated with other institutions. Securities markets, insurance firms, and futures exchanges all provide opportunities for market participants to speculate on the outcomes of particular events (securities, defaults). Should, for instance, responsibility be assumed by the central banks? While there appears to be no single model appropriate for all countries, there are certain principles that should guide the design of the regulatory structure.

194. While different countries, at different stages of development, may find different structures better in meeting their overall needs, one possible structure entails two apex regulatory institutions working closely together: a New Central Bank (NCB), focusing on macroeconomic issues, and a Financial Regulatory Authority (FRA), focusing on micro-issues, closely coordinated with each other so that, for instance, the NCB would be aware of the macroeconomic consequences of the actions taken by the FRA. This is especially important because micro-prudential regulations have macroeconomic consequences. The FRA would have several subcommissions under it: a Securities and Exchange Commission, an Insurance Commission, a Financial Products Safety Commission, an Accounting Oversight Commission, and a Financial Systems Stability Commission (which among other things would look at the interlinkages among financial institutions and the vulnerability of the failure of one to that of another). It would have cross-cutting committees to ensure that similar functions performed by different institutions are treated similarly. The Financial Systems Stability Commission could impose high margin requirements or large down payments for products sold to retail customers if it felt that there was growing excess leverage in the economy or in the market. The Accounting Oversight Commission would ensure that the information provided by firms is not misleading and represents the best estimate of the overall state of the firm, including its vulnerability. It might, over time, develop a broader set of metrics that might be of use to investors and other regulators. It would seek to prohibit off-balance-sheet exposures but recognize that financial institutions have been creative, both in their accounting and in devising ways of circumventing regulations and accounting standards, and be given broad discretion to impose additional reporting requirements and to employ conservative methodologies in the valuation of risk or dilution. For example, while there may be controversies over valuing stock options for purposes of reporting at the time they are issued, given the objectives of accounting standards and the importance of developing good incentive structures, methodologies which might be at risk of overestimating the value of the dilution are to be preferred to those that underestimate the value.

Global Regulation and Regulation of Cross-Border Finance and Capital

195. This crisis in global financial markets differs from all previous crises in its global reach. The new financial products and procedures that caused difficulty in the U.S. were exported on a large scale, with severe consequences for the importing countries. While it may not be the only source of the problems facing some European countries, it is a major contributor. As the crisis has evolved, there has been a breakdown of trust in financial institutions. Citizens no longer trust the regulators supposed to regulate them, and regulators in one country no long trust that regulators in other countries, even those with seemingly good institutions, are doing their jobs properly.

196. Moreover, the policies pushed by the international financial institutions (financial market liberalization and capital market liberalization) are now seen as having contributed to the crisis and its rapid spread around the world. This has undermined confidence in these institutions, the advice that they proffered, and the conditionalities that they imposed, raising questions about the suitability of excess reliance on these institutions for the disbursement of funds to developing countries, as already noted in Chapter 2. New international regulations will thus be paramount in the response to the crisis. There is a need for a new approach to comprehensive global regulation.

Global coordination

197. As financial markets become global, it is imperative to have global coordination of regulation. Failure of regulation by one country can have adverse effects on others. This is especially important since responsibility for bailouts remains at the national level. If countries cannot rely on the safety of the financial products exported by a country, they may restrict the purchase of these products by their citizens and financial institutions; if they cannot trust the safety and soundness of other countries' financial institutions, they will have to restrict dealings lest their own institutions be put into jeopardy.

198. Without global coordination, there can be a race to the bottom, with countries competing to attract financial institutions on the basis of the laxity of regulation. This crisis illustrates the danger of such adverse competition. Countries should realize that the benefits of a larger financial market may be far outweighed by the costs which their citizens may have to pay, as Iceland illustrates.

199. Circumstances differ across countries, which suggests that the optimal regulation and regulatory structures might differ. Thus, there are items of regulation which should be national in focus with international coordination where the appropriate scope of regulation is international. The dividing line relates to those issues which require a high degree of reciprocity, particularly those issues where inadequate regulation in one country has large effects on other countries, either because of network effects, because of an induced race to the bottom, or because the regulations are designed to check money laundering, financing of terrorism, and tax secrecy.

200. The dividing line also depends on the representativeness of regulatory bodies. In existing global regulatory bodies, concerns of developing countries are often unrepresented or under-represented. For instance, the Basel I standards encouraged short-term lending (over long-term lending) by developed country banks to developing countries, exacerbating the volatility of their capital flows. Many are concerned that Basel II has the effect of discriminating against developing countries whose institutions do not have the ability to develop the complicated risk management

systems it requires—which, in any case, are now recognized as being totally inadequate.

201. These regulatory systems have been developed by international institutions with biased governance structures, with the under-representation of developing countries and other emerging markets, and with the over influence of the banks being regulated. Basel II is seen by many developing countries as a prime example of this.

Capital market liberalization

202. Regulations that affect the flow of capital into and out of a country may be among the most important in determining macroeconomic stability and the scope for policy responses in the event of a crisis. There is growing consensus that capital market liberalization may contribute to economic volatility, especially in developing countries. More broadly, a fully integrated global financial system may be subject to more volatility than one with "circuit breakers," such as those employed in many regulated securities exchanges. Part of the reason for this is that capital flows, particularly those to developing countries, tend to be pro-cyclical. And yet, there is little evidence that capital market liberalization contributes to economic growth, especially for less developed countries. A major reason is that the increased volatility associated with liberalization imposes high costs on an economy, including higher risk premiums, that increase financing costs. Another part may be associated with the fact that much cyclical lending finances consumption rather than investment.

C*apital account management for development*

203. Developing countries may need to stabilize international financial flows to promote financial and economic stability, to encourage desirable investment and financing arrangements, to enhance policy autonomy, including the maintenance of stable and competitive exchange rates, and to enhance national sovereignty and democracy. Full capital account convertibility, as well as implicit and explicit agreements to forego intervention in international capital markets, can make such desirable outcomes impossible.

204. To achieve these objectives, governments should have the space to undertake capital account management techniques as part of their development and risk management strategies. Such techniques have been used successfully in the past. They have included, but are not limited to, prudential management of foreign borrowing, imposing unremunerated reserve requirements, limiting short-term and other volatile flows, limiting foreign equity ownership of certain financial and other activities, and so on. It is imperative for the success of development strategies that countries undertake dynamic capital account management by having the flexibility to both tighten and loosen controls as and when necessary.

Capital market interventions during crises

205. Governments have a variety of policy tools to help stabilize financial flows. In a crisis, when traditional instruments such as interest rates are less effective, they may consider temporary restrictions or longer-term taxes on outflows, as well as quantity restrictions. Particularly in the context of a financial and economic crisis, countries may find it necessary to impose restrictions on capital outflows in order to give them more scope for monetary policy discretion.

206. To a limited extent, counter-cyclical reserve requirements on capital inflows can act as "speed

limits" (or "speed bumps") on international capital movements that have a preventive focus and increase the room for counter-cyclical macroeconomic policies. In a similar vein, greater prudential regulation of banks designed to avoid their own currency mismatches as well as those they finance can be simultaneously used as an important instrument in capital account management. In this area, some countries have gone as far as prohibiting financial institutions from holding currency mismatches in their portfolios or lending in foreign currencies to individuals or firms that do not have revenues in those currencies. Others have chosen to increase capital requirements for those who have currency mismatches.

207. "Host" versus "home" country regulation (see discussion below) may also allow governments greater scope for imposing such stabilizing and development-oriented regulation.

Financial market liberalization

208. The framework for financial market liberalization under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors (see Chapter 4, Appendix).

209. There is some evidence that, at least in some countries, the entry of foreign banks has done nothing to increase lending in general or to small and medium enterprises in particular but has contributed to the faster unwinding of lending in a crisis. Restrictions of the kind proposed in the following paragraphs may be helpful in addressing this concern. Such restrictions should be imposed broadly, on both domestic and foreign banks, even if such uniform restrictions indirectly have a differential effect on foreign banks.

210. Problems in the banking system in one country can spread to other countries in which that bank has branches or subsidiaries. Parent banks may restrict the lending of their foreign units, or governments may restrict the use of bailout funds to support lending in foreign countries. The current crisis has shown the need to ensure that "national treatment" means effectively equal treatment for domestic banks and foreign subsidiaries.

211. In order to ensure adequate funding for domestic lending by foreign banks and that the effective capital underlying such lending is not repatriated (as seems to have occurred in some countries), developing countries may find it desirable to require foreign banks to operate as subsidiaries, rather than as branches, and to closely regulate and monitor the outflow of capital from such institutions.

International banking centers and international tax cooperation

212. Well-regulated economies have to be protected from those that are under- or unregulated. The problems of tax competition and regulatory arbitrage are often linked. The lack of transparency and regulatory standards in some countries is harmful to the functioning of national tax systems as well as to the financial stability of others. Tax evasion and inappropriate tax practices are major problems for developed as well as developing countries. Each year, developing and developed countries lose revenues that could be used for the financing of development. It is necessary to strive

for a universal no-tolerance policy towards financial centers that provide banking secrecy and facilitate tax evasion.

213. While particular attention has focused on offshore financial centers in developing countries, so far the principal sources of tax evasion, tax secrecy, money laundering, and regulatory arbitrage have been through on-shore tax havens in developed countries' financial centers. Delaware and Nevada, for instance, are two U.S. states that make the establishment of anonymous accounts far easier than almost all international banking centers. Bank secrecy remains an issue in several developed country financial centers. London's light touch regulatory regime has also been a source of much regulatory arbitrage. The biggest money laundering cases involved banks in London, New York, and Zurich. The European Commission has decided to refer four smaller member states to the European Court of Justice over non-implementation of the 2005 anti-money laundering directive, and two large member states have been given a final warning. Moreover, the development of financial centers such as London, Luxembourg, and Dublin has been based partly on tax competition, and some developed countries engage in greater tax incentives, subsidies, and tax competition to attract foreign investment than developing countries can afford.

214. *Ad-hoc* and discriminatory targeting of the small international financial centers in developing countries while turning a blind eye to lax rules in developed economies is neither fair nor effective. For instance, while many developing country financial centers have several bilateral tax information agreements, the advanced economies do not reciprocate. It is important to move away from bilateral to multilateral agreements.

215. The determinants of standards and whether particular countries are in violation of those standards must be conducted through a multilateral process in which developing and developed countries have adequate representation. The current dominance of an organization of the advanced industrial countries in this area should be viewed as unacceptable.

216. The matter would be best handled through multilateral agreements on issues of tax secrecy, which have reciprocity and are enforceable by international courts. The major financial centers should sign up to these agreements first and then urge others to follow, with the threat that those who do not chose to do so will not be allowed to have links with those financial centers that have accepted the conditions of the agreement. Under these agreements, "rogue centers" should be ring-fenced from the rest of the international financial system, but this would be done in an objective manner that could include rich as well as poor countries.

217. The current system of one rule for the rich and a tougher rule for the poor and the preservation of centers and practices in developed countries that are not permitted in developing countries is patently inequitable. This is why focus should be on the removal of tax secrecy that facilitates tax evasion and highlighting tax avoidance practices. For responsible small states that accept multilateral agreements proposed to eliminate tax secrecy, exporting high-value services that are found in international financial centers is a viable development strategy that has, in fact, been promoted by international financial institutions over the past two decades.

218. Institutional arrangements for improving harmonization and cooperation on tax matters need to be strengthened. Building on Paragraph 16 of the Financing for Development Doha Declaration of December 2008, the UN Committee of Experts on International Cooperation in Tax Matters, which is part of the UN Economic and Social Council (ECOSOC) system, should be "upgraded"

into an intergovernmental body, such as a (functional) commission, to strengthen its ability to enhance international cooperation in this area. It should work to ensure that all countries commit themselves to the voluntary automatic exchange of information that would help root out tax evasion and corruption and also the repatriation of illegal funds. The IMF and other bodies could also have consultative status with the new intergovernmental body.

219. An International Tax Compact should be instituted that would complement existing initiatives and programs, strengthen the voice and participation of developing countries in ongoing processes, and provide more coordinated support for national tax systems in developing countries. Development cooperation needs to support domestic resource mobilization of developing countries challenged not only by tax evasion and avoidance due to weak domestic tax systems but also the existence of onshore and offshore financial centers facilitating tax evasion. The international community is encouraged to start a dialogue on how to tackle these problems within the framework of an international tax compact.

220. Of equal concern to developing countries as tax evasion and avoidance is corruption and money laundering, which not only deprive countries of needed resources but also undermine democratic governance. Bank secrecy facilitates this corruption.

Home versus host country regulation

221. The trend in financial regulation and supervision, under the auspices of the Bank for International Settlements' attempts to deal with cross-border settlement risk, has been toward home country responsibility. This trend needs to be reversed. Indeed, since host countries are still responsible for the functioning of their real and financial sectors, they can only fulfill that responsibility with effective oversight over all financial institutions operating within their country. This entails host country supervision and almost surely the requirement that foreign banks operating in a country establish subsidiaries rather than branches.

222. Strengthening host country regulation, introducing counter-cyclical capital charges and provisions, redefining the boundary of regulation to be more comprehensive while promoting diversity are all under the remit of domestic regulation—and permitted as part of supervisory discretion under Basel II.

Cross-border bankruptcy

223. The current crisis has illustrated the special problems posed by cross-border bankruptcies. In some cases, citizens of a country have been forced to bear the costs of insuring depositors from other countries. In other cases, worries about the consequences of a default on citizens abroad may have provided part of the rationale for massive government bailouts and part of the justification for why an institution is too big to fail or to be financially resolved.

Financial Policy

Going beyond financial regulation

224. Ensuring a well-functioning financial market requires, as already noted, more than just financial

sector regulation. Financial policies can play an important role in ensuring access to finance, especially for long-term investment and for underserved communities.

225. Policies outside the financial sector can also play an important role in affecting the behavior of the financial sector but can take on especial importance within the financial sector. Examples include competition policy, bankruptcy procedures (financial restructuring), and corporate governance. Failures in any of these areas can have profound systemic effects.

Lending and public banking to promote development

226. The objective of financial policy is not only to regulate institutions and the financial system in a prudential manner but also to ensure that the financial sector can live up to its potential positive contribution to society, including ensuring access to credit for all and the provision of credit for long-term development. As already noted, financial sector regulation is a key instrument of financial policy. But there are other instruments which countries, especially developing countries, should consider in order to ensure that the objectives of a good financial system are attained.

227. In the past, many financial institutions engaged in discrimination in lending to groups or sectors with particular risk characteristics. In the U.S. mortgage market this is known as "red-lining.". As a result, certain sectors of the economy may not have sufficient access to credit.

228. Financial institutions have also tended to focus on short-term lending, which is thought to have lower risk than long-term development financing. Financial sector policy in general and, on occasion, regulatory policy can play important roles in filling these lacunae in private institutions' lending practices.

229. In many countries, government institutions have played an important role in the provision of credit to underserved sectors and segments of society and in promoting development. Development banks have played an important role in the successful financing of development of several countries. Even in advanced industrial countries, these institutions have provided mortgages and credit to small and medium sized enterprises and to the agricultural sector, financed exports, and provided student loans. Public financial institutions have sometimes done a far better job at providing financial products that mitigate critical risks facing ordinary citizens at lower transaction costs than the private sector. These include public lending programs to finance educational expenses, which have been far more efficient than private lending and have avoided the corruption and abuses that have marked private lending. In many countries, including the U.S., the government has had to introduce special programs to ensure adequate credit access for small and medium-sized enterprises (e.g. partial guarantees, as under the Small Business Administration loan programs). In many successful developing countries, development banks have played an important role at particular stages of their development.

230. While there has been a presumption that a fully private banking sector is the best system to ensure the most productive and efficient provision of liquidity and management of risk, recent crises have shown another problem with private sector lending—it can be highly cyclical, exacerbating economic fluctuations. In addition, the experience of various developing countries suggests reasons to support a much more substantial role for publicly owned banks and financial institutions. A public bank can substantially realign incentives driving bank managers.

231. Further, by making the inherent and incessant profit motive subordinate to social objectives, it allows the financial system to exploit the potential for cross-subsidization and to direct credit—even if the bank incurs higher costs—to targeted sectors and disadvantaged sections of society. Given that a significant characteristic of those in poverty is limited access to finance, public banking can thereby facilitate financial inclusion. In the experience of several successful development strategies, public banking has allowed for the mobilization of technical and scientific talent to deliver both credit and technical support to agriculture and the small-scale industrial sectors that have the most direct effect on job creation and poverty reduction.

232. The current crisis has also highlighted problems associated with pervasive exploitation in the context of mortgages, lending to the poor, and student loans. Given the record of abusive lending to poor individuals, governments may need to consider whether regulatory mechanisms suffice or whether direct lending programs through public sector banks is a better option to reduce abusive practices.

233. Nevertheless, there is always a danger that public banks may have their portfolios manipulated for political rather than social reasons, and the record of public banks has been spotty. However, some recent experiences of public development banks, with better and more transparent governance structures, are encouraging.

234. Public and private banks have to coexist in a sustainable financial system. The Keynesian idea that government takes on those tasks the private sector is not able to carry out more efficiently, or where the risks of market failure are too high (including the risk of exploitation), may be one principle in establishing sustainable, developmental, and inclusive banking sectors.

235. In some banking systems, a large proportion of bank assets are loans to government in the form of holdings of government bonds. Banks that do so are failing to fulfill the critical social function of banks of providing credit to enterprises. This will almost inevitably impair growth and development. Governments should be encouraged to explore various mechanisms by which the banking system could be used to facilitate productive activity. One arrangement, for example, may be for the government to accept savings directly through a network of post offices to reduce the spread between the bank deposit rate and interest charged by banks for government paper and, in doing so, induce banks to look for other way ways to enhance the profitability of expanding their lending to productive enterprise.

CHAPTER 4: INTERNATIONAL INSTITUTIONS

The Need for New Global Economic Governance

1. The inadequacy of the response of international financial institutions to the global financial crisis and their failure to take effective actions to prevent the crisis have demonstrated the urgency of reforming existing international institutions. Such a review needs to include an appraisal of the mandates of these institutions and their governance. Attention also needs to be paid to the policies and philosophies underlying their operations.

2. There is a need to provide more effective voice and representation for developing countries, which now represent a much larger proportion of world economic activity than in 1944, when the World Bank and the IMF were created. Developing countries, as a group, also have a direct interest in a more equitable global governance system. Above all, it is imperative that reform of the existing institutions should re-establish their credibility as truly international institutions contributing to growth with equity and stability for all countries.

3. There currently is a unique opportunity to bring forward global economic governance reforms. The current financial and economic crisis not only has made clear the deficiency of existing institutional arrangements but also clearly calls for enhanced cooperation and coordination to deal with it.

4. Our analysis suggests that not only is there a need for substantial reforms in existing institutions, but that in addition there is also a need to create a new institution, a Global Economic Coordination Council (GECC), supported by an International Panel of Experts. While we understand the concern about the proliferation of international institutions and the hesitancy to create any additional bodies, the need for such a GECC is compelling and spelled out in greater detail below.

5. Not only did the existing international institutions and institutional arrangements fail to take the actions that might have prevented the current crisis from developing, some institutions even promoted policies that are now recognized to have contributed to the creation and amplification of the crisis and to its rapid spread from the U.S., where it originated, to other countries around the world. Without substantial reform of these institutions (that entails more than a change in name), it will be difficult to ensure financial stability.

6. The current crisis reflects problems that go beyond the conduct of monetary policy and regulation of the financial sector. It has made clear that globalization of trade and finance calls for enhanced global cooperation and global regulation, as previous chapters have forcefully pointed out.

7. But the current economic and financial crisis is not the only problem facing the world today. The international community is confronted with multiple, interrelated threats of unprecedented scope besides the collapse of the global financial system and the worldwide economic downturn. The economic crisis followed upon the food and energy crises, which also imposed a high toll on many developing countries. These crises, as well as the growing divide between poor and rich within and

between countries and the risk of systemic climate change, are all interconnected global challenges that threaten to unravel the fragile state of globalization.

8. Global economic integration ("economic globalization") has outpaced the development of the appropriate political institutions and arrangements for governance of the global economic system. Economic globalization means that actions that occur in one country have effects on others. There is a need for global collective action to address not only these issues of global "externalities" but also the provision of global public goods. Among the global public goods are the stability of the global economic system and fair trading rules.

9. In short, strong global collective action is needed in order to pursue joint goals, particularly the adequate and appropriate provision of global and regional public goods and the broader objectives agreed to in the UN Summits and Conferences of the past two decades. By definition, without coordination, countries do not have sufficient incentives to invest in global and regional public goods (e.g. economic, financial, and ecosystem stability).

10. The same is true for common social objectives, such as combating poverty. To achieve the goal of sustainable development, stronger collective action is needed in a number of inter-related areas. With the adoption of the Millennium Development Goals, the international community reiterated its commitment to the overarching goal of eradicating poverty. Joint approaches have been agreed upon, and many countries have developed a joint understanding on the relevant financing needs and the respective burden-sharing. However, commitments have to be monitored and implemented.

11. Among the most important of the global public goods is the preservation of the environment. The atmosphere had appeared to have an unlimited ability to absorb greenhouse gas emissions. We now know that is not true and the continuation of emissions at current levels puts the entire planet at risk. Preventing global warming and climate change is a quintessential global public good. The international community thus faces a collective action problem in that there is a need for an international set of rules and incentives that will ensure international cooperation in preserving the self-sustaining nature of the earth's atmosphere.

12. While the financial crisis has brought to the fore severe structural lacunae in the existing global economic governance structure, in particular the lack of incentives for global collective action (e.g. with regard to the provision of global and regional public goods and poverty reduction) and the failure of the institutional framework to ensure the consistency—or, in UN terminology, coherence—of global policy making, many of the problems have long been apparent. There is a pressing need for a substantial improvement in the coordination of global economic policy. There is also clearly an urgent need to reform the international monetary and financial system to ensure that it is more inclusive and equitable and to thus enable more effective and credible global economic governance.

13. Already, some developed countries, such as the United Kingdom and France, and many developing countries, such as those in the Commonwealth, have called for an international conference to redesign the system of international economic governance into a new post-Bretton Woods system in order to ensure accountability and transparency in international economic policy-making and to overcome existing systemic weaknesses. We agree that there is a compelling need for major reforms, and we hope this report will provide some guidance in any such endeavor. Meanwhile, this chapter focuses on one important initiative, the creation of the GECC, as well as

the necessary reforms in existing international institutions. The next chapter discusses some further innovations in the global international architecture that we believe are necessary for sustained global stability and growth.

14. This chapter is divided into five sections and an appendix. The first discusses briefly the international system of economic governance; the second, the proposal for the creation of a Global Economic Coordination Council; the third, needed reforms in existing international financial institutions; the fourth, international aid; and the fifth, the global system for trade and investment.

The Existing System

15. The existing system of international economic governance has relied on two basic principles: specialization and coordination. A set of global institutions—specialized agencies—were created, each with a mandate to deal with a specific and limited set of issues. The first such economic institutions were the specialized agencies within the UN system, the World Bank and the International Monetary Fund. A third agency called for in the Havana Charter, the International Trade Organization (ITO), was to deal with commercial policy, employment policy coordination, and the position of developing countries but was never approved. Only the General Agreement on Tariffs and Trade (GATT) survived, and it provided, more than three decades later, the basis for the World Trade Organization (WTO), which is not formally part of the UN system. These three post-war international economic institutions—the World Bank, IMF and GATT/WTO—were expected to work in a complementary fashion to promote sustained economic recovery and growth, full employment, and thus economic welfare, as well as reconstruction and development of economic capacities and capabilities. They were complemented by other agencies of the UN system, which include both the strictly specialized agencies with their own governance structures (International Labour Organization (ILO), Food and Agriculture Organization (FAO), UN Educational, Scientific, and Cultural Organization (UNESCO), World Health Organization (WHO), and others) as well as the UN funds and programs (such as the UN Development Programme (UNDP), UN Environment Programme (UNEP), and UN Children's Fund (UNICEF)).

16. The overall coordination of UN activities concerned with economic, social, and ecological affairs, including the specialized agencies, was to be entrusted to the Economic and Social Council (ECOSOC), one of the UN system's main organs, in coordination with the General Assembly. Coherence is not a new concept in the arena of international relations, as the original UN model provided, in theory, for the coherent design of policies for the achievement of internationally agreed goals. Although the system has never worked the way it was originally envisioned, its internal logic remains compelling; the incomplete arrangements provided support to post-war reconstruction and the Golden Age of Keynesian-inspired economic growth that existed until the early 1970s.

17. The underlying challenge to effective global economic governance originates from the absence, in a world of sovereign states, of an adequate body or bodies as a locus of coordination and accountability and no way to enforce transparency and elicit compliance. A series of issues, including cooperation in trade in goods and services, cross-border environmental goods, cross-border labor policies, payments and clearing, regulation, contract enforcement, exchange rates, and other related cross-border matters, have to be addressed through coordinated arrangements which involve negotiated derogations (or better, sharing) of sovereignty in specific areas.

18. Neither the G-7 industrialized countries nor the G-20 represents a sufficiently inclusive global steering group for addressing global systemic challenges. The G-7 has taken a number of initiatives that are important for developing countries and is engaged in a systematic dialogue particularly with African countries. While the G-20 (which actually has 22 members) is more broadly based, there is still no representation of the remaining 170 countries.

19. Any future governance format must ensure inclusiveness and adequate representation of developing countries, including least-developed countries (LDCs), promote complementarity and coherence, and establish links between existing and new forums. Thus, although informal groups such as the G-7 and G-20 can play a useful role, they should not be allowed to undermine the functioning of formal institutional arrangements and the discharge of their respective mandates. This inclusive response will require the participation and the involvement of the entire international community. Apart from the G-7, G-8, or G-20, it must encompass representatives of the entire G-192.

20. The United Nations is the most legitimate forum for addressing the pressing needs of global collective action facing the world today. It can, for instance, play a central role in achieving greater coherence among different actors. Given the specific institutional purposes of the IMF, the World Bank, and other international institutions, there is a need for better coordination and political accountability and for a forum for consensus building to broaden and guide their policy agendas. An overarching theme of the UN Financing for Development (FfD) conference and the resulting Monterrey Consensus was the need to enhance the coherence and consistency of the international monetary, financial, and trading systems to ensure that they support the internationally agreed upon development goals, including social and environmental sustainability.

Global Economic Coordination Council

21. The variety of international institutions and organizations with specific mandates requires an overarching, inclusive body with an integrated view of the economic problems confronting the world and the adequacy of existing institutional arrangements and institutions, including their mandates, policies, instruments, and governance for addressing the economic challenges facing the world today. A globally representative forum, which we call the Global Economic Coordination Council, that addresses areas of concern in the functioning of the global economic system in a comprehensive and sustainable way must be created.

International panel of experts

22. As an immediate step, an International Panel of Experts tasked with the assessment and monitoring of both short-term and long-term systemic risks in the global economy should be established. The panel could serve as an internationally recognized source of expertise in support of better coherence and effectiveness in the global governance system, fostering dialogue between policy makers, the academic world, international organizations, and recognized social movements. The panel should analyze systemic risks in relation to the global economy, their root-causes, and their implications for human development. It should establish criteria for the identification of systemic risks and issue recommendations as to preventive measures and sound economic policymaking. The panel could thereby also play an important "early-warning function," the need for which has been noted by the G-20 and others. The panel would also identify lacunae and deficiencies in the current global economic system, especially the system of global economic

governance, and make suggestions for their remediation. It might, for instance, flesh out some of the proposals in Chapter 5 of this report for the global reserve system, for new mechanisms for better risk bearing, and for alternative proposals for sovereign debt restructuring and dealing with the problems posed by cross-border defaults.

23. While its analysis would focus on economic issues, it would also take into account the social and ecological dimensions of economic trends and policies and analyze their long-term developmental implications, as well as identify obstacles to economic systems achieving developmental, social, and environmental goals. It should therefore adopt a multidisciplinary and long-term approach to observed economic change.

24. The panel should be made up of experts from all continents: OECD, emerging, and developing countries. It would not rely on its own research but pool the global knowledge and resources of a large number of acknowledged experts. Such Expert Panels have proven invaluable in other areas of the functioning of the international community where there is a need for expertise to support the political process. Notable examples include the Intergovernmental Panel on Climate Change (IPCC), which has played a critical role in the evolution of global climate change policy, and the scientific panel that led to the Montreal Convention.

The mandate and governance of the Global Economic Coordination Council

25. In the longer-term, a Global Economic Coordination Council should be established at a level equivalent with the UN General Assembly and the Security Council. Its mandate would be to assess developments and provide leadership in addressing economic issues that require global action while taking into account social and ecological factors. Based on this mandate it would promote development, seek consistency of policy goals and policies of major international organizations, and support consensus building among governments on efficient and effective solutions for global economic, social, and environmental issues. Its work would go beyond simply the coordination of existing institutions. With the support of the Panel of Experts, the GECC could also promote accountability of all international economic organizations, identify gaps that need to be filled to ensure the efficient operation of the global economic and financial system, and make proposals to the international community for remedying deficiencies in the current system.

26. The Council would have a mandate over the UN System in the economic, social, and environmental fields, which include the Bretton Woods Institutions (BWIs) and should include the WTO by bringing it formally into the UN System, and not only over the UN and its Funds and Programs, as has been characteristic of ECOSOC (which will thus continue exercising its traditional functions). Representation could be based on a constituency system designed to ensure that all continents and all major economies are represented. At the same time, its size should be guided by the fact that the Council must remain small enough for effective discussion and decision-making. In addition, active participation by and consultation with other important institutions, such as the World Bank, IMF, ILO, WTO, and of course the UN Secretariat, would be crucial.

Bretton Woods Institutions and Regional Development Banks

27. The IMF and the Multilateral and Regional Development Banks continue to have a very important role in the international economic financial architecture. The mandate of the IMF is to assure global financial and economic stability. It has been expected to survey the economic

performance of its member countries, alert them of economic dangers, and provide policy advice and financing to members facing balance of payments difficulties in addition to helping developing nations achieve macroeconomic stability and support employment. While by its own admission the IMF did not perform as well as one might have hoped in identifying systemic vulnerabilities or in anticipating the present crisis, the G-20 has placed special responsibilities on the IMF for helping developing countries respond to the crisis. At the same time, the G-20 has noted deficiencies in existing governance. For the IMF to be fully effective, both in addressing the crisis in the short run and in promoting growth and stability in the long-run, there have to be substantial reforms, not only in governance but also in the policies that it has traditionally espoused.

28. The World Bank and regional development banks are supposed to have a key role in supporting the developing countries, in enhancing their growth and stability and their efforts at reducing poverty. To achieve their objectives they provide concessional loans and grants to developing countries, as well as technical assistance. Within their mandate of poverty reduction and the promotion of sustainable development and inclusive growth, they should play a counter-cyclical role in tackling the crisis. The Multilateral Development Banks (MDBs) have recently revised their policy approach, moving away from earlier market-fundamentalist approaches, starting with debt relief for Heavily Indebted Poor Countries (HIPCs) and the adoption of new poverty alleviation strategies.

29. The severe shortcomings in the mandate, policies, resources, and governance of these institutions have impaired their ability to take adequate actions to prevent and respond to the crisis and have also had a negative impact on their mandate to promote sustainable development. The ability of the IMF to safeguard the stability of the global economy has been undermined by the vastly greater resources and volatility of globally integrated private financial institutions. Uncoordinated national policy responses have made the task it faces all the more difficult.

30. The effectiveness and credibility of the Bretton Woods Institutions have been adversely affected by deficiencies in governance (including their skewed voting structures and non-democratic processes of choosing their heads), the checkered record of their forecasting, policy, and other recommendations, including the onerous conditionalities they have imposed on borrowing countries and their tendency to proffer pro-cyclical rather than counter-cyclical policy advice. Major reforms are thus necessary.

31. There is a global consensus behind recommendations to provide substantial amounts of capital to developing countries that have been the victims of a crisis in the developed world. On the other hand, the means to achieve those capital flows to the developing world have been controversial. The severe conditionalities imposed in the past have in many cases been counterproductive. As noted in Chapter 2, this and other concerns about IMF governance and past performance have led both borrowers and lenders to become reluctant to utilize the IMF.

Surveillance

32. There is a need for independent and even-handed macroeconomic surveillance. The IMF has not implemented its mandate consistently and even-handedly. For example, in recent decades, it has largely ignored its mandate to sustain growth and employment and has focused almost exclusively on curbing inflation. It has also promoted financial, including capital account, liberalization, although its Articles of Agreement clearly allow governments to use capital controls. Before the current crisis, the IMF also failed to provide early warnings—unlike the United Nations system in

various publications such as the *World Economic Situation and Prospects* and the *Trade and Development Report*.

33. Surveillance should pay special attention to those countries and sectors that are systemically important, including the financial sectors in the U.S. and Europe. It should also address the adequacy of the "circuit breakers" that might prevent the contagion of a problem in one country from spreading to another.

34. The GECC and the International Panel of Experts can play an important role in monitoring the adequacy of surveillance and whether these deficiencies have been adequately addressed.

Public goods and the Multilateral Development Banks

35. Developing countries' actions in support of the provision of global and regional public goods need additional funding if other developmental objectives are not to be compromised. The provision of global and regional public goods should thus be an important part of development institutions' work and mandates. In some areas, such as combating climate change, the different dimensions associated with the provision of global public goods needs to be assessed, including the implications for the respective mandates of the UN Framework Convention on Climate Change (UNFCCC) and the World Bank.

36. Given the critical nature of climate change, support for developing country efforts at reducing emissions is of special importance. The architecture for financing climate change-related expenditures will be reviewed in the course of the UN climate negotiations. From a development perspective, the key issue is that climate-related tasks in the developing countries are considered as an integral part of a sustainable development agenda and that all partners act accordingly. To that end, the full set of existing development instruments, procedures, and institutions must be used and further developed. Multilateral climate financing must come under the authority of the UNFCCC and serve to meet its climate change mitigation and adaptation objectives.

Governance

37. There is a growing international consensus in support of reform of the governance, accountability, and transparency in the International Financial Institutions (IFIs). The governance reforms have to be based on a joint understanding of the respective mandates and a common understanding of the strategic directions of the respective institutions. The inconsistency between the economic and financial weight of developing countries in the world economy and their role as recipients of IMF and World Bank funds, on the one hand, and their representation in these institutions, on the other, is one of the factors behind the loss of legitimacy and relevance of those organizations in addressing systemic issues. Better voice and representation of developing countries in IFIs must therefore be high on the agenda. Governance reform must strengthen, in particular, the weight of low-income countries.

38. The participation of developing countries is essential if there is to be an adequate provision of global and regional public goods, such as climate protection and financial stability. Accordingly, these agendas can only be successfully realized if the developing country perspective is appropriately reflected in global decision-making.

International Monetary Fund governance reform

39. To strengthen the effectiveness and legitimacy of the IMF, its governance must be enhanced to ensure that it fully reflects changes in the world economy. Emerging and developing economies, including the poorest, should have greater voice and representation. On this basis, major reforms in the governance of this institution, including giving greater voice to developing countries and greater transparency, have to be accelerated. The Report of the Committee of Eminent Persons on IMF Governance Reform, chaired by Trevor Manuel, contains interesting recommendations in this regard. The IMF (and other international institutions) should aspire to the highest standards of transparency and consider the introduction of the kinds of principles embodied in the Freedom of Information Acts and Right to Know laws that have been adopted by democracies throughout the world.

40. The decisions for broader reform taken by the Board of Governors of the IMF at its Annual Meetings in Singapore in 2006 and in Washington in 2008 have resulted in modest progress. Quota reform has only been made on an ad-hoc basis, first in 2006 for a small group of emerging market countries and in April 2008 for the larger membership, leading to marginal changes that failed to shift significantly the balance of power between developed and developing countries. The April 2008 decision by the Board of Governors to adopt a new quota formula is not sufficient to address the problems in governance. In fact, the new formula actually shifts voting weight to industrial countries at the expense of middle- and low-income ones, with the modest progress achieved due to voluntary forgoing of votes by major industrial countries and ad-hoc decisions. Therefore, a step towards more inclusiveness and representative governance at the IMF would require an improved quota formula and/or alternative procedural reforms.

41. Strengthening the voting weight of low-income countries can be done by increasing quotas or by further increasing the share of basic votes. When the IMF was established in 1944, basic votes were set at 250 votes for each member and represented 11.3 per cent of total voting power when it had 44 members. However, as a result of the increase in quotas that has occurred over the years, the share of basic votes has fallen considerably and reached its lowest level of 2.1 per cent of total voting power for 184 members in the mid-2000s! The April 2008 decision taken by the IMF Board of Governors to reverse this trend by tripling basic votes only increased the total share of basic votes to 5.5 per cent of current voting power, which falls far short of restoring the share let alone the weight of basic votes.

42. The application of double majority voting to a broader set of decisions could also compensate for voting imbalances at the IMF. At present, a double majority—85 per cent of voting power and a 60 per cent majority of members—is required to amend the Articles of Agreement. Double majority voting (e.g., shares and chairs) should be extended to the selection of the Managing Director and the chair of the IMF Committee, as well as for key policy decisions and approval of access to lending operations. At the same time, the reform must consider eliminating effective veto powers over decisions to amend the Articles of Agreement. These changes could help strengthen the sense of ownership in the IMF by requiring a significant majority of members to support key decisions that determine the direction of the organization. Consideration should be given to alternative forms of double majority (e.g., developed and developing countries).

International Bank for Reconstruction and Development governance reform

43. Some of the basic principles for IMF governance reform would apply to reforming other international financial institutions, such as the World Bank. However, the Bank's specific mandate as a development bank is distinct from the IMF, and its governance should reflect this difference. Hence, in determining the participation rights of its members, distinct World Bank governance arrangements would be needed.

44. The first stage of the World Bank's voice reform should be implemented rapidly. The doubling of basic votes and a third African seat on the Board will increase the influence of developing countries. The second stage, focusing on a reform of quotas, should be accelerated and completed by the Spring Meetings in 2010. With regard to the quota reform, three criteria should be taken into account for allocating votes: the member states' economic weight, their contribution to the development mandate of the World Bank (for example, measured in terms of contributions to International Development Association (IDA) and trust funds), and the significance of borrowing levels from the Bank. The two latter criteria would reward member states for being closely connected with the Bank.

45. Against the background of the challenges ahead, such as the financial crisis and climate change, the second stage of the reform process should start with an in-depth debate on the Bank's mandate and its strategic directions. The World Bank Group already has different "arms," such as IDA and the International Bank for Reconstruction and Development (IBRD), with their own governance structures. New fields, or traditional areas becoming a new focus of support, such as the increasing role of the Bank in the area of global and regional public goods or aid for trade, might also require new governance structures as well as new ways of interacting with other global institutions.

Common issues

46. Other important governance reforms include reforms in the way that the head of the institution and the most senior officers are chosen and conflict of interest reforms ("revolving doors") consistent with the best practices of democratic governance. Within the IMF and the World Bank there should be a merit-based, transparent process for the selection of the senior management. Conventions associated with the choice of the leaders of the World Bank and the IMF make little sense in the 21st Century.

47. Given the wide impact of IMF programs and the steady expansion of its operations into the areas of development and poverty alleviation, it does not seem appropriate that the IMF should just reflect the views of representatives from finance ministries and central banks. The views of development and planning ministries should be better integrated. The same principle should be applied to the World Bank, as it has along the way added new tasks to its mandate, in particular in the area of global and regional public goods such as health and environmental policy. Doing so will promote coherence between the policies of national governments and those of the international institutions.

Other International Financial Bodies

48. The governance of global financial regulation remains a question of concern. While national regulatory authorities have the ability and mandate to protect the vulnerable within their borders,

there is a difficulty in extending this mission across borders. The present crisis has shown how deficient regulation on the part of one country can have adverse effects on others. Unless effective coordination in global financial regulation is achieved, as we noted in Chapter 3, there is the risk of fragmentation of the global financial system, as each country will seek to protect itself from toxic products and practices originating from abroad. (While much of what is to be done at the international level will be difficult to achieve in the short-term, there is a great deal that can be done at the domestic level without prior international agreement. The necessary reforms are discussed at length in Chapter 3.)

49. Existing institutional arrangements have obviously proven ineffective for reasons that will be explained more fully below. Again, the international community faces the difficult choice between reforming existing institutions and creating new institutions. Reform of existing institutions may be difficult, for the staff of those institutions are often wedded to the economic philosophies that have contributed so much to the crisis. Moreover, it has proven difficult, at best, to reform existing institutions sufficiently to create confidence in them, especially within developing countries. It is therefore imperative that there should be consideration of a new Global Financial Authority to co-ordinate financial regulation in general and to establish and/or coordinate global rules in certain areas, such as regarding money laundering and tax secrecy. (Chapter 3 discusses the role that the UN Committee of Experts on International Cooperation in Tax Matters should play in these efforts.)

50. The FSF was created in the aftermath of the 1997-98 financial crisis in order to promote international financial stability, improve the functioning of financial markets, reduce the tendency for financial shocks to propagate from country to country, and enhance the institutional framework to support global financial stability. It is now apparent that the reforms that it has proposed have not been sufficient to avoid major global financial instability. These failures imply that there will need to be substantial reform if there is to be confidence that it will fulfill its mandate. In April 2009, the Financial Stability Forum (FSF) was re-established as the Financial Stability Board (FSB). Chapter 3 explains the need for robust regulations—a marked departure from the stance of the FSF. Making marginal changes to the regulatory structure would neither ameliorate the current situation nor be effective in preventing future crises.

51. Deeper reforms in the FSB must, accordingly, address deficiencies in its governance, mandate, and economic perspectives. The initial move to strengthen and reform the FSF (now the FSB), as agreed at the April 2009 G-20 Summit, should only be an initial step toward establishing much more representative, appropriate, and effective financial regulation at both national and international levels. The proposed widening of the membership is, for instance, necessary if there is to be international confidence in the FSBs effectiveness and balance, but governance and participation reforms have not gone far enough.

52. In particular, the FSB and all other standard-setting institutions must become more representative and accountable to adequately reflect the views of and the conditions in developing countries. Most developing countries are not represented in today's standard-setting institutions. The Basel Committee of the Bank for International Settlements (BIS) and the FSF/FSB set important global economic standards in areas such as data dissemination, bank supervision, financial regulation, and corporate governance. While the original intention of the Basel Committee was to provide regulations for large internationally active banks, the Committee's regulatory proposals have been generally adopted by most countries. As a result, the inadequate representation of developing

countries in these ad-hoc bodies has made their analysis and recommendations incomplete and biased in crucial aspects. Inattention to the fact that countries are at different stages of economic development with varying financial and institutional capacities poses a challenge for global acceptance of standards and codes developed by these non-inclusive bodies. This dilemma is a major obstacle to universal and effective implementation. While standard-setters liaise with developing and transition economies from time to time, consultations do not substitute for participating in the decision-making.

53. The task of ensuring coherence in regulatory principles among national authorities must be undertaken by international standard-setting bodies, such as the U.S. Financial Accounting Standards Board (FASB), supported by an accountable Secretariat with access to a diversity of viewpoints. For the FSB to take on this role as a global authority in identifying systemic risk for the financial system, it would require an international capability that goes beyond that of the FSB and the BIS. International financial regulation will require coordination beyond central banks (the major constituency of the BIS) and must include securities and corporate regulators as well as accounting standards among its key priorities.

54. By the same token, if the FSB is to become the main instrument for the formulation of reforms of the global financial system, it must do a better job in taking into consideration the distinctive aspects of developing country economies, how regulations in developed countries may affect the economies of the developing countries, and the importance of financial stability for economic development. But it should also be cognizant of how financial sector regulation and development can affect the growth of developing countries. Previous regulatory structures (Basel I and Basel II), in addition to all of their other flaws and inadequacies, may have (perhaps unintentionally) discriminated against developing countries.

55. The challenge is to create globally representative institutions that are cognizant of the concerns of the advanced industrial countries, emerging markets, and developing countries. Even if it is not easy to change institutional cultures, more inclusive and appropriate representation in the BIS and FSB would result not only in a fairer system but also in better regulation leading to a more stable global financial system with welfare-enhancing effects for all. It would be less dominated by those who have benefited from current arrangements, with greater voice from those countries that have not benefited. But as Chapter 3 has pointed out, self-regulation cannot work, and regulation dominated by those from the sector being regulated should be viewed as, at best, problematic. Increased international public oversight in the governance of the international financial system requires that critical standard setting activities are, at a minimum, reported to an intergovernmental body for coordination, such as the GECC described earlier.

56. The lack of accountability of important, private standard-setting bodies is an additional area of concern. Private entities such as the International Accounting Standards Board (IASB) and the International Organization of Securities Commissions (IOSCO) develop, for instance, standards for cross-border regulation that have systemic impacts on the international financial system, yet they are exempt from any political accountability. Increased international public oversight of governance of the international financial system requires that critical standard-setting activities, at a minimum, be reported to an intergovernmental body for approval. This is particularly important in light of the greater interconnectedness among financial market segments. Global banks have increasingly expanded their operations into securities markets and own or control brokerage and security firms.

International Lending and Official Development Assistance

57. There is an urgent need for donors to fulfill their existing bilateral and multilateral Official Development Assistance (ODA) commitments. Developed countries must make a renewed effort to meet the commitments made in the UN Millennium Declaration, the Monterrey Consensus, the 2005 Global Summit, and the Doha Declaration by 2015. The consequences of a failure to do so have been described elsewhere in this report.

Additional funding for developing countries needed

58. Funding is required to contain the negative impact of the crisis on developing countries as well as to offset the distortions of the level playing field created by some of the massive stimulus and bailout programs of the advanced industrial countries, including large subsidies to financial institutions and corporations and extensive guarantees. (See the discussion in Chapter 2.)

Aid effectiveness

59. The processes for achieving aid effectiveness need significant enhancement. The 2002 Monterrey Consensus asserted that "effective partnerships among donors and recipients are based on the recognition of national leadership and ownership of development plans and, within that framework, sound policies and good governance at all levels, are necessary to ensure ODA effectiveness." The 2005 Paris Declaration on Aid Effectiveness sought to operationalize these basic principles. Despite commendable early OECD leadership in this area, a more universal body, where all parties share responsibility for progress, can effectively lead in further enhancing aid effectiveness. The Development Cooperation Forum (DCF) of ECOSOC has begun promising work in this area.

60. Donor conditionalities and the realizing of national ownership of development strategies were the most contentious issues in negotiating the 2008 Accra Agenda for Action, which affirmed that national ownership and effective leadership are unattainable without a reform of conditionality. Achieving national leadership will require a shared understanding of what conditionality is appropriate and mutually acceptable. Aid recipients must meaningfully participate in the agenda-setting and operations of multilateral institutions that manage development aid. ODA should not undermine national accountability, democratic processes, parliamentary oversight, or national capacities for designing, negotiating, and implementing development strategies appropriate to domestic conditions.

61. Ironically, ODA has proven to be the most volatile of foreign flows to many of the poorest countries in the world. Improving the predictability of aid is necessary for aid effectiveness. The international community must make progress to genuinely align aid programs with national priorities.

62. The use of governance indicators (and more broadly, the Country Policy and Institutional Assessment indicators) for aid allocation and other international cooperation has been greatly discredited. Yet these indicators are currently a critical element in determining access to aid and debt financing for developing countries. They should no longer be used as a basis of aid allocation, as they represent a hidden form of conditionality.

Expansion of resources by IFIs

63. Steps must be taken to ensure that the World Bank and the regional development institutions have sufficient financial capabilities, as these institutions must be able to provide counter-cyclical financing. It is necessary to determine whether certain international financial institutions may possibly require a capital increase, which is doubtless the case with the Asian and Inter-American Development Banks. There is also a case for early replenishment of IDA funds, since without such replenishment and/or other form of fund enhancement, many developing countries may be reluctant to take enhanced IDA funding in response to the crisis for fear that there will be insufficient funds available in subsequent years.

64. In order to be able to react more promptly in future crises, the MDBs' policies and facilities should be reviewed. There could prove to be a need for additional facilities within their respective mandates (including the support for safety net/social protection measures discussed earlier) and the establishment of a fast-track mode of project preparation.

65. In addition, regional efforts to augment liquidity should be supported. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighboring countries.

Immediate expansion of IMF resources

66. It is obvious that the IMF's current lending resources are not sufficient to allow it to respond appropriately to the worsening problems in developing countries. To allow the IMF to fulfill its mandate of stabilizing the global economy and to respond to increased members' demands in the current uncertain international environment, the IMF's position should be strengthened through a very substantial increase in its lending capacity along the lines already decided at the recent London G-20 meeting. This will require reviewing the various options, including the allocation of further special drawing rights (SDRs) already agreed upon, bilateral loans, an expansion of the membership and scale of the New Agreements to Borrow (NAB), and completion of the quota review now scheduled for 2011.The resource increase should go in parallel with decisive progress in long-overdue governance and voice reforms, along the lines discussed earlier.

Debt sustainability

67. Several developing countries are facing debt sustainability problems. The new Debt Sustainability Framework recently introduced by the IFIs is meant to be forward-looking and prevent debt servicing problems before they arise by limiting a country's debt position. However, the current crisis suggests that there should be a further assessment of MDBs' policies, (both in terms of what is considered to be sustainable debt dynamics and what the appropriate responses are to situations in which the debt dynamics appear unsustainable). In those countries where the crisis is seriously threatening debt sustainability, consideration could be given to debt moratoria and, where appropriate, partial debt cancellation within the framework of a permanent international debt regime (see Chapter 5 for further details). Furthermore, low-income countries in particular need more access to highly concessional funds and grants if they are to meet their essential spending needs and respond in a counter-cyclical way to the crisis without getting back into debt difficulties. The current provisions of the G-20 in this regard are too limited in scope. The various options, such as an early replenishment of IDA funds, should be examined. Also, MDBs and other donors should

make every effort to make repayment flexible in response to exogenous shocks. Better systems of risk mitigation and risk sharing (along the lines discussed in Chapter 5) need to be explored and developed.

A new credit facility

68. In order to mobilize additional funds, the creation of a new credit facility is a matter of urgency. The new facility, which has been more fully discussed in Chapter 2, could draw upon financial contributions from all countries. It could leverage any equity funds contributed by borrowing in financial markets. Countries that have accumulated large reserves, including those that are commodity exporters, could use their surpluses to make direct investments in developing countries. It would benefit both developing countries and the world economy if savings from emerging markets could be at least partly transferred to developing country projects. The new credit facility's ability to borrow could be enhanced through guarantees provided by governments, especially those of the advanced industrial countries. Chapter 2 discussed the various uses to which these funds could be put, including investment projects in key sectors, such as agriculture, financing temporary guarantees for trade credit or for the debt of their corporations, forestalling the risk of a run on these corporations. The current financial system does not provide these intermediary services.

Commodities trade and compensatory financing

69. The volatility of export earnings of countries dependent on primary commodity exports has long been recognized as a key source of instability in the global economic system. Unless they take strong protective measures, these countries not only experience boom-bust cycles but also tend to find themselves in debt distress and in need of additional aid when commodity prices collapse. Developing countries that are dependent on exports of commodities with high price volatility need to establish stabilization funds and to otherwise manage their economies to reduce the extent of the boom-bust cycle, including by restricting borrowing during the boom phase. But, inevitably, such management will be imperfect, and there will be need for compensatory finance. When it is provided, it is important that it be done in ways that do not impose counterproductive conditionalities. The international community, including the IFIs, should explore ways of mitigating the risks from commodity fluctuations, including perhaps by providing loans in which repayments vary with commodity prices.

Trade and Investment

70. The World Trade Organization (WTO) is the only universal body for setting trade rules and resolving trade disputes. The WTO is the only universal intergovernmental institution which, at the insistence of major industrial countries, does not have an institutional agreement with the UN (i.e. the "Arrangements for Effective Cooperation with other Intergovernmental Organizations—Relations Between the WTO and the United Nations" of 15 November, 1995, provides only for informational cooperation), even though it has separately acceded to coherence commitments with the Bretton Woods Institutions. Given its status as a major stakeholder in the UN Financing for Development process, the WTO should be brought into the UN system of global economic governance while maintaining its legal and institutional constituency.

71. Through the WTO dispute settlement mechanism, small or weak countries have a means to defend themselves against unfair trade practices, but asymmetric legal and other resources, as well as

limited developing country participation in drawing up existing rules and regulations, limit the mechanism's potential to promote justice and development. Imbalances in WTO accession practices, trade dispute mechanisms, and negotiation modalities have also placed developing countries and new members at a disadvantage, besides deterring the possibility that it might serve as a model for a similar organization for international finance. All countries acceding to the Principles and Agreements of the WTO should be given membership. There needs to be an end to the current practice of "extortion at the gate." In particular, developing countries seeking membership should not be subjected to conditions that go beyond those to which existing members are subjected. Furthermore, developed countries need to provide developing countries with additional resources for support of adequate legal representation in the dispute settlement mechanism.

72. The growth of bilateral trade agreements may undermine the multilateral trading system. Indeed, the fragmentation of the global trading system is a major step backwards in creating a system of free international trade. The resulting "Rules of Origin" regime, for instance, undermines the free flow of goods and services across borders, one of the objectives of the multilateral trading system. Developing countries are often put in a more disadvantageous position in these bilateral trade negotiations than they are in multilateral trade negotiations.

Protectionism in the midst of the crisis

73. Reform of rules governing international trade has the potential to stem protectionism and could provide a signal of confidence in a time of crisis. But the current crisis has exposed limits to the effectiveness of these measures shielding the world from protectionism. The WTO should be commended for its work monitoring these protectionist actions in the current crisis.

74. The global crisis has been marked by precipitous declines in world trade. The dangers of trade contraction represent a far more serious risk to the global economy than in the Great Depression because trade today is so much more important for many economies. Those low-income countries that are heavily dependent on exports will suffer severely from trade contraction, and commodity exporters will suffer doubly as a result of the collapse of many commodity prices.

75. These inevitable consequences of a global contraction of trade have been augmented by protectionism. Throughout the world, protectionism has increased. In its initial communiqué, the G-20 warned of these dangers, and the members committed themselves not to engage in protectionism. Yet, pressures for protectionism have been difficult to resist.

76. Trade restrictions, subsidies, guarantees, and domestic restrictions on government procurement contained in some stimulus packages and recovery programs distort world markets. Although international agreements contain the same rules for each country, due to very different economic and social points of departure, seemingly "symmetric" provisions can have markedly asymmetric effects.

77. For instance, government procurement provisions under the financial stimulus packages sometimes heavily distort competition at the expense of developing countries, since signatories of the WTO plurilateral agreements on government procurement are mainly industrialized countries.

78. Subsidies, implicit and explicit, can be just as (or even more) distorting to open and fair trade as tariffs. (See the more extensive discussion in Chapter 2.) As has been recognized, subsidies can

create an uneven playing field just as tariffs do, but these are even more unfair, since only rich countries can afford subsidies. Firms in developing countries simply can't compete against those in the more developed countries that receive massive assistance from their governments, whether in the form of open subsidies (including bailouts) or less transparent subsidies (guarantees and access to government or central bank lending). While the domestic imperatives that give rise to domestic subsidies are understandable, efforts need to be made to finance additional support to developing countries to mitigate the impact of the crisis as well as of both open and hidden subsidies in order to avoid further distortions.

79. The WTO should systematically assess the policies conducted by Member States in the framework of their stimulus and recovery packages, giving adequate attention to the consistency of the letter and spirit of WTO agreements, the exigencies of the situation, and the adverse effects, especially on developing countries. We need to avoid at all costs a return to the beggar-thy-neighbor policies that the creation of the WTO was intended to prevent.

80. In these assessments, attention should be paid both to the "legal" and "illegal" protectionist measures. An example of legal but nonetheless harmful protectionist measures are the domestic procurement provisions in certain stimulus packages, mentioned above. Other examples include the increased use of non-tariff barriers, such as safeguards and dumping duties. It has long been recognized, for instance, that WTO-legal criteria for dumping do not accord with standard notions of predatory pricing ("unfair competition") and represent a major exception to WTO principles of non-discrimination: if these standards were applied domestically, a large fraction of domestic firms in many advanced industrial countries would be guilty of dumping. It has also been recognized that these criteria may be, and have been, used discriminatorily against developing countries. Just as beggar-thy-neighbor tariffs can lead to retaliation, so too can non-tariff barriers. There can be retaliation, for instance, by bringing dumping and countervailing duty cases. This would undermine progress in creating an open and fair global trading regime.

81. At the same time, some developing countries are being subjected to pressure not to raise tariffs, even when existing tariffs are substantially below the bound rates and when raising these tariffs might help stabilize these economies and help them cope with the crisis.

82. These problems (and the problems discussed in previous chapters on financial market liberalization) highlight deficiencies in existing global rules, e.g. concerning non-tariff barriers, financial market liberalization, and the ability to respond to crises.

83. In our Preliminary Report released in February 2009, we urged developed countries to unilaterally open up their markets to the goods of the least developed countries, globalizing and strengthening the Everything but Arms initiative. Further extending that initiative so that even middle-income countries opened up their markets to those countries that were smaller and poorer could be very beneficial to the developing countries and help deal with the economic shock of the crisis.

84. Reductions in non-tariff barriers could substantially stimulate the global economy. As tariff barriers come down, the importance of non-tariff barriers increases, and some, such as phyto-sanitary conditions, are particularly and differentially harmful to developing countries.

The Doha Round

85. Recent discussions have often highlighted the importance of the completion of the Doha Round of trade negotiations. However, after the initiation of the Doha Round negotiations, the development thrust has been lost, and whatever the merits of the current proposals, they do not deserve to be called a "development round." Serious studies suggest that the conclusion of the round, regardless of its symbolic value, is unlikely to make much difference for low-income countries and particularly for least-developed countries. An agreement at the existing stage of negotiations could or would be at the cost of its development content without providing any change to international market dynamics in favor of developing counties. It would be especially unfortunate if there were a sense that, having completed the "development round," there would be a return to the unfair kinds of trade negotiations that have marked the past.

86. The current Doha negotiations on multilateral trade risk descending into a "one size fits all" approach, with narrow focus on market access to all countries, irrespective of their economic circumstances. The round has been increasingly reduced to an endless bargaining session between industrialized countries and emerging markets about market access in industrialized goods. Consequently, as the original spirit of development orientation has faded away, the likely benefits to low-income countries have diminished, and completion of the round has become endangered by deadlocked positions of major WTO members.

87. What is needed is a renewal of commitment by all countries to the original spirit of Doha, a true development round. Rapid completion of negotiations within that spirit could be of benefit to all countries and help offset the adverse effects on trade of the current recession.

88. The 2004 ILO Commission on the Social Dimension of Globalization pointed out that developing countries today cannot take advantage of many policies that have been used by industrialized countries in their developmental process. Particularly troubling are provisions in both bilateral and multilateral trade agreements that go beyond trade into intellectual property and investment and which may restrict the ability of developing countries to design appropriate regulatory regimes.

Capital and financial market liberalization

89. Capital and financial market liberalization, pushed not only by the IMF but also within certain trade agreements, exposed developing countries to more risk and has contributed to the rapid spread of the crisis around the world. In particular, trade-related financial services liberalization has been advanced under the rubric of the WTO's General Agreement on Trade in Services (GATS) Financial Services Agreement with insufficient regard for its consequences either for growth or stability. Externalities exerted by volatility in the financial sector have severe negative effects on all areas of the economy and are an impediment to a stable development path. Chapter 3 and discussions earlier in this chapter emphasized how inadequate regulation in one country may harm others. Unfortunately, while the GATS Financial Services Agreement provides the only significant regulatory framework for international financial services, it was not conceived and negotiated with these broader considerations in mind but rather was driven by sectoral interests. These special interests often do not realize (or care about) the vulnerabilities that these commitments impose on other aspects of their economy or the international economy.

90. The crisis has brought home the importance of a strong financial market regulatory regime. It has also exposed new risks as international banks reduce lending in developing countries in order to preserve lending at home. Recent research has also called into question whether financial market liberalization enhances economic growth. At least in many instances, there is a tendency for foreign-owned banks to restrict lending to small and medium-sized businesses as they concentrate on lending to government, multinational corporations, and/or large domestic monopolies and oligopolies. Financial market liberalization may bring risk without reward. As Chapter 3 has emphasized, a well-functioning financial system requires regulation, not only to ensure the safety and soundness of banks and stability of the financial system and the economy but also to ensure competition and access to funds and to prevent abusive lending practices.

91. One of the central arguments for financial market liberalization was that foreign banks (including those from the United States) were better at risk management and credit assessment than domestic banks and thus entry of these banks into a market would improve the competencies of domestic banks. The massive failures of U.S. banks have cast doubt on the validity of that presumption.

92. Developing countries also need policy frameworks that can enable them to protect themselves from regulatory and macroeconomic failures in systemically significant countries. To achieve this as well as to develop appropriate regulatory policies, for instance of the kind discussed in Chapter 3, policy space is a necessary precondition.

93. Policy space is restricted not only by a lack of resources but also by multilateral and bilateral agreements and by the conditionalities accompanying assistance. Many bilateral and regional trade agreements contain commitments that restrict the ability of countries to respond to the current crisis with appropriate regulatory, structural, and macroeconomic reforms and support packages. Developing countries have had imposed on them deregulation policies akin to those that are now recognized as having played a role in the onset of the crisis. In addition, they have also faced restrictions on their ability to manage their capital account and financial systems (e.g. as a result of financial and capital market liberalization policies). These policies are placing a heavy burden on many developing countries.

94. Agreements that restrict a country's ability to revise its regulatory regime—including not only domestic prudential but, crucially, capital account regulations—obviously have to be altered, in light of what has been learned about deficiencies in this crisis. In particular, there is concern that existing agreements under the WTO's Financial Services Agreement might, were they enforced, impede countries from revising their regulatory structures in ways that would promote growth, equity, and stability.

95. More broadly, all trade agreements need to be reviewed to ensure that they are consistent with the need for an inclusive and comprehensive international regulatory framework which is conducive to crisis prevention and management, counter-cyclical and prudential safeguards, development, and inclusive finance. Commitments and existing multilateral agreements (such as GATS) as well as regional trade agreements, which seek greater liberalization of financial flows and services, need to be critically reviewed in terms of their balance of payments effects, their impacts on macroeconomic stability, and the scope they provide for financial regulation. Macroeconomic stability, an efficient regulatory framework, and functioning institutions are necessary preconditions for liberalization of financial services and the capital account, not vice versa. Strategies and concepts of opening up

developing economies need to include appropriate reforms and sequencing. This is of particular importance for small and vulnerable economies with weak institutional capacities. But there has to be a fundamental change in the presumptions that have guided efforts at liberalization. As noted in previous chapters, one of the lessons of the current crisis is that there should be no presumption that *eventually* there should be full liberalization. Rather, even the most advanced industrial countries require strong financial market regulations

Concluding Comments

96. This crisis has exposed a large number of failings in the system of global economic governance. These failings have left the world unnecessarily exposed to grave risks and less prepared to cope with the current crisis.

97. Previous chapters have highlighted the need for global collective action arising out of the interdependencies that have resulted from greater economic integration. There is a need for cooperation in the design of the macroeconomic responses and in the global regulatory regime.

98. As we have repeatedly noted, economic globalization has outpaced the development of adequate global institutions to help manage globalization. When national economies were formed, national institutions were gradually developed to help manage their economies. These include institutions and regulatory frameworks to ensure competition, to protect consumers and investors, to manage bankruptcies, to enforce contracts, and to ensure the stability of the economy. With the increase in cross-border economic activity, the functioning of the world economy will require the creation of institutions and institutional arrangements fulfilling similar functions at the global level. Critics will worry that a wide array of new institutions might result. But these new institutions and institutional arrangements are simply the consequence of the new challenges presented by globalization.

99. This chapter has highlighted the reforms that are needed in the existing institutions—in how they are governed, their mandates, their instruments and policies, and the economic philosophies that have been the basis of the policies that they have advocated and pursued. In many cases, the developing countries in particular have suffered as a result of the shortcomings of these institutions.

100. But this chapter has also highlighted the need for the creation of a Global Economic Coordination Council to provide better coherence in the management of the global economy. Such a Council would identify some of the key problems facing the governance of the global economy today.

101. The next chapter proposes several innovative solutions to a few of the key issues.

Appendix: The Doha Round and Development

102. This appendix discusses several aspects of the Doha Round of trade negotiations as they affect development. As we have noted, the development round, as negotiations have proceeded, has rightly been criticized for having lost much of its original mission of rectifying the imbalances of past trade negotiations and actively promoting the development and well-being of those in the developing world.

103. Some have argued that an important step forward would be the elimination of all forms of agricultural export subsidies by the end of 2013 (as agreed to during the Hong Kong Ministerial Conference of December 2005). However, the full benefits of such a commitment hinge upon a series of other mandated negotiating objectives being met. It is in the nature of negotiations that early harvest outcomes, based on selected elements of the negotiating modalities—however attractive they may seem—risk reducing the gains that would accrue to developing countries, and may have the effect of making an outcome in areas of crucial relevance to developing countries less likely politically, not more.

104. This is all the more so because export subsidies do not constitute the bulk of the distorting trade arsenal of developed countries. Developing countries would greatly benefit if other forms of distorting support were substantially reduced in line with the Doha mandate. This means bringing down permitted levels of Overall Trade-Distorting Domestic Support (OTDS) and further limitations to the various "boxes" (AMS, Blue Box, Green Box, and de minimis) as well as effective monitoring in order to prevent big subsidizing developed nations from shifting their domestic programs from one "box" to another. Many of the so-called non-trade distorting subsidies actually do distort trade. These reforms need to be complemented by product-specific disciplines that restrain maximum allowed levels of support by developed countries on a per-product basis. This is an especially important outcome of the round for developing countries, as it improves market conditions for agricultural goods of particular interest to them.

105. The cotton dispute is a dramatic example of how trade-distorting export subsidies and internal support in the rich, developed economies can undermine income generation and growth prospects in poor countries, affecting their capacity to become players in their own right in the global marketplace and thereby relegating them to dependence on aid or on other kinds of non-binding commitments or concessions over which they have no control.

106. The fact that distorting cotton subsidies remain in place, in spite of the ruling of the WTO's Appellate Body against them, threatens the credibility of the WTO dispute settlement system.

107. In the important area of industrial goods, or non-agricultural market access (NAMA), there cannot be full reciprocity in tariff reduction if the asymmetries that have worked historically to the detriment of developing countries are to be addressed. The two goals are simply at odds. Accordingly, special attention needs to be given to the problem of tariff escalation, which restricts the ability of developing countries to move up the value chain.

108. Furthermore, developed countries should not try to extract additional concessions from developing countries in sectoral negotiations that would negate the principle of less-than-full reciprocity. The Development Round was intended in part to rectify previous imbalances in trade negotiations; demanding full reciprocity would obviously run counter to that goal.

109. Moreover, an acceptable package must also include binding commitments on Special and Differential Treatment for developing countries through exceptions to and longer transition periods for LDCs to implement their obligations as well as other mechanisms that allow developing countries greater flexibility in coping with the challenges posed by trade liberalization.

110. Much could be done, of course, on a voluntary basis, if developed countries and developing countries in a position to do so provide full duty-free quota-free (DF-QF) treatment in favor of

LDCs and if developed countries start with the immediate elimination of all forms of export subsidies (as agreed to during the Hong Kong Ministerial Conference of December 2005, foreseen by the end of 2013). This would be an important step towards mitigating the effects of the global financial crisis on the poorest and most vulnerable.

111. But voluntary measures are not a substitute for binding commitments because they can be withdrawn at any time, and the threat of such withdrawal can be used as an important political and negotiating weapon.

112. Supporting South-South trade can also make a big difference for developing countries during the global economic recession, since these trade flows have been increasing well above world trade average growth. They contribute to export diversification and improvements in the value-added chain, and they are becoming a significant source of dynamism for the regional and global economy. More attention should be paid to enhancing the Global System of Trade Preferences among developing countries (GSTP), along with additional and non-conditional facilities for South-South trade financing.

113. In devising a Doha Round "Aid for Trade" (AFT) package, a set of baseline rules are called for: they should not be construed as a substitute for the development gains to be derived from negotiations on market access and the approval of balanced trade rules; they should be funded with additional resources either on concessional terms or in grant form; they should be provided without conditionalities other than those implicit in adhering to the Doha agreement and taking into account the specificities of each country; and they should be commitments enforceable like other commitments in the Trade Agreements. Accordingly, the governance structure of the World Bank and IMF funds created to administer Aid for Trade should be markedly different, with full voice given to the recipients.

114. Mechanisms for monitoring respect for and implementation of Special and Differential Treatment provisions as well as for allowing members to request AFT in accordance with their own priorities and needs should be created as an integral part of the Doha Round "single undertaking."

115. Further tightening of intellectual property protection beyond the standards set in the Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement, or imposing trade-distorting or public health threatening levels of intellectual property (IP) enforcement that negatively affect access to medicines by poor developing countries, would certainly not be a welcome result in any negotiation premised on a development perspective. What is positive in this sense about the Doha Round is that changes to IP obligations are not on the negotiating table except for two very specific and narrowly defined areas, of which one, an amendment to the TRIPS Agreement to mitigate bio piracy and protect genetic resources traditional knowledge, has actually become a point of proactive negotiation by the virtual majority of developing countries members of the WTO. A mandatory requirement for disclosure of the country providing/source of genetic resources and mechanisms such as Access and Benefit Sharing and Prior Informed Consent should be implemented in the TRIPS Agreement.

116. An agreement on modalities for concluding the Doha Round has to be sufficiently broad to create a critical mass of bargaining elements that would allow developed members to overcome long entrenched domestic lobbies that otherwise will resist the call for the elimination and reduction of trade-distorting subsidies.

117. A successful conclusion of the Doha Round would set the basis for further work adapting the WTO to the ever-changing needs of the world economy. But as we have noted, a successful conclusion must go some way to meeting the original commitments that it be a development round.[1] A discussion on possible reforms of the WTO itself should directly be addressed after the conclusion of the Round.

[1] Major reports about the future of the WTO, such as the Sutherland and the Warwick report point into this direction and provide concrete proposals.

CHAPTER 5: INTERNATIONAL FINANCIAL INNOVATIONS

1. Previous chapters have analyzed the macroeconomic policy and regulatory reforms needed to guarantee a sustainable and development-friendly recovery of the world economy. Chapter 4 looked at reforms of current financial institutions and broader institutional innovations. This chapter confronts another set of innovations to improve the global reserve system, manage sovereign debt defaults, better distribute the risks between lenders and borrowers in world markets, and create novel financing mechanisms for development cooperation and the provision of global public goods.

The Global Reserve System

2. Since the breakdown of the Bretton Woods system with the suspension of the gold convertibility of the dollar in 1971, a system of flexible exchange rates among major currencies has predominated. Although alternative national and regional currencies (such as the euro) compete with each other as international reserve assets and means of international settlement, the dollar has maintained its predominant role in both regards. This system has proven to be unstable, incompatible with global full employment, and inequitable.

3. One of the main problems of the Bretton Woods system was identified by Robert Triffin in the 1950s: the use of a *national* currency (the US dollar) as the *international* reserve currency. This generated a difficult dilemma since the dollar deficits necessary to increase global liquidity eroded confidence in the dollar as a reserve currency and created doubt about the ability of the U.S. to maintain dollar-gold parity. Abandonment of dollar convertibility and the acceptance of flexible exchanges rates eliminated some of these problems but at the same time created new ones. Instead of uncertainty over the ability to maintain dollar-gold parity, the "Triffin dilemma" has been reflected in large swings in U.S. current account imbalances and associated volatility of the dollar exchange rate and, in the long-run, with the risk of loss in the value of foreign exchange reserves held in dollars as U.S. external deficits increased.

4. Instability and the inability to guarantee full employment have arguably worsened after the introduction of flexible exchange rates. Floating exchange rates have not been able to eliminate the deflationary bias associated with the greater pressure on deficit countries than surplus countries to adjust to payments imbalances. The exception is, of course, the country issuing the dominant international reserve currency, which can actually generate during some periods the opposite phenomenon—an inflationary bias associated with excess dollar liquidity. As pointed out in the previous paragraph, though, this bias comes at the cost of dollar exchange rate volatility and eventual erosion in the value of dollar assets. The relaxation of controls on capital flows that accompanied more flexible exchange regimes has introduced new forms of instability associated with the volatility of capital flows and particularly, but not only, short-term flows.

5. As a result of a sequence of severe crises experienced since the breakdown of the Bretton Woods system, a number of developing countries, particularly in Asia and Latin

America, have sought new instruments to protect themselves against global financial and economic instability. Coupled with the increasing unwillingness of developing countries to submit to the conditionalities associated with IMF lending, this has led to a massive accumulation of reserves over the past two decades. As these reserves are mostly held in hard currencies, they also represent a transfer of resources to the United States and other industrialized countries.

6. Many believe that the problems of the current reserve system could be eliminated by creating a supranational international reserve currency. Indeed, the idea of an international reserve currency issued by a supranational bank is not new. It was broached more than 75 years ago by John Maynard Keynes in his 1930 *Treatise on Money* and refined in his Bretton Woods proposal for an International Clearing Union.

7. There currently exist a number of alternative proposals for a new global reserve currency, for how the system might be administered, how the emissions of the new currency might be allocated, and how the transition to the new system might be best managed. Considerable discussion will be required for the international community to decide the precise arrangements. However, this is an idea whose time has come. This is a feasible proposal and it is imperative that the international community begins working on the creation of such a new global reserve system. A failure to do so will jeopardize prospects for a stable international monetary and financial system, which is necessary to support a return to robust and stable growth.

Instability

8. The operation of the current international system has been marred by a number of sources of instability. As noted, it has been unable to constrain the size of payments imbalances that have led to large holdings of the international reserve currency. This in turn has led to deterioration in confidence in the dollar's role as a global store of value. After the abandonment of fixed exchange rates in the early 1970s, the main manifestation of expanding domestic demand and "excess" dollar liquidity was a decline in confidence in the dollar. When this led to measures by the U.S. to reduce dollar liquidity, in part to restore the credibility of the dollar's reserve currency status, it generated dollar appreciation and contractionary pressures on the world economy. Two additional cycles of excess dollar liquidity, followed by U.S. adjustment, were also experienced in the following decades. U.S. monetary policies have been implemented with little consideration of their impact on global aggregate demand or demands for global liquidity and are thus a potential cause of instability in exchange rates and global activity.

9. Since the 1960s, the system has indeed been plagued with cycles of diminished confidence in the U.S. dollar. These cycles have become particularly intense since the 1980s, leading to unprecedented volatility both in the U.S. current account deficit and the effective exchange rate of the U.S. dollar. As a result, the major attribute of an international store of value and reserve asset, a stable external value, has been eroded.

10. There is another sense in which the current system is unstable. By definition, for the world economy, the sum of all deficit countries' balance of payments must equal the sum of

all other countries' surpluses. But the way surpluses and deficits are brought into equality is not necessarily smooth and will usually involve changes in incomes of individual countries. If a large number of countries choose policies aimed at increasing their trade surpluses, or if international institutions encourage deficit countries to improve their balance of payments, the deficits of the remaining country or countries will become increasingly large. With the dollar as the major international reserve currency, if the rest of the world seeks to run external surpluses, this will result in a decline in global income, unless the U.S. is willing to be the "deficit country of last resort." In turn, if U.S. macroeconomic policies are overtly expansionary and the rest of the world is unwilling to accumulate dollar assets, the adjustment will also take place through downward adjustment in global income. In either case the result is likely to be growing global imbalances, exchange rate instability, and erosion of confidence in the dollar as a reserve currency.

11. The introduction of flexible exchange rates in the presence of growing private international capital flows failed to meet the expectation that adjustment of the balance of payments would become smoother while leaving each country the necessary autonomy to guarantee their domestic macroeconomic policy objectives. The basic reason is that countries can avoid adjustment as long as they can attract sufficient external flows. When these prove to be insufficient to fund the imbalance or are reversed because of lack of confidence in the deficit countries, the adjustment takes the form of a financial crisis. The asymmetry remains, but the negative impact on the deficit countries is much greater, as the increasing frequency and severity of financial crises since the mid-1970s have made clear.

Self-insurance and deflationary bias

12. Global imbalances, associated in part with the way different countries reacted to the financial instability of the late 1990s and early 2000s, played an important role in the macroeconomic conditions leading to the current world financial crisis. The asymmetric adjustments to these global imbalances played a part in generating the insufficiency of global aggregate demand that has helped convert a U.S. financial disruption into a global economic recession. Unless both global imbalances and the insufficiency of aggregate demand are remedied, it will be difficult to restore robust, stable economic growth.

13. Problems in the design and functioning of the international financial system led to large accumulations of reserves by developing countries in recent years, especially after the Asian and Russian crises of 1997-1998. These crises, like those that preceded them in the late 1970s and early 1980s, showed that developing and emerging countries are subject to strong pro-cyclical capital flows. If authorities react by allowing capital surges during booms to generate rapid exchange rate appreciation and the build-up of current account deficits, the outcome is almost certainly a balance of payments crisis accompanied or soon followed by a domestic financial crisis. This problem is particularly acute when the boom is in the form of largely speculative short-term capital flows, a point that came to be increasingly recognized after the Asian crisis. The decision to build stronger current account positions and to accumulate large foreign exchange reserves in the face of booming capital inflows in 2004-2007 were therefore often a common response of these countries to reduce the likelihood that they would face crises and to create policy space to respond if they occurred.

14. Similarly, commodity-exporting countries have experienced repeated crises, when improvements in the terms of trade lead to unsustainable demand expansion and exchange rate appreciation that generates "Dutch disease" effects. As a result, since the Asian crisis, commodity exporting developing countries, as well as export-oriented economies more generally, have tried to avoid exchange rate appreciation by saving part of the exceptional export proceeds considered to be temporary. High commodity prices in the boom years preceding the current crisis exacerbated the problems that this posed for global balances.

15. These policies could be considered as "self-insurance" or "self-protection" against reversals of capital flows, adverse movements in the terms of trade, excessive exchange rate volatility, and the associated risks of balance of payments and domestic financial crises. The fact that the only available "collective insurance" is IMF financial assistance, which is highly conditional, often imposing pro-cyclical policies during crises, reinforced the view that self-protection in the form of reserve accumulation was a better strategy.[1]

16. As a result of these factors, reserve accumulations rose to 11.7% of world GDP in 2007, compared to 5.6% a decade earlier when the Asian crisis struck. Reserve accumulations in the period 2003-2007, in the run up to the current crisis, amounted to an annual average of $777 billion a year, or 1.6% of global GDP. The major concern is that if the current crisis is as long and as deep as feared, and if the assistance provided to developing countries is inadequate, there will be attempts to preserve strong external balances through protectionist measures, beggar-thy-neighbor exchange rate policies, and stronger "self-insurance" through reserve accumulation. All these measures reduce global aggregate demand and impede a rapid response to the crisis.

17. When reserve accumulation is the result of current account surpluses and not simply the result of tempering the impact of autonomous private foreign capital inflows on the exchange rate, there is a reduction in global aggregate demand.[2] In the past, the negative impact of these reserve accumulations on global aggregate demand was offset by other countries' large current account deficits, particularly due to loose monetary and fiscal policies in the United States. But the outcome, as we have seen, has been global instability. Today, most countries eschew these policies.

18. The question posed by the autonomous reduction of the United States' deficit now underway is: what will sustain global aggregate demand? It is unlikely to be another American bubble leading to another period of large and unsustainable American deficits and

[1] There may be other reasons, such as the need to provide for an aging population that would lead countries to adopt policies to increase domestic savings and hold them in the form of foreign assets. The associated "imbalances" would then simply reflect differences in the propensities of countries at different stages of development and with different age structures of the population to save and invest. Financial flows would then be from developed countries with high saving, aging populations to developing countries with younger populations and higher returns on investment. However, this has not been reflected in the statistics on international capital flows. Restrictions on the ability to use industrial policies to encourage nascent industries in emerging countries (as many of the currently industrialized countries did in earlier phases of their development) under recent WTO agreements may have led some countries to substitute exchange rate policies to effect similar outcomes, and this too may have contributed to reserve accumulation.

[2] These reserves are sometimes called "owned reserves" to differentiate them from "borrowed reserves," whose counterparts are foreign capital inflows.

the continuation of global imbalances. Such a course risks a repeat of the current crisis. Thus, something has to be done about the underlying sources of the insufficiency of global aggregate demand.

19. A global reserve currency whose creation is not linked to the external position of any particular national economy could provide a better system to manage the instability analyzed above. It should be designed to regulate the creation of global liquidity and maintain global macroeconomic stability. It would also make the problems noted above related to the creation of excess liquidity by the reserve currency country less likely to occur. Reforms in the global financial system should also include innovations to improve risk-sharing mechanisms that would reduce the demand for reserve accumulations, and thus reduce the magnitude of the requisite liquidity creation (see below).

20. The system should similarly be designed to put pressure on countries to reduce their surpluses and to thus reduce their contribution to the insufficiency of global aggregate demand. This would also contribute to the reduction of global imbalances.

Inequities

21. The current system is also inequitable because it results in developing countries transferring resources, typically at low interest rates, to the developed countries that issue the reserve currencies. In particular, the buildup of dollar reserves represents lending to the United States at very low interest rates (today close to zero). This transfer has increased over time due to the realization by developing countries that large foreign exchange reserves are their only defense in a world of acute financial and terms of trade instability.

22. Developing countries are, in effect, lending to developed countries large amounts at low interest rates—$3.7 trillion in 2007. The difference between the lending rate and the interest rate which these countries pay to developed countries when they borrow from them is a transfer of resources to the reserve currency countries that exceeds in value the foreign assistance that developing countries receive from the developed countries. The fact that developing countries choose to hold such reserves is testimony to their perception of the costs of instability—of the adjustment costs that they would have to bear if they did not have these reserves.

Costs to the reserve currency country

23. The United States also incurs costs associated with its role in supplying global reserves. The demand for global reserves has led to increasing current account deficits in the United States that have had adverse effects on U.S. domestic demand; when dollars are held to meet increased demands for liquidity in surplus countries, they fail to produce any countervailing adjustment in foreign demand. This necessitates the U.S. maintaining persistent fiscal deficits, if it wishes to keep the economy at or near full employment—with the exception of periods of "irrational exuberance," such as the tech bubble of the late 1990s. In addition, the periodic need to correct these deficits requires contractionary monetary or fiscal policies that have adverse domestic effects on the U.S. economy.

24. Countries holding substantial dollar reserves have called for assurances that the U.S. authorities do not allow any depreciation in the international value of the dollar and thus a decline in the value of their reserve holdings. China, the major holder of dollar reserves, has already noted the risks to its dollar reserves should the U.S. adopt policies leading to depreciation of the dollar. The only way to respond to this call would involve a loss of policy autonomy for the U.S., as it would have to take into consideration the effects of its monetary policy on the rest of the world and their perceptions of these impacts. Maintaining U.S. monetary policy autonomy, as would be required to respond effectively to the current crisis, is a major reason for the U.S. to move to a global reserve system, in addition to the benefits it would receive from a more stable global financial and economic system and from the reduction in its domestic aggregate demand (as a result of the trade deficit), with all of the adverse consequences that follow. These disadvantages more than offset the advantages that may accrue to the U.S. from its ability to borrow at low interest rates. Besides, if confidence in the dollar as a reserve system erodes (as appears to be the case), the ability of the U.S. to continue borrowing at low interest rates may be limited.

Problems with a multiple currency reserve system

25. It should be emphasized that a system based on multiple, competing reserve currencies would not resolve the difficulties associated with the current system, since it would not solve the problems associated with national currencies—and, particularly, currencies from major industrial countries—being used as reserve assets.

26. The basic advantage of a multi-polar reserve world is, of course, that it provides room for diversification. However, it would come at the cost of adding an additional element of instability: the exchange rate volatility among currencies used as reserve assets. If central banks and private agents were to respond to exchange rate fluctuations by changing the composition of their international assets, this would feed into exchange rate instability. Under these conditions, the response to the introduction of a multiple currency reserve system might be calls for a return to a fixed exchange rate arrangement. But fixing the exchange rates among major currencies in a world of free capital mobility would be a daunting task that would require policy coordination and loss of monetary policy sovereignty that seems unlikely under current political conditions.

27. Furthermore, it would be particularly problematic for countries that are restrained in their monetary and fiscal policies (as Europe may be with its Growth and Stability Pact and with a central bank committed to focusing on inflation) to become reserve currencies, for they would face difficulties in offsetting the adverse effects on national aggregate demand arising from the associated trade deficits.

Call for a global reserve currency

28. These long-standing deficiencies in existing arrangements have become manifest in the period leading up to the current global financial crisis and can make the crisis deeper. If countries choose increased savings and higher international reserves as a response to the uncertainty of global market conditions, this would further deepen the aggregate demand problem the world economy is now facing.

29. The increases in the U.S. national debt and the size of the balance sheet of the U.S. Federal Reserve have led to concerns in those countries holding large dollar reserves about the stability of the dollar as a store of value. In addition, the low (near zero) return on dollar holdings means that they are receiving virtually no return in exchange for the foreign exchange rate risk which they bear. However, any attempt to reduce dollar holdings will produce the Triffin dilemma noted above, provoking the collapse in the value of their dollar holdings that they fear.

30. These are among the reasons to adopt a truly global reserve currency. Such a global reserve system can also reduce global risks, since confidence in and stability of the reserve currency would not depend on the vagaries of the economy and politics of a single country.

31. The current crisis provides, in turn, an ideal opportunity to overcome the political resistance to a new global monetary system. It has brought home problems posed by global imbalances, international instability, and the current insufficiency of global aggregate demand. A global reserve system is a critical step in addressing these problems and in ensuring that, as the global economy recovers, it moves onto a path of strong growth without setting the stage for another crisis in the future. It is also a propitious moment because the United States may find its reserve currency status increasingly costly and untenable. The dollar can be a reserve currency only if others are willing to hold it as such, and as the return falls and the risk increases, greater reservations about the dollar as a reserve currency are being expressed. The dollar reserve system is likely to fray, if it is not already doing so. Moreover, the U.S. has embarked on a response to the crisis that will involve large domestic imbalances and also potentially large external imbalances, with unpredictable implications for the international reserve system. Thus, both the United States and foreign exchange reserve holding countries may actually find it acceptable to introduce a new system. The former would be able to take policy decisions with less concern about their global impact; the latter would be less concerned about the impact of U.S. policies on their reserve holdings.

Institutional frameworks for a new global reserve system

32. In setting up such a system, a number of details need to be worked out, including who would issue the reserve currency, in what amounts, to whom, and under what conditions.

33. The issues are largely separable. Responsibility for managing the global reserve system could be given to the IMF, which currently issues the only global currency, Special Drawing Rights (SDRs), on which the system could be built. But it could also be given to a new institution, such as a "Global Reserve Bank." If we turn to existing institutions, this could be contingent on needed reforms of these institutions.

34. One possible approach would require countries to agree to exchange their own currencies for the new currency—say International Currency Certificates (ICCs), which could be SDRs—and vice-versa, in much the same way as IMF quotas are made up today (except that developing countries would only make their quota contributions in their own national currencies and would thus be exempted from making part of such contributions in

SDRs or convertible currencies as is the rule today). This proposal would be equivalent to a system of worldwide "swaps" among central banks. The global currency would thus be fully backed by a basket of the currencies of all members.

35. In an alternative approach, the international agency in charge of creating global reserves would simply issue the global currency, allocating ICCs to member countries, much as IMF Special Drawing Rights are issued today. There would be no "backing" for the global currency, except the commitment of central banks to accept it in exchange for their own currencies. This is what would give the ICCs (or SDRs) the character of an international reserve currency, the same way that acceptance by citizens of payments in a national currency gives it the character of domestic money. However, if the issues of global currency received by countries are considered deposits in the IMF or the Global Reserve Bank, and the institution in charge of managing the system is allowed to buy the government bonds of member countries or to lend to them, then these investments would be the "backing" of the global currency, just as domestic moneys are "backed" today by the assets of national central banks (the government bonds in their hands and their lending to private sector financial institutions).[3]

36. Under any of these schemes, countries could agree to hold a certain fraction of their reserves in the global currency. The global reserve currency could also pay interest, at a rate attractive enough to induce its use as an investment for central banks' reserves. Exchange rates would be managed according to the rules that each country chooses, subject to the condition that exchange rate management does not affect other countries—a rule that is already included in the IMF Articles of Agreement and must be subject to appropriate surveillance. As with SDRs, the exchange rate of the global currency would be the weighted average of a basket of convertible currencies, the composition of which would have to be agreed.

37. In the alternative, in which the global currency is considered to be a deposit in the IMF or Global Reserve Bank, earnings by these institutions' investments (lending to countries undergoing balance of payments' crises, or otherwise via Treasury securities of member countries) would finance the interest paid to those countries that hold deposits of the global currency (possibly in excess of the original issues they received). Obviously the major advantage to holding the global currency is that the diversification away from individual currencies would generate more stability in the value of reserve holdings.

38. The global currency could be allocated to countries on the basis of some formula ("quota") based on their weight in the world economy (GDP) or their needs (some estimation of the demand for reserves). Since developing countries hold reserves which are, in proportion to their GDP, several times those of industrial countries (26.4% of GDP in 2007 vs. 4.8% for high-income OECD countries), to manage the trade and capital account volatility they face, a formula that would allocate the currency according to some definition of demand for reserves would result in larger proportional allocations to these countries. One possibility is, of course, to give developing countries all allocations. Note that the current SDR allocation is based on a particular "quota" system, that of the IMF, which

[3] In the current system, SDRs are both booked as assets and liabilities on the central banks' balance sheets. This is reflected in an IMF account. Therefore, at the moment, SDRs are not considered as deposits in the IMF.

continues to be subject to heated debate because richer countries, on average, get a larger share of new allocations—i.e., the opposite to what a criterion based on need would suggest.

39. The allocation can and should have built into it incentives and/or penalties to discourage maintaining large surpluses. Countries that maintain excessive surpluses could lose all or part of their quota allocations if they are not utilized in a timely manner to increase global demand.

40. The size of the annual emissions should be targeted to offset the increase in (non-borrowed) reserves, i.e. reductions in global purchasing power resulting from reserve accumulations. Simpler versions of this proposal would have annual emissions fixed at a given rate of say $150 to $300 billion a year (the first figure corresponds to the world demand for reserves in 1998-2002, but the demand for reserves was much larger in 2003-2007, suggesting that even $300 billion a year might be insufficient).

41. More sophisticated and elaborate versions of this proposal would have emissions adjusted in a countercyclical way, with larger emissions when global growth is below potential. It might be easier to get global consensus on either of these simpler variants, but more detailed versions would be able to support a variety of global needs (e.g. to generate badly needed revenues for development or global public goods).

42. One institutional way of establishing a new global reserve system is simply a broadening of existing SDR arrangements, making their issuance automatic and regular. Doing so could be viewed simply as completing the process begun in the 1960s, when SDRs were created. The simplest version, as noted, is an annual issuance equivalent to the estimated additional demand for foreign exchange reserves due to the growth of the world economy. But they could be issued in a counter-cyclical fashion, thereby concentrating issuances during crisis periods. One advantage of using SDRs in such a counter-cyclical fashion is that it would provide a mechanism for the IMF to play a more active role during crises.

43. Still another mechanism to manage SDRs in a counter-cyclical way was suggested by IMF economist Jacques Polak three decades ago: providing all financing during crises with SDR loans. This would generate emissions that would be automatically extinguished once loans are paid back and create the global equivalent to what the central banks of industrial countries have been doing on a massive scale during recent months.

44. Indeed, a large counter-cyclical issue of SDRs is the best mechanism to finance world liquidity and official support to developing countries during the current crisis. This was recognized by the G-20 in its decision to issue the equivalent of $250 billion in SDRs. However, this decision also illustrates the problems associated with tying SDR issuance to IMF quotas, as somewhat less than $100 billion of the proposed emissions would benefit developing countries, with even a much smaller amount (about $20 billion) going to low-income countries. This implies that this issue is closely tied to the ongoing debate about reform of IMF quotas. None of the proposed reforms to quotas deal adequately with the issue of equity or indicate that different rules may have to be applied to quotas and SDR issues, as noted above.

45. Although developing countries would only receive part of the allocations, the capacity of the IMF to lend would be considerably enhanced if the current system was reformed in such a way that unutilized SDRs, particularly from industrial countries, could be used by the IMF to lend to member countries in need—such as the proposal of treating unused SDRs as deposits in the IMF. However, unless there are strong reforms in the IMF's practices, the ability of the emissions to address the liquidity and macroeconomic management problems noted earlier might be impaired, as developing countries might be reluctant to turn to the IMF for funds. Reforms in that direction were adopted in March 2009 with the creation of the Flexible Credit Line with only ex-ante conditionality, the doubling of all credit lines, and the elimination of structural benchmarks in conditional IMF lending. But additional reforms to make access less onerous will be needed.

46. A simple way to further the use of SDR allocations to advance developmental objectives (which might require changing the Articles of Agreement) would be for the International Monetary and Finance Committee and the IMF Board to allow the IMF to invest some of the funds made available through issuance of SDRs in bonds issued by multilateral development banks. This would be similar to the proposal for a "development link" made by the UNCTAD panel of experts in the 1960s (see below).

47. Thus, a well-designed global currency system would go a long way to correct the "Triffin dilemma" and the tendency of the current system to generate large global imbalances and the deflationary biases characteristic of balance of payments adjustments during crises. Depending on the way emissions are allocated, the system could also correct the inequities associated with the large demand for reserves by developing countries, provide collective insurance against future shocks, help finance global public goods, including the costs of climate change mitigation and adaptation, and promote development and poverty alleviation, including in the poorest countries. If emissions were issued in a counter-cyclical way, they could perform an even more important role in stabilization.

Historical antecedents

48. When Keynes revised his idea of a global currency in his proposal for an International Clearing Union, as part of the preparations for what became known as the Bretton Woods Conference, his major concern was the elimination of asymmetric adjustment between deficit and surplus countries leading to the tendency towards deficiency of global aggregate demand and a constraint on the policy space needed for policies in support of full employment. He also had in mind the significant payments imbalances that, he feared, would characterize the post-war order and therefore the need to provide a better source of liquidity, both globally and for countries that would leave the war with structural payments deficits. Of course, the first of these problems, the asymmetric adjustment, was not corrected by the Bretton Woods system, and the second, the adequate provision of global liquidity, was only partly corrected.

49. In turn, when SDRs were created in the 1960s, the major concern was how to provide a more reliable source of global liquidity to replace gold and reserve currency holdings (mainly dollars, but also British pound sterling at the time). It was believed that the existing sources of international liquidity were not reliable, as they depended in the first case on gold

production and in the second on deficits of the reserve currency countries, particularly the United States. As the initial problems of global liquidity—the "dollar shortage"—were overcome, attention shifted to risks of excessive dollar liquidity, particularly that U.S. gold reserves would not be sufficient to support dollar-gold convertibility. This finally generated the demise of the Bretton Woods "dollar-gold exchange standard" in 1971 and the adoption of flexible exchange rates among major currencies in 1973.

50. At the time SDRs were created, it was hoped they would become a major component of global reserves, thus creating a system in which the growth of global liquidity would depend on deliberate international decisions. This expectation was not fulfilled, and a total of only 21.4 billion SDRs (about $33 billion) were issued in two different periods (1970-72 and 1979-81), which represent only a minimal fraction of current world reserves. The recent approval by the IMF of a new emission of SDRs, for the equivalent of $250 billion, thus constitutes a major step to enhance this instrument of international cooperation.

51. The nature of the problems of global liquidity provision was obviously transformed with the development of private financial markets in Eurodollars and other European currencies and the introduction of a flexible exchange rate system. These problems associated with the provision of global liquidity are less important today, except during extraordinary conjunctures such as those generated by the severe shortage of liquidity, including the global liquidity crisis in August 1998 and the world financial crisis since September 2008. But a major problem remains: dependence of global liquidity on the vagaries of U.S. macroeconomic policies and balance of payments' imbalances, which can generate either excessive or limited world liquidity. The recurrent problem of developing country access to international liquidity is still a feature of the system as a result of pro-cyclical capital flows.

52. In Keynes's initial proposal for a post-war arrangement, there was no need to address the problem of equity in issuance since the creation of clearing credits was entirely endogenous. This question was also evaded in the initial issuances of SDRs, although some ideas were proposed at the time on how to tie the issuance of a global currency to development financing, particularly in the proposal made by an UNCTAD expert panel to link the question of liquidity provision for developed economies to the needs of developing economies for development financing. But, as already seen, equity issues cannot be ignored today because of the magnitude of the inequities associated with the current system in subjecting developing countries to recurrent problems of illiquidity or inducing them to accumulate large amounts of foreign exchange reserves.

Transition to new system

53. The reform of the global reserve system could take place through a global agreement or through more evolutionary approaches, including those that could build on a series of regional initiatives.

54. If a large enough group of countries agreed to pool reserves in a system they agreed to create and to hold a common reserve currency which they would stand ready to exchange for their own currencies, a regional reserve system—or even a system of near-global coverage—could be established without the agreement of all countries. So long as the new

currency is convertible into any hard currency that is itself convertible into other currencies, it could serve effectively as a reserve currency. The countries participating might also agree to reduce, over time, their holdings of other reserve currencies.

55. Membership in this new "Reserve Currency Association" could be open to all who subscribe to its Articles of Agreement. The advantages of participation are sufficiently great that it is likely to grow over time, embracing more countries that hold a greater fraction of their reserves in the new global reserve currency. Eventually, even the United States would probably find it desirable to join. Thus, gradually, through a stable, evolutionary process, we can achieve the creation of a new Global Reserve System, an alternative to the current system. Of course, there is also a risk of adverse selection—as long as participation is voluntary, soft currency countries would be more willing to participate, and convertible global currencies outside the scheme could remain the preferred currencies.

56. Existing regional agreements might provide an alternative way of evolving towards a Global Reserve System. Regional mechanisms have advantages of their own, and can be based either on swap arrangements among central banks or on foreign exchange reserve pools. Given the reluctance of governments to give up control over their reserves, swap arrangements may be more acceptable. Reserve pools offer, however, other advantages, such as the possibility of allowing the reserve fund to borrow during periods of stress, and, as noted, to issue a currency or reserve asset that could be used at a regional or global level. In the 1980s, for example, the Latin American Reserve Fund (FLAR) was allowed to issue Andean pesos.[4] This asset, which has never been used, was expected to be used in intra-regional trade, with periodic clearing of those held by central banks. The Chiang Mai Initiative, created in 2000 by members of ASEAN, China, Japan and the Republic of Korea, is another important example of regional cooperation.[5] Were this initiative to evolve into a reserve fund, it could back the issuance of a regional asset that could actually be attractive to central banks in other parts of the world to hold as part of their reserve assets. However, if the Chiang Mai Initiative is to play a more effective role in stabilization, it would be necessary to eliminate the requirement that countries would need to have an IMF program to qualify for access to its swap facilities.

57. A common criticism of regional arrangements is that they are not effective in providing diversification for protection against systemic crisis, as regional members are more likely to be adversely affected at the same time, implying that they are a complement to, rather than a substitute for, a global solution. Although the ability of regional arrangements to address external shocks depends on negative events not being correlated across participating countries, they could still be useful if shocks affect member countries with different intensities or with varying lags, since this would allow some countries to lend their reserves to those experiencing more severe or earlier shocks. Furthermore, lending at the onset of a liquidity squeeze could prevent a crisis in a given country from affecting other countries, thereby reducing the correlation produced by contagion. More generally, a country would

[4] The Latin American Reserve Fund was created by Andean countries in 1978 and was then called the Andean Reserve Fund. Its current members are Bolivia, Colombia, Costa Rica, Ecuador, Peru, Uruguay, and Venezuela.
[5] This initiative works as a system of bilateral swaps by member central banks, which are in the process of becoming multilateral. The system has not been used so far. ASEAN has a swap arrangement of its own that has a longer history.

benefit from the regional arrangement if the variability of the regional reserve pool is lower than that of its individual reserves and if potential access to the pool reduces the possibility of attacks on individual members. These regional arrangements thus act as a mechanism of collective insurance that is substantially more powerful than self-insurance. Statistical analysis by the UN Economic Commission for Latin American and the Caribbean supports the benefits that accrue from this approach, by indicating that correlations of relevant macroeconomic variables among countries in the region may be lower than usually assumed.

58. Regional initiatives could become part and parcel of the global reserve system. Some have suggested that the reformed IMF should be a network of such regional reserve funds. Such a decentralized system would have many advantages, including the possibility of better solving problems associated with crises in the smaller countries at the regional level. The system would also be attractive for medium and small-sized countries that could have stronger voices at the regional level. One way to link regional and global arrangements would be to make contributions to regional arrangements one factor to take into account in determining SDR allocations.

Sovereign Debt Default and Restructuring

Inadequacies of the existing system (or "non-system")

59. Sovereign debt crises have been a major source of the difficulties faced by developing countries in achieving sustained growth and development at different times since the 1980s. The social costs of these crises have been extremely large and have included long periods of lost income and jobs, increased poverty, and, in some cases, worsening income inequality. Given the instability of external capital flows, severe financial crises have even hit countries judged by international opinion to have been soundly managed. In several cases, crises originated from governments taking over the responsibility for servicing private-sector debts of the banking system or key firms judged "too big to fail"—in a way not too different from how the U.S. and other industrial country governments have done during the current global crisis. Such "nationalization" of private sector external debt was a feature of the Latin American debt crisis of the 1980s and has been quite common in developing country debt crises since then.

60. Not only are current "work-out" processes protracted and costly, but often, the debt write-downs have also been insufficient to ensure debt sustainability. The existence of debt overhangs depresses growth, contributes to poverty, and crowds out essential public services. Often, when write-downs have been insufficient, they are soon followed by another crisis. And because of the adverse terms and high costs imposed by debt work-outs, developing countries are reluctant to default in a timely way, resulting in delays in dealing with the underlying problems.

61. Moreover, worries about a protracted crisis in one country having spill-over effects for others have motivated massive bailouts, contributing in turn to problems of moral hazard and enhancing the likelihood of future crises.

62. Whatever the explanation of these crises (whether they are due to risky policies on the

part of governments or the intensified economic fluctuations of liberalized financial environments), the existing system of protracted, creditor-biased resolution of sovereign debt crises is not in the global public interest and far from the interests of the poor in the affected countries.

63. The existing "system" (or really "non-system") arose as piecemeal and mostly ad hoc intergovernmental responses to sovereign debt crises as they occurred over the past half-century or so. The fact that the solutions the current system provides take time to be adopted and provide inadequate relief implies that the system for addressing sovereign debtors is clearly inferior to that provided in many countries for corporations and sub-sovereign public entities by national bankruptcy regimes. The latter aims to find not only a quick and equitable solution that recognizes the claims of formal creditors as well as the rights of ordinary citizens, e.g. to education, health, or old age benefits, but also a solution that achieves nationally desired economic and social outcomes, particularly a "fresh start" (or "clean slate") when a bankrupt entity is reorganized. In contrast, the system for resolving sovereign debt crises is plagued by horizontal inequities. Official lenders have always complained that private creditors do not follow restructurings agreed in the Paris Club (and have been "free riders"). The magnitude of debt rescheduling and relief accorded in individual cases has clearly depended on the weight and negotiating capacity of the debtor country.

64. The system for sovereign debtors has operated under the informal and imperfect coordination of the debtor and its creditors by the IMF, under the guidance of the G-7 major industrialized countries, which set the overall policy directions for the IMF and the other involved institutions, such as the Paris Club, where debts owed to governments are restructured. The system assumes a developing country government in debt distress will adopt an IMF-approved macroeconomic adjustment program, that the program will be effective, and that all the relevant classes of creditors (banks, bondholders and suppliers, government creditors, and multilateral institutions) will cooperate in providing the overall amount of relief and financial support deemed necessary on the basis of IMF documents. Often there is very little real debt relief, only a rescheduling of obligations, and the magnitude of relief is based on excessively optimistic growth projections—setting the stage for problems down the line.

65. Since these basic conditions for the successful implementation of debt relief were seldom met, confidence in the system has quickly eroded and was severely affected by how the East Asian, Russian, Ecuadorian, and Argentine crises were handled. Even the Heavily Indebted Poor Countries (HIPC) Initiative as initially instituted was recognized to be insufficient to give the poorest countries a fresh start. After almost a decade of negotiations, it was supplemented in 2005 with the Multilateral Debt Relief Initiative. Nevertheless, the HIPC Initiative represented the first comprehensive approach to a solution of the debt problems of poor developing countries. The initiative came along with a framework that placed poverty reduction strategies at the center of development cooperation, based in part on a dialogue including the participation of civil society. Nevertheless, pro-cyclical conditionalities were often applied, which had damaging effects on socio-economic conditions.

66. Apart from that, some individual non-HIPC renegotiations that took place after the East Asian crisis have been judged as unsatisfactory. Most single country "workouts" from debt crises in this period were under cooperative voluntary arrangements with the bondholders that did not reduce the level of debt. The transparency of some of these renegotiation processes—including the pressures exerted on debtor countries by other nations and IFIs—has also been questioned.

67. Moreover, while creditors have a seat at the table, other claimants—such as government retirees, for instance, who have been promised a particular level of pensions—do not. Chapter 9 of the U.S. bankruptcy code, which applies to municipalities and other sub-sovereign public entities, gives priority to these "public" claimants on government revenues. In contrast, international procedures seem to pay insufficient attention to such interests.

68. Finally, some critics of current practices suggest that they are unnecessarily "painful" because they are designed to provide strong incentives for countries not to default on their obligations. Small and weak countries are more likely to be forced to pay the price for ensuring that the overall system exercises discipline on borrowers.

69. Argentina's rapid growth after its 2001 default, in spite of the long delay to the final resolution, shows that eliminating debt overhang can provide conditions for rapid economic growth even in seemingly adverse conditions. Despite rapid growth, however, this country faced significant problems regaining access to private financial markets.

An International Debt Restructuring Court

70. Some have argued that new debt restructuring procedures are not needed; all that is required are small reforms in debt contracts, such as collective action clauses. But no country relies solely on collective action clauses for debt resolution, and there is no reason to believe that doing so for international debt would be sufficient. For instance, collective action clauses do not provide effective means for resolving conflicts among different classes of claimants.

71. It is easy to agree that the amount of debt relief accorded to different countries should depend on their circumstances. However, it is artificial to have one set of rules for determining relief for selected developing countries, as was the case for the HIPCs and then for the Multilateral Debt Relief Initiative, and another for the rest of the world. Rather, a single statutory framework for debt relief is needed to ensure that creditors and debtors restructure the debt to provide a fresh start based on a country's unique economic conditions. The debt workout regime should be efficient, equitable, transparent, and timely in handling debt problems ex post (as problems become apparent, especially after default) while promoting efficiency ex ante (when the borrowing takes place).

72. A well-designed process should protect the rights of minority, as well as majority, creditors—as well as "public" claimants. It should give debtors the opportunity to default through a structured process. The principles of human-centered development, of sustainability, and of equity in the treatment of debtors and their creditors and among creditors should apply equally to all sovereign debt crises resolved through the international

system. As in national bankruptcy systems, principals should be encouraged to reach a workout on their own to the extent possible. But whether such an agreement can be reached, and the nature of the agreement, can be affected by the backdrop of legal structures.

73. Achieving these objectives requires a more structured framework for international cooperation in this area. For the same reason that governments adopt bankruptcy legislation and do not rely solely on voluntary processes for resolving corporate bankruptcies, an efficient sovereign system requires something more than a moral appeal to cooperation. This means the creation of a sovereign debt workout mechanism.

74. This entails the creation of an "International Debt Restructuring Court," similar to national bankruptcy courts. This court would ensure that agreed international principles regarding the priority of claims, necessary overall write-downs, and sharing of "haircuts" are followed. It could differentiate between distinct debt categories, which might include government, government guaranteed, and government-acquired private debt, so as to make transparent the actual effective liabilities of the sovereign. It could also determine what debts could be considered "odious," and it would be able to grant potential private or public creditors authority to extend "debtor in possession" financing, as in corporate restructurings. National courts would have to recognize the legitimacy of the international court, and both creditors and debtors will therefore follow its rulings.

75. As an interim step in the creation of the International Debt Restructuring Court, an International Mediation Service might be created—a kind of "soft" law to facilitate the creation of norms for sovereign debt restructurings, recognizing that to a large extent compliance with international law and the repayment of sovereign debts is, in some sense, "voluntary."

76. Even after the creation of the court, there is a presumption that judicial proceedings would be preceded by mediation. With a view to realizing a comprehensive workout, the court would encourage creditors to coordinate their positions within and across different classes of lenders, including in the long-run the government creditors that operate today through the Paris Club as well as multilateral creditors. Were mediation to fail or become unduly lengthy, the court should have the power to arbitrate. The court might also work in cooperation with the IMF, the World Bank, or regional development banks to help provide interim finance in order to maintain economic strength while negotiations take place. But such lending should not be a mechanism simply for bailing out creditors who failed to do due diligence in providing lending.

77. Beyond the problems of sovereign debt restructuring, there are also serious problems in managing cross-border private debt workouts, with conflicts among different jurisdictions and with concerns about "home" country bias. The International Debt Restructuring Court could extend its reach to consider bankruptcy cases involving parties in multiple jurisdictions. (These problems have been particularly acute in the current crisis in international financial institutions operating in many jurisdictions. See the discussion in Chapter 3.)

78. In earlier discussions of sovereign debt restructuring mechanisms, it was presumed that the IMF, or a separate and newly established division of the IMF, would act as the bankruptcy court. However, while it may be desirable to institutionalize the sovereign debt restructuring mechanism under the umbrella of an international institution, the IMF, in its current form, is unlikely to be the appropriate institution as it is a creditor and also subject to disproportionate influence by creditor countries. It is therefore unlikely to be seen as a "neutral" mediator or arbitrator. The arbitration process of the International Centre for Settlement of Investment Disputes (ICSID) within the World Bank has similarly failed to generate confidence from the developing countries as a fair arbitrator of investor-state disputes under bilateral investment agreements.

79. Any procedure must be based on widely shared principles and processes with political legitimacy. Agreed upon goals, such as that the work-out must be fair, transparent sustainable, and promote development, would boost its credibility with debtors. Indeed, all stakeholders could benefit from improved processes for restructuring debt, including creditors who would appreciate the reduction of uncertainty under clear rules of the game and the knowledge that any post-workout debt situation would have a larger chance of being sustainable. But translating these goals into agreed upon principles and procedures may be difficult, given the conflicts in interests.[6]

80. Public debt audits for transparent and fair restructuring and eventual cancellations of debts should be encouraged. Norway and in Ecuador provide examples.

81. There is nothing immutable in the current approach to resolving sovereign debt crises. It arose in the political and economic environment created after World War II, and the need to develop a better system remains on the international policy agenda. The international community needs to actively resume the effort to define the specific mechanism to institutionalize the principles advanced here.

Foreign debt management

82. The crisis also gives urgency to reform of institutional structures for debt relief as an increasing number of developing countries, especially the most vulnerable low-income countries, may face difficulties in meeting their external debt commitments. This crisis therefore gives urgency to these reforms. Unless these debts are better managed than they have been in the past, the consequences for developing countries, and especially the poor in these countries, can be serious.

[6] As the conflicts over bankruptcy law in many countries demonstrates. The argument put forward by lenders that better (or more debtor-friendly) debt restructuring mechanisms might increase interest rates needs to be viewed with skepticism. It is obviously self-serving. We have suggested that all could benefit from better debt restructuring mechanisms. A more debtor-friendly system would induce more due diligence on the part of lenders. The current system, where the public sector has to repeatedly pick up the pieces as a result of deficient credit assessments by lenders, should be viewed as totally unacceptable. Debt crises impose large costs on society that go beyond the costs imposed on borrowers and lenders. Hence, even if lending rates increased, this may be beneficial.

83. Although, as argued above, there is a need for new procedures for restructuring sovereign debt, it is also important to take measures to ensure that debts that are currently being incurred are better managed. It is important to take actions to manage debt better so that countries are not forced into default.

84. The United Nations should therefore strengthen the UN Conference on Trade and Development's (UNCTAD) advisory role in debt management. Alternatively, the establishment of a Foreign Debt Commission that assesses external debt problems of developing countries and economies in transition could be considered. The Commission, with balanced geographic representation and technical support from the Bretton Woods, regional, and other financial institutions, would provide advice on ways to enhance external debt management and crisis prevention and resolution.[7] It would also examine existing arrangements and advise on the design of better debt sustainability frameworks for the international community. It would help debt-distressed countries return to debt sustainability, extend Paris Club-plus type approaches to new official creditors, set up an interim mediation service, and help craft more permanent debt mediation and arbitration mechanisms (i.e. the International Debt Restructuring Court) on the basis of that experience.

Innovative Risk Management Structures

85. The volatility of private capital flows to developing countries has generated increasing demand for policies and instruments that would allow these countries to better manage the risks generated by increasing international financial integration and, in particular, to better distribute the risks associated with this integration among different market agents. As demonstrated during past and current crises, the pro-cyclical and herding behavior of international capital flows tends to generate boom-bust cycles, which are particularly damaging for developing countries. Current arrangements also reduce the scope developing countries have to undertake counter-cyclical macroeconomic policies. Moreover, many developing and emerging countries borrow short-term, in hard currencies, which forces them to bear the risk of interest rate and exchange rate fluctuations. Finally, inadequate debt resolution mechanisms impose high costs on developing countries.

86. In light of this, there have been a variety of ideas and proposals for the introduction of innovative financial instruments. The proposed instruments include tools that enable better management of risks arising from the business cycle and fluctuations in commodity prices, particularly GDP and commodity linked bonds and financial guarantees that have a counter-cyclical element embedded in their structure. Promoting local currency bond markets has also been seen as a way to enhance financial development and reduce the currency mismatches that affect debt structures in developing countries.

87. GDP-linked bonds are conventional bonds that pay a low fixed coupon augmented by an additional payment, linked by a pre-determined formula to the debtor country's GDP growth. This variable return structure links returns to the ability to service and thus reduces the likelihood of costly and disruptive defaults and debt crises. The reduction of a country's

[7] See United Nations, "Doha Declaration on Financing for Development: outcome document of the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus" (A/CONF.212/L.1/Rev.1), Doha, Qatar, 29 November-2 December 2008, paragraph 67.

debt service when the economy faces financing difficulties can also facilitate more rapid recovery, as it allows higher public spending in difficult times. For investors, GDP-linked bonds reduce the probability of default and thus the costs of expensive renegotiation, and they offer a valuable diversification opportunity. Average returns might be higher than with conventional bonds, but the fact that these bonds enable countries to manage the risks which they face may more than compensate for the additional costs.[8]

88. Since private financial markets are unlikely to develop these instruments autonomously (because of the externalities associated with their introduction, the social returns exceed the private returns), multilateral development banks should take an active role in their development. In particular, these institutions could have an active role as "market-makers." The expertise developed by the World Bank as market-maker for the sale of carbon credits under the Kyoto protocol provides a precedent for these activities. The World Bank and regional development banks could, for example, make loans whose servicing would be linked to GDP. The loans could then be sold to financial markets, either individually or grouped and securitized. Alternatively, the World Bank or regional banks could buy GDP-linked bonds that developing countries would issue via private placements. The fact that major multilateral development banks became active in this type of lending could extend the benefits of adjusting debt service to growth variations to countries that do not have access to the private bond market. GDP-indexed securities are particularly appropriate for Islamic finance, as they can be made compatible with shari'a law, which prohibits charging interest.

89. There might also be alternative ways of ensuring flexible payment arrangements that would allow automatic adjustment for borrowers during bad times. For instance, one possibility is for coupon payments to remain fixed and for the amortization schedule to be adjusted instead. Countries would postpone part or all of their debt payments during economic downturns and would then make up by pre-paying during economic upswings. A historical precedent was set by the United Kingdom when it borrowed from the United States in the 1940s. The 1946 Anglo-American Financial Agreement included a "bisque clause" that provided a 2 percent interest payment waiver in any year in which the United Kingdom's foreign exchange income was not sufficient to meet its pre-war level of imports, adjusted to current prices.

90. Commodity-linked bonds can also play a useful role in reducing country vulnerabilities, which is of special relevance to commodity exporters. Examples of commodity-indexed bonds include oil-backed bonds, such as the Brady bonds with oil warrants first issued on behalf of the government of Mexico. In such instruments, the coupon or principal payments are linked to the price of a referenced commodity. Again, it might be desirable for international institutions to help create a market for such bonds.

[8] However, the introduction of these securities must overcome some practical difficulties. One possible set of concerns is associated with lags in the provision and frequent revisions of GDP data as well as over the quality of these estimates, but these issues should be easy to resolve through international standard setting and provision of technical assistance. More important in this regard is how to manage concerns that have been raised about the liquidity of such instruments, especially when they are newly issued. Such concerns were similarly raised when inflation indexed bonds were first introduced, but they are now accepted worldwide. Governments and multilaterals can help create a deeper market.

91. Developing countries may face higher debt costs as they attempt to shift commodity price risk to others, but the benefits of such risk shifting should exceed the costs if markets are working well. While they are likely to be less useful than GDP-indexed bonds for the growing number of developing countries that have a fairly diversified export structure and therefore lack a natural commodity price to link to bond payments, they have the decided advantage that the risk being "insured" through the bond is not affected by the actions of the country (i.e. moral hazard is less of a problem).

92. Another way of addressing the problems created by the inherent tendency of private flows to be pro-cyclical is for public institutions to provide offsetting counter-cyclical finance, possibly through the issue of guarantees that have counter-cyclical elements. For example, Multilateral Development Banks (MDBs) and Export Credit Agencies (ECAs) could introduce an explicit counter-cyclical element in guarantees they issue for lending to developing countries. When banks or other lenders lower their exposure to a country, MDBs or ECAs would increase the level of guarantees that they are willing to extend, if they consider the country's long-term fundamentals remain to be basically sound. When matters are seen by private banks to improve and their willingness to lend increases, MDBs or ECAs could reduce their exposure. Alternatively, there could be special stand-alone guarantee mechanisms for trade and/or long-term credit—for example, within multilateral or regional development banks—which have a strong explicit counter-cyclical element. These mechanisms could be activated in periods of sharp decline in capital flows; their aim would be to try to catalyze private sector trade or provide long-term credits, especially for infrastructure.

93. Finally, a number of developing countries have encouraged development of domestic capital markets, particularly local currency bond markets. These markets in fact boomed after the Asian crisis, multiplying fivefold between 1997 and 2007 for the twenty large and medium-sized emerging economies for which the Bank of International Settlements provides regular information. This trend can be seen as a response of emerging economies to the volatility and pro-cyclical bias of international capital flows and the volatility of exchange rates. It can be viewed as a means of creating a more stable source of local currency funding for both the public and private sectors, thereby mitigating the funding difficulties created by sudden stops in cross-border capital flows, reducing dependence on bank credit as a source of funding and, above all, lowering the risk of currency mismatches. For foreign investors, it could actually be attractive to form diversified portfolios of emerging market local currency debt issued by sovereign governments or developing country corporations, with a return-to-risk that competes favorably with other major capital market security indices.

94. Further development of these markets is desirable. First, developing countries' bond markets are still largely dominated by relatively short-term issues and therefore tend to correct currency mismatches while increasing maturity mismatches. Second, it has proved to be much easier to develop large and deep local markets for public sector debt than for corporate debt. As a result, large corporations have continued to rely on external financing. To the extent that such external financing is shorter-term than what many developing countries' governments are able to get in global debt markets, the overall debt structure of these countries tends to become shorter-term and therefore riskier. Indeed, the rollover of

external corporate debt is viewed as the major problem facing many emerging economies today. Third, many of these markets are not very liquid. This problem has actually become more acute during the recent market downswing. Fourth, although local bond issues have attracted foreign investors, they were largely, or at least partly, lured by the generalized expectations of exchange rate appreciations that prevailed in many developing countries during the recent boom. As the world financial crisis hit, there were large outflows of such funds, and in this sense, reliance on these short-term portfolio flows did not correct but may have enhanced the pro-cyclicality of financing, much as short-term external bank debt did during previous crises.

95. Therefore, although the development of local bond markets has been a major advance in developing country financing since the Asian crisis, its promise remains partly unfulfilled in terms of risk mitigation. It is important for developing country governments, with support from international organizations, to correct some of the problems that have been evident and to continue investing in the development of deep and longer-term domestic bond markets.

Innovative Sources of Financing

90. For some time, the difficulty in meeting the official UN development assistance target of 0.7 per cent of GNI of industrial countries, as well as the need for adequate funding for the provision of global and regional public goods (peace building, fighting global health pandemics, combating climate change, and sustaining the global environment more generally) has generated proposals on how to guarantee a more reliable and stable source of financing for these objectives.

91. This debate has led to a heterogeneous family of initiatives. A distinguishing feature of developments in recent years is the fact that the old idea of innovative finance has lead to action, with the launching in Paris in 2006 of the "Leading Group on Solidarity Levies." The Leading Group now involves close to 60 countries and major international organizations.

92. Some of the initiatives proposed encompass "solidarity levies" or, more generally, taxation for global objectives. To avert their being perceived as encroachments on participating countries' fiscal sovereignty, it has been agreed that these taxes should be nationally imposed but internationally coordinated. Some countries have already decreed solidarity levies on airline tickets, but there is a larger set of proposals.

93. There have also been suggestions to auction global natural resources—such as ocean fishing rights and pollution emission permits—for global environmental programs.

94. Receipts from these innovative initiatives could be directed to support developing countries in meeting their development objectives, including their contribution to the supply of global public goods, as well as international organizations active in guaranteeing the provision of such goods. The existing taxes on airline tickets, for example, are being used to finance international programs to combat malaria, tuberculosis, and HIV/AIDS.

95. The proposal of taxes that could be earmarked for global objectives has a long history. While universal participation is not indispensable, it would serve the interest of development, as more resources would be raised. Some suggestions aim at both raising funds for global objectives and mitigating negative externalities at the global level. Two suggestions deserve special attention: a carbon tax and a levy on financial transactions.

96. Since carbon dioxide is the main contributor to global warming, a tax on its emission (or the auctioning of emission rights) can be defended on environmental efficiency grounds; it would simultaneously correct a negative externality and be a significant source of development financing. Revenues generated from the sale of emission rights in developed countries (or from the imposition of a tax in developed countries) would be transferred to developing countries, either for narrow purposes of climate change mitigation and adaptation (in fulfillment of obligations to which the developed countries have already agreed) or for broader purposes of development and poverty alleviation. The design of any tax/cap and trade system must, of course, take into account distributional impacts within countries and between countries. Some of the revenues generated would have to be devoted to ameliorating any adverse distributional impacts.

97. Similar mechanisms can be designed to pay for environmental services. Such schemes are already in operation locally in different areas of the world. They allow for consumers of a given public good to compensate for some of the costs borne by those producing or preserving it, and they provide incentives for the provision of the good. For instance, downstream users of water can pay those who manage the upstream forest to ensure a sustainable supply into the future. Similar instruments could pay for the provision of global environmental services, such as the conservation of rainforests. These forests play an important role both in protecting bio-diversity and in carbon sequestration. Payments to developing countries for providing these ecological services through maintaining their rainforests would provide incentives for them to continue to do so and, at the same time, provide substantial sums that could be used for development and poverty alleviation.

98. Taxes on pollution are an example of instruments that simultaneously raise revenue as they improve economic efficiency by correcting a negative externality. It is more efficient to tax bad things (like pollution) than good things (like work and savings). Earlier chapters have identified other negative externalities, especially those associated with excessively volatile cross-border, short-term capital flows ("hot money"). Concern about these destabilizing capital flows has led to proposals for a financial service transactions tax. Besides strong political opposition in some countries by a number of stakeholders, there are difficulties in implementation. How easy it would be to overcome these obstacles remains a subject of controversy. Some have suggested a more narrowly based tax, e.g. on trade in shares, bonds, and derivatives; because large stock exchange centers exhibit positive agglomeration externalities, a small tax imposed on transactions would not lead to a flight of trading to alternative, smaller exchanges. (A similar argument might apply to the over-the-counter trading in derivatives by large banks; again, because of the large advantages they have in lower counterparty risk, there would not be a flight to smaller institutions.)

99. Another set of proposals rely on the use of new financing mechanisms. One mechanism that already has a long history is swaps of debt for development objectives. It has been recently been used in the Debt2Health initiative launched in Berlin in 2007, which converts

portions of old debt claims on developing countries into new domestic resources for health. The International Finance Facility was proposed by the UK in 2003 to front load commitments for future flows of ODA, by issuing bonds backed by public or private sector donor pledges. The first of these mechanisms, the International Finance Facility for Immunization, is already in place. While these mechanisms may provide more funding in the short-run, they risk short changing the availability of funds at later dates. Such intertemporal transfers can only be justified if: (i) the interest rate in these facilities is lower than that at which governments can borrow; and (ii) the funds are invested in ways that generate more than offsetting returns.

100. Public-private sector partnerships can also be used to advance certain international objectives. Particularly noteworthy are some recent health initiatives involving large foundations, national governments, and international organizations.[9]

101. Developing countries have demonstrated that they have the capacity to use efficiently substantially greater resources than they currently have access to. At one time, it was thought that global financial markets would make the provision of funding unnecessary for all but the poorest countries. We now realize that that is not the case. Funding goes to relatively few countries and relatively few sectors and is highly cyclical. The current crisis has highlighted the need for substantially more resources, especially in a time of crisis. Further exploration of innovative mechanisms for finance is clearly needed. Annual emissions of the Global Reserve Facility discussed in the first section of this Chapter may be one possible source of substantial and stable funding.

[9] There has also been experimentation with new mechanisms for financing and incentivizing research. An example is the Advanced Market Commitments through which government donors commit funds to guarantee the prices of vaccines once they have been developed, provided they meet a number of criteria on effectiveness, cost, and availability. This helps encourage pharmaceutical firms to focus on research into neglected diseases which mainly affect poor countries. These mechanisms may, however, be inferior to other ways of funding and motivating research because they typically rely on the patent system, so that those who purchase the vaccine without assistance have to pay a price far in excess of the marginal cost. These problems are addressed by alternative financing/incentive schemes, such as prize funds.

CHAPTER 6:
CONCLUDING COMMENTS

1. This is the most significant global crisis in eighty years. The crisis is not just a once in a century accident, something that just happened to the economy, something that could not be anticipated, less alone avoided. We believe that, to the contrary, the crisis is man-made: it was the result of mistakes by the private sector and misguided and failed policies of the public.

What Went Wrong: A Recap of Failed Policies and Philosophies

2. This Report is premised on the belief that if we are to respond adequately to the crisis—both if we are to have a robust recovery and if we are to prevent a recurrence—we must have an adequate diagnosis of the crisis. Both policies and economic theories played a role. Flawed policies helped create the crisis and helped accelerate the contagion of the crisis from the country of its origin around the world.

3. But underlying many of these mistakes, in both the public and private sectors, were the economic philosophies that have prevailed for the past quarter century (sometimes referred to as neoliberalism or market fundamentalism). These flawed theories distorted decisions in both the private and public sector, leading to the policies that contributed so much to the crisis and to the notion, for instance, that markets are self-correcting and that regulation is accordingly unnecessary. These theories also contributed to flawed policies on the part of Central Banks.

4. Flawed institutions and institutional arrangements at both the national and international level also contributed to the crisis. Deficiencies in international institutions, their governance, and the economic philosophies and models on which they relied contributed to their failure to prevent the crisis from erupting, to detect the problems which gave rise to the crisis and issue adequate early warning, and to deal adequately with the crisis once it could no longer be ignored. Indeed, some of the policies that they pushed played a role both in the creation of the crisis and its rapid spread around the world. All of this facilitated the export of toxic products, flawed regulatory philosophies, and deficient institutional practices from countries claiming to be exemplars for others to follow.

5. The debate about appropriate institutional practices and arrangements and the economic, political, and social theories on which they rest will continue for years. The ideas and ideologies underlying key aspects of what have variously been called neo-liberalism, market fundamentalism, or Washington Consensus doctrines have been found wanting. Other ideas, which might have been more helpful in avoiding the crisis and mitigating its extent, were overlooked.

6. The last quarter of a century has had some notable successes, not the least of which has been the rapid growth in Asia which has lifted hundreds of millions of out of poverty and brought many benefits, including extended life spans, higher literacy, and improved health. But while some countries have done well, others have not. International financial and

economic arrangements have in many cases worked to the disadvantage of developing countries. The global arrangements that have facilitated rapid growth in many parts of the world have not come without a cost: growing inequality in many countries and, in some cases, excessively rapid depletion of natural resources and degradation of the environment.

7. The last quarter century has also been marked by high levels of instability. In the past, the successes in preventing crises originating in developing countries from becoming global have come at a great cost, with many facing unnecessarily severe recessions and even depressions and with the assistance sometimes being accompanied by a loss of national sovereignty in matters of vital importance to a country's citizens. This, the Great Recession of 2008, is only the worst of the frequent crises that have plagued the world, but there was a complete failure in preventing this crisis that originated in the developed countries from bringing down with it even those developing countries that had put into place sound macro-economic and regulatory policies. While globalization offered the promise of greater economic stability, it has instead led to greater instability.

What Has Been Done

8. The international community has responded to the crisis in an unprecedented way. The massive stimulus and rescue packages adopted by most governments have brought the world back from the precipice of a global depression. By and large, government expenditure policies to support economic activity have worked as predicted. In most countries these expenditures have been on productive investments so that new assets corresponding to the new liabilities have been created. Particularly commendable are the many stimulus packages that have included a "green" component, which addresses the major long term environmental problems facing the planet at the same time that the spending enhances the strength of the global economy in the short run.

9. The substitution of the G-20 for the G-8 as the major forum for global discussions is to be welcomed, as it allows greater participation and includes some emerging markets. Yet the majority of the countries of the globe, whose voices need to be heard, are still excluded. There is particular concern about political legitimacy of discussion that excludes the voices of the least developed countries. The Commission recognized the importance of combining effectiveness (which may be enhanced by the relatively small size of the deliberative group) with political legitimacy, and a key proposal presented has suggested how this might be done. It is essential for the success of any proposals for reform of the international trade and financial system that these concerns be addressed.

10. Also welcome are commitments to reform the international financial institutions. The agreement that the heads of the institutions would be chosen on the basis of merit is long overdue. Reforms in governance are essential if these institutions are to fulfil their mandates. Chapter 4 has provided an explanation of why the proposed reforms are not likely to go far enough and what additional reforms are desirable.

11. It now seems to have been recognized (even by those who pushed for deregulation) that there is a need for more, or at least better, regulation and enforcement, especially in the arenas of finance. But, as noted in Chapter 3, the task ahead is large, and it is not clear that there is yet an adequate understanding of the dimensions of the required action. The Commission, for instance, focused attention on the ways in which capital market and financial market liberalization and deregulation may have contributed not only to the creation of the crisis but also to its rapid spread around the world. Reforms must, moreover, go beyond finance, for instance, to laws and regulation affecting corporate governance,

competition, and bankruptcy. Because the devil is often in the details, announcements of agreement on certain principles may not suffice.

12. While the numerous instances of protectionist actions which have been taken around the world, including by governments who had committed themselves not to doing so, have been a setback, matters might have been far worse without those commitments and an international framework designed to prevent such policies.

What is to be Done

13. It is essential that, as the international community works for a robust and sustainable recovery and for reforms that ensure long term, democratic, equitable, stable, and sustainable growth, it do so with a broader respect for a wide range of ideas and perspectives. At the very least, we need to be more modest about our confidence in particular economic theories, and our policies have to be robust enough not only to withstand shocks to the economy but also to hold us in good stead if some of the premises of our theories turn out to be wrong.

14. It is also imperative that policies be framed within a set of goals that are commensurate with a broad view of social justice and social solidarity, paying particular attention to the well-being of the developing countries and the limits imposed by the environment. It would be wrong and irresponsible to only seek quick fixes for this current crisis and ignore the very real problems facing the global economy and society, including the climate crisis, the energy crisis, the growth in inequality in most countries around the world, the persistence of poverty in many places, and the deficiencies in governance and accountability, especially within international organizations. To many, the crisis is but one symptom of a deeply dysfunctional set of global arrangements. Our Report approaches the current crisis from these broader perspectives.

15. We believe that a comprehensive agenda is required to attack the problems we have identified and to achieve the goals we should be seeking. This Report has focused on some of the Key Reforms in both national and international policies, regulations, and institutions. This is a macro-economic crisis, caused in part by micro-economic failures, bringing home the intertwining of these often disparate aspects of economic analysis and policy. Some analyses have focused on one, others on the other. We believe that these problems have to be approached from a coherent framework, and in this Report we have attempted to do just that.

Some Common Themes

16. There are several common themes that run through the analysis. One is that the growing inequalities in most countries around the world are not only socially unjust but have also contributed to the problem of potentially weak effective demand.

17. Another is that the crisis has to be seen as a *global* crisis. Accordingly, the responses have to be framed from a global perspective. The imbalances that marked the global economy in the years preceding the crisis were not sustainable; poorly designed responses, however, could exacerbate these imbalances. The high level of global volatility, combined with inadequate international arrangements enabling developing countries especially to manage this risk, has prompted many of the latter, at least those which had the means to follow an

export-led strategy and to create their own self-insurance. This is one of several motivations which have led to the buildup of high levels of reserves, which also contributes to the global demand deficiency.

18. A third theme of the analysis is that there are large global asymmetries, illustrated by the differences in responses imposed on the East Asian countries at the time of the last crisis and the policies pursued by developed countries in response to this crisis, which is a disadvantage of developing countries. These asymmetric responses may contribute to greater volatility in developing countries and thereby to a higher cost of capital, with adverse effects on growth and poverty. The problems are compounded by the fact that the poor countries have almost no say in the design of the rules of the game. Even allegedly symmetric rules, because they are applied in such a heterogeneous world, have strong asymmetric effects. Government guarantees to financial institutions by some of the advanced industrial countries contributed to the ironic situation of capital moving from the developing countries to those countries whose failed policies had caused the global conflagration.

19. A fourth is that the financial sector has systematically failed to perform its key roles of allocating capital and managing risk, all at low transactions costs. Governments, deluded by market fundamentalism, forgot the lessons of both economic theory and historical experience which note that if the financial sector is to perform its critical role, there must be adequate regulation.

20. A fifth is that economic globalization has outpaced the development of the political institutions required to manage it well. Economic integration implies increased economic interdependence, and that implies a greater need for global collective action, as illustrated by recent events. While this is a global crisis, policy responses are framed at the national level. The host of areas in which national governments have had to take action—from bankruptcy to competition policy to financial market regulation—now have to be addressed at the international level. Current institutional arrangements are not up to the task. They will either have to be reformed, or new institutions will have to be created. A strong, independent, and politically neutral body offering advice to relevant international institutions to improve their ability to shape economic policies in a sustainable and globally responsible way is necessary. In one way or the other, if our global economy is going to work for the benefit of the majority of the citizens of the world—and if it is to exhibit greater stability than it has in recent decades—something will have to be done. We cannot continue to let these problems fester.

21. A sixth and crucial theme, to which we have already referred, is the pervasiveness of externalities, one of several market failures that help explain why markets on their own are not necessarily either stable or efficient. These externalities are pervasive within countries and across borders. The failure of one financial institution contributed to weaknesses in others; the failure of the financial system to perform its core functions has imposed huge costs on society—on the economy, on taxpayers, on homeowners, on workers, on retirees, on virtually everyone—and the world will be paying the bill for their mistakes for years to come. Mistakes in one country have imposed huge costs on other countries; in this case, the mistakes of a few developed countries have imposed large costs on many developing countries. Well-functioning globalization might have protected them; well-functioning

financial markets might have shifted these risks from those less able to bear them to those who were more able. Neither globalization nor financial markets performed well.

22. The response to the crisis must recognize these externalities. Regulations in one country can have impacts on others. At a minimum there needs to be coordination of global financial regulation. While this crisis has become global, the responses to the crisis are designed at the national level, with a minimum of coordination between nations and with each country doing whatever it can to protect its own economy. The developing countries—including many that managed their monetary, fiscal, and regulatory powers far better than those in the advanced industrial countries from which the crisis emanated—have been put in a particularly disadvantageous position, as the problems of unfair competition, that they simply can't match the subsidies and guarantees of the wealthy countries, are compounded with a lack of resources to conduct countercyclical fiscal policies.

23. A seventh theme concerns *innovation*. Financial markets prided themselves on their innovativeness. Yet they failed to innovate in ways that led either to more sustained growth or greater stability, that enabled ordinary citizens to manage better the risks which they faced, and that enabled risks to be effectively shifted from those who are less able to bear them to those who are more able. Indeed, some of the innovations may have contributed to the problems: they enhanced problems of information asymmetries, and the increased complexities made assessments of risk harder and therefore the management of risk more difficult. Some of the innovations were directed at circumventing accounting and financial regulations that were designed to ensure the efficiency and stability of the financial system. The notion sometimes put forward that more regulation may stifle innovation may be false: better regulation may direct entrepreneurial talents to innovations that enhance societal well-being. We believe that modern technologies combined with advances in the understanding of economic processes have enhanced the scope for such innovations, and we have devoted considerable efforts at identifying some of the institutional innovations that might contribute to improvements in the well-being of ordinary citizens and to the functioning of the global economic system.

24. While discussions of the failures of markets have focused on the financial sector, it should be clear that some of the key problems are more pervasive. Flawed incentive structures that led to excessive risk taking and shortsighted behavior were, in part at least, a result of problems in corporate governance, which are manifest elsewhere. The problems of too-big-to-fail, too-big-to-be-resolved banks (discussed in Chapter 3) are a reflection of inadequate competition laws and/or deficiencies in enforcement.

25. A final theme is that in responding to the exigencies of the moment, we must take care not to worsen the underlying problems. This crisis should be seen as an opportunity to engage in necessary reforms. Historically, moments of crises often provide a rare chance for fundamental reforms that would otherwise be impossible. But there is also a danger: existing power structures can seize hold of these moments of crisis and use them for their own benefit, reinforcing inequalities and inequities. There may be a greater concentration of economic and political power after the crisis than before. This has happened in the past and seems to be happening in this crisis in certain countries, as the share of the too-big-to-fail banks has increased even further.

Some Key Recommendations

26. This crisis poses a deep question: can we have the benefits of globalization without bearing all of its most adverse costs? Can we manage the global economy in ways that

enhance the well-being of most citizens around the world? We believe we can. We can at least manage the world economy much better than we have. This Report presents a large number of recommendations that suggest how this can be done, focusing, in particular, on how we can reduce the risk of the kind of crisis that the world has just experienced and how we can respond to the crisis in ways that especially help the poorest countries.

27. We have proposed short-term remedies—measures that can and should be taken up immediately—as well as longer-term actions, which may take months, even years, of debate. In some areas, such as the reform of financial regulations, we have provided rather specific recommendations (e.g. on the treatment of derivatives or the too-big-to-fail banks). In other cases, we have laid out a menu of options: we believe that a new global reserve system is absolutely essential, but there are many alternative designs, some of which would provide better macro-economic stability and some of which might enable the international community to address a number of other social and economic objectives. It should also be clear from what we have already said in these concluding remarks that we believe it is absolutely essential to create better institutional arrangements for coordinating global economic policy—for instance, along the lines of the Global Economic Coordination Council and International Panel of Experts discussed in Chapter 4.

28. The international community has recognized that it is both a matter of fairness and a matter of self-interest that something be done to help the developing countries. This Report has urged that more needs to be done. Too large of a fraction of the funds being provided are short term loans; there is at least some risk that the effects of the crisis may be felt for a considerable period of time. It would not be in anyone's interest for there to be another debt crisis. We have emphasized that the funds that are provided must not be accompanied by the counterproductive pro-cyclical conditions that were often imposed in the past. While we have argued for a diversity of arrangements for the disbursement of funds and for critical reforms in existing institutional arrangements, we have also suggested that there is a need for a New Credit Facility, with a governance structure more in accord with the times and more responsive to both those providing the funds and the borrowers, thereby engendering greater confidence from both.

29. If this crisis has taught us nothing else, it has reminded us of the magnitudes of the risks confronting all economies, even those that are well-managed. We need to admit that our systems of risk management, including the sharing and transferring of risk from those less able to bear them to those more able to do so leave much to be desired. Our systems of resolving cross-border defaults, including restructuring sovereigns faced with the threat of default, are not what they should be to deal with twenty-first century globalization, nor are the institutional arrangements for handling cross-border commercial disputes or ensuring effective global competition. In some of these arenas, we have provided concrete suggestions on the way forward; in others, we have simply flagged the issue, hoping that others will follow up and develop alternative approaches.

30. The Commission has emphasized that, even after fixing the financial system, the problem of insufficiency of aggregate demand is likely to persist, making it imperative to begin work on some of the more fundamental reforms, such as in the global reserve system. These persistent problems also make the design of the "exit strategy" from existing stimulus policies of particular importance. Premature or unbalanced withdrawal of stimulus spending or government guarantees could impair a smooth recovery and exacerbate global imbalances.

31. The Commission drew its members from a diverse set of countries, backgrounds, and perspectives. The long hours of discussions and debates, extending over more than half a year, with meetings in New York, Geneva, Kuala Lumpur, Berlin, and The Hague, helped develop an understanding of the perspectives of each of the members and an appreciation of their viewpoints. This Report reflects the consensus among the members of the Commission that emerged out of these long deliberations.

32. In the course of our deliberations, we issued a Preliminary Report (in February 2009) and an Interim Report (in May 2009). We have been pleased with the reception that these reports received. We have incorporated many of the helpful comments and suggestions we have received.

33. As we note in Chapter 1, our Commission is but one of several efforts to address the challenges posed by this crisis. Readers of this Report will notice a considerable overlap between what we have said, and, say, the Communiqués of the G-20, but they should also note the important differences. Whether one agrees with the conclusions of the Commission, we believe that the issues that we have raised have not been adequately dealt with to date and cannot be ignored. Nationally and internationally, they must be addressed. These include, for instance, the deficiencies in the existing global reserve system and the development of too-big-to-fail and too-big-to-financially resolved financial institutions. Policies of financial and capital market liberalization need to be looked at from new perspectives. Bank secrecy not only is a problem for tax compliance but also poses a problem for developing countries fighting corruption, and the problems occur sometimes in major money centers and not just off-shore. Most importantly, if we are to make globalization work, we will need to have better—more democratic, with a greater voice for developing countries—institutional arrangements for managing it.

34. This crisis is complex and multi-faceted, as have been the issues that we have attempted to address. We cannot hope, in a short Report like this, to resolve all the issues that are in dispute. Our ambition is more modest: to convince the international community that there is room for improvement—substantial scope for improving the efficiency and stability of the world economy, especially in ways that promote the well-being of all, especially the less developed countries and the poorest people in all the countries. They have been among the innocent victims of this crisis.

35. If we are to live together in peace and security on this planet, there must be a modicum of social justice and solidarity among the citizens of the world. We must be able to work together to protect the world from the ravages of climate change, to help each other in times of global crisis such as that confronting the world today, and to promote economic growth and stability in the long run.

36. The UN is the one inclusive international organization with the political legitimacy and the broad mandate to address all of these issues and to take into account, in a comprehensive way, all the relevant dimensions of the policies designed to address these global economic, social, and environmental challenges. The UN and the various institutions that constitute the UN family were borne of previous crises—World War II and the Great

Depression. This global crisis provides an occasion to strengthen the UN and its role in global economic governance. That is why the members of the Commission welcomed this initiative of the President of the General Assembly. The work of the Commission has reflected the broad concerns and mandates of the United Nations but with a particular focus on the impact of the crisis and of the policies designed to respond to the crisis and prevent a recurrence on the less developed countries and emerging markets and on the poor in all countries.

37. This Report provides an outline of some of the reforms that we believe will help us move in the right direction. If it widens the space for more open debate on these issues of such vital importance to all of us, it will have fulfilled its missions, and all of our hard work will have been for good purpose.