

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 societies. 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.