BROOKINGS

QUALITY. INDEPENDENCE. IMPACT.

To: President-elect Obama

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Subject: Restore Global Financial Stability

The Situation

With financial systems around the world ravaged by the global economic crisis, economic aftershocks are likely to reverberate through the end of, and perhaps beyond, 2009. Even though the crisis originated in the United States, the world is greeting your presidency with an outpouring of goodwill and hope. While grappling with enormous challenges in getting our own economy back on its feet and fixing our financial system, your administration has a singular international opportunity: *America can reclaim its leadership role in the world economy—it must lead by example and embrace multilateralism*.

Unilateralism is no longer a viable strategy. The world has become so interconnected—through flows of goods, capital and people—that every major country's economic policies have worldwide effects. Many countries, especially the industrial ones, are challenged to repair their financial systems and make them more resilient. They must rethink many aspects of financial market regulation, both national and international. For emerging-market countries, the challenge is to rethink the financial development pattern and take the right lessons from the crisis.

In the short term, many countries need to rework macroeconomic policies to forestall a long and deep recession. They also face medium-term challenges, especially bringing public finances under control to deal with aging populations and other problems.

Greater cooperation among the world's major economies would be hugely beneficial in meeting all these challenges. A cooperative approach can actually enhance America's leadership role. While the United States needs to put its own economic house in order first, the global repercussions of domestic macroeconomic and financial policies also must be kept in mind.

You can set the tone early on in three ways:

- Take forceful actions to get the U.S. economy restarted, but in a disciplined and well thought-out fashion that jump-starts the economy now, but then tackles long-term challenges and global macroeconomic imbalances.
- Develop an approach to fixing the broken financial system that is driven by facts and careful analysis rather than ideology. This means taking the lead on keeping world trade and financial markets operating smoothly.
- Approach global economic issues and catalyze reforms of international financial institutions in a genuine spirit of multilateralism.

Your Stance

On issues of the economy and globalization, your campaign focused correctly on the needs and concerns of American workers. You advocated fair trade with foreign nations in order to strengthen the U.S. economy and create more American jobs. That was the right choice. But, as president, you will need to address the nation's economy as part of an interconnected, global set of issues.

You also advocated diplomatic action and multilateral engagement to address other pressing problems across the globe—in Asia, Africa and Latin America, as well as Europe and the Middle East. Your campaign positions establish a solid platform for effective multilateralism on economic issues as well.

Further Recommendations

National and International Financial Regulation: The crucial set of first steps consists of reforming the regulatory structure in the United States, increasing transparency and moving managerial incentives away from excessive risk-taking. Rather than rushing precipitously toward more regulation, your administration should carefully strive to strike the right balance between making government regulation more effective and improving private monitoring.

Redesign of financial regulation must respond to the reality that financial institutions now have global reach. The concept of financial regulation at a supra-national level has some merits, but it is still unclear whether any international agency can effectively coordinate cross-border regulation, especially among countries with different levels of financial development and regulatory capacity.

At any rate, it is important as a minimum to use the Bank for International Settlements (BIS) and International Monetary Fund (IMF) as forums where best practices are evaluated and disseminated. The United States should push for broadening the membership of the Financial Stability Forum to include the major emerging market economies, as proposed in the recent G-20 Communiqué.

For many emerging markets, the reform agenda includes strengthening domestic banking systems, developing “plain-vanilla” derivatives (such as currency derivatives), increasing access to the formal financial system and building up regulatory capacity. Your administration could earn much international goodwill by providing guidance and technical assistance to middle- and low-income economies on these basic aspects of financial development, rather than single-mindedly pushing for greater capital account liberalization or greater access for U.S. financial firms.

Trade: This is a perilous time for free trade, as countries focus on strengthening their own economies; already trade protectionism is rising in various guises. Indeed, actions taken by our government to prop up some U.S. industries, such as the auto industry, appear to the rest of the world as protectionist. Your administration will need a strategy to extricate government from direct involvement in these industries once the economy and financial markets settle down.

You then should take bold steps to reinvigorate trade discussions—by tackling the seemingly intractable problem of agricultural subsidies, for instance. Unilateral actions may benefit the United States itself and help bring other countries to the table to restart trade talks.

Your administration will need to make a strong argument against efforts to block foreign investments in U.S. companies without good cause. National security is a valid concern but, all too often, merely a figleaf for financial protectionism. Such efforts have created animosity among countries that wished to invest in the United States and simultaneously faced U.S. demands to open up their own markets.

Strategic Economic Dialogue (SED) with China: Relations with China should develop into a genuine partnership. The relationship can be made more productive by using the SED as a forum to address common challenges. Do not focus on the exchange rate between the U.S. dollar and the Chinese renminbi or the U.S.-China bilateral trade imbalance. Rather, use the dialogue to persuade Chinese officials that a flexible exchange rate would help make progress on their own key priorities: independent monetary policy, financial sector reforms and economic growth that is more balanced and less reliant on high levels of investment and exports.

Similar dialogues with other pivotal countries can set a tone of constructive bilateral engagement. Indeed, countries like India would welcome deeper engagement so long as the United States undertakes dialogue in a collaborative spirit rather than by presenting a list of economic demands on economic issues.

Macroeconomic Policies for the Present and Future: Creative monetary and fiscal policies are essential now to pull the economy back from the brink. The priorities you have articulated in recent speeches—increasing expenditures on infrastructure and education and revamping the health care system—will indeed improve the economy's long-term productive potential as well. Nevertheless, the piper will someday have to be paid—government finances will have to be repaired to bring down the budget deficit and public debt. Large public deficits have kept the national savings rate very low in recent years, fueling large current account deficits.

Global macroeconomic imbalances—large current account deficits in many industrial countries, notably the United States, and corresponding surpluses in many emerging markets, notably China—were not the root cause of the financial crisis but certainly added tinder to the flames. Once the U.S. economy has begun to recover, you will need to take steps to bring government finances into balance over the medium term (as others have noted the plan matters more than a precise target date).

Reform of IMF Governance: The global economy needs a credible multilateral institution to serve as an impartial referee. The IMF is capable of providing independent critical advice on countries' macroeconomic policies and their financial systems. Along with the BIS, it can facilitate the more efficient functioning of international financial markets. However, the IMF has been weakened by the perception that it largely follows the bidding of the United States and other advanced economies, denying the emerging markets the voice they deserve.

To strengthen the IMF's credibility as an impartial monitor, the United States should use it to evaluate its own financial and macroeconomic policies. Your administration should also push for reforms to increase the voting shares of large emerging markets and increase the IMF's capital base, (perhaps through additional contributions from countries with large stocks of foreign exchange reserves, in exchange for giving them more voting rights).

Conclusion

The process by which you generate and implement ideas and policies to deal with the unprecedented economic challenges of our times will determine not just America's economic future, but also the future of the global economic, trading and financial systems. On all these fronts, America is capable of regaining its moral authority and the goodwill of the international community—if its president acts as a statesman for the world.