

# **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 contribute 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 of 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.