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
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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.

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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.

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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.

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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.

[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.

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 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

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.

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.