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FOR ECONOMIC RECOVERY &
FINANCIAL RECONSTRUCTION

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PROLOGUE

The global economic crisis is rapidly worsening. Meanwhile the incoming Obama administration is intensively developing plans to ward off economic catastrophe. In this atmosphere of hope laced with tremendous uncertainty, a group of progressive economists met on November 21, 2008 at the New School for Social Research in New York for a discussion, sponsored by the Political Economy Research Institute (PERI) of the University of Massachusetts, Amherst and the New School's Schwartz Center for Economic Policy Analysis (SCEPA), with financial support from the Ford Foundation. The goal of the meeting was to discuss macroeconomic and financial policies for economic revival that can solve the short-term crisis we face and help put the economy on an environmentally sustainable path of widely shared prosperity. From that meeting evolved a statement of principles signed by many of the participants (www.peri.umass.edu or www.newschool.edu/cepa/), as well as the more detailed program presented here.

INTRODUCTION

BACKGROUND

Not since the Great Depression has the world faced an economic crisis as it does today, with enormous attendant loss in human progress and a serious threat of global instability. An interlocking set of downward pressures starting from the financial markets and extending into the real economy is unraveling economic stabilizers and institutions. This unraveling is especially cataclysmic because it follows a decades-long period of stagnating real wages, increasing inequality, disappearing decent jobs, deteriorating security for households and families in the U.S. and recurring financial crises around the globe.

Swift and coordinated action by the Obama administration, other national governments and international financial institutions can stave off these crises if the action is boldly directed at serving the needs of people and communities, rather than protecting the failed institutions and past practices that helped create the crisis.

So far, the Bush Administration, the Federal Reserve and Congress have spent or committed several trillion dollars to protect bank and credit solvency, with the expectation that these funds would trickle down to the rest of the economy. This has failed to stop the downward spiral, as major financial institutions have hoarded much of the cash and used the funds to continue their decades-long policies of taking over other banks and paying lavish salaries. Moreover, it has not stopped the rapid decline of businesses, households, and state and local governments which is leading to a worldwide spread of contractionary pressures that threaten catastrophe.

The Obama administration has signaled a desire to take swift action, and to do “whatever it takes” to restore economic health. We support many of these policies. But to succeed, Obama’s program must promote a fundamental reversal of direction. It must reject the extreme ‘free market’ and ‘neoliberal’ policies followed by governments in the U.S. and many other countries in recent decades, policies that contributed to the economic crisis we now face. Markets, including financial markets, must be properly embedded in and managed by governments and other social institutions for them to work efficiently and serve the needs of society. Economic policies should aim to promote green growth, while reversing the stagnating wages, extreme inequality, growing insecurity, and lax regulatory conditions that have led to debt-driven spending booms. Only then will the U.S. achieve sustainable and widely-shared growth.

This means restructuring the financial system to serve the needs of ordinary people and families—workers, taxpayers and homeowners. As for the future financial landscape, we call for resisting efforts to ‘hit the restart button’ and restore the economic trajectory we were on before the crisis hit. Instead, regulation of the financial system should aim to create a sustainable economy and to finance productive investment and innovation.

To promote these policies, we present this *Progressive Program for Economic Recovery and Financial Reconstruction*, an interlocking set of initiatives that include: 1) a massive fiscal expansion program to

promote economic recovery; 2) economic policies to restore the societal balance of power and health to labor, communities and families while making the transition to a greener economy; 3) policies to reconstruct, regulate and manage financial institutions so they will serve the needs of people and contribute to financial stability; and 4) principles for international cooperation and coordination to help the world economy recover and make a transition to fairer and more balanced global growth.

We reject the notion that President-elect Obama and his administration should put plans to reform health insurance, reduce U.S. dependence on fossil fuels, raise the minimum wage and facilitate the ability of workers to organize into unions on hold. Embedding these longer-term goals into policies for short-term economic recovery will not only make it more likely that the longer-run goals will succeed, but will also greatly enhance the effectiveness short-term recovery efforts.

Raising the minimum wage allows more households to spend on goods without going into more debt, and investments in clean-energy technologies have greater employment impacts than other types of macroeconomic policies, such as tax cuts. Dramatically reducing health care costs will substantially reduce poverty and create a healthier workforce. It will also help make U.S. car companies and other American businesses more competitive and allow them to weather the current storms and achieve competitiveness over the longer term.

Delaying a much-needed economic transformation would make the recovery program less effective, and it would undermine the possibilities for required transformations themselves. The costs of the economic recovery program will be large. Eventually, the government may need to moderate its spending on these programs relative to the size of the economy. If the initial money has not been spent on green investments, creating decent jobs that pay family-supporting wages and provide workers with paid time off to care for their families, providing a social safety net for children and families, and investing in needed infrastructure, then budget demands might mean that the money will never be so spent. For these reasons, it is necessary that the key investments and institutional changes be part of the recovery and reconstruction program from its inception.

This program is based on well established economic principles forged by political economists like John Maynard Keynes in the crucible of the Great Depression of the 1930s and developed by numerous economists, including many of us, since that time. These principles are a far more reliable guide to solutions for the current crisis than the extreme 'free market' and 'neoliberal' policies followed by governments in the U.S. and in many other places in recent decades, policies that contributed to the economic crisis we now face. These more reliable principles include the following:

- Capitalism, left to its own devices, is unstable and needs proper regulation and automatic stabilizers to avoid major destructive economic episodes.
- Markets, including financial markets, must be properly embedded in and managed by governments and other social institutions for them to work efficiently and serve the needs of society.
- Government is needed to provide leadership in economic areas that have major spillover effects and where markets are therefore likely to fail, such as health care, climate change, and public investment in basic infrastructure.

- Families need financial support to help them provide their crucial care giving services. It is grossly unfair and ultimately self defeating for government to continue to function as a mechanism for socializing costs and risks for the financial sector, while ignoring the needs of workers, families and productive industries which provide good jobs with good wages and benefits.
- Workers need a legal infrastructure such as the Employee Free Choice Act that allows them to fight for and win their basic rights. The achievement of these rights will promote better political governance and a healthier economy overall, and will better enable workers to achieve healthy living standards that will trickle up through the economy.

These principles inform the policies we outline below. Of course, this short document does not attempt to develop a comprehensive program of economic recovery and reconstruction; it focuses primarily on macroeconomic and financial issues. Nor, in such a short space, can this statement outline comprehensive and detailed solutions to even this set of issues. For further information, please consult the list at the end of this document for readings that provide more detail on many of the ideas presented here.

PRINCIPLES AND GOALS OF A PROGRAM FOR ECONOMIC RECOVERY AND FINANCIAL RECONSTRUCTION

Our program consists of principles and policies to:

- Revive the economy by instituting a massive public investment and financial support program focusing on jobs, housing, state and local services, green investments, and infrastructure investments, supported by expansionary monetary policy.
- Reform the financial sector bailouts to be fairer, less costly and more effective, by broadening and strengthening the oversight of financial institutions and using government leverage to realize significant changes in how these financial institutions operate.
- Reverse extreme inequality and increase the prosperity and power of families and communities.
- Re-regulate and restructure the financial sector.
- Reform international economic governance to make the transition to a more balanced, prosperous and just global economy appropriate to changing global realities.

We aim to:

- End the downward global economic spiral and promote economic recovery through a massive and well-targeted spending program at home.
- Promote coordinated global expansion and aid for the poor abroad.
- Keep people in their homes by establishing a moratorium on foreclosures, creating new financing mechanisms for mortgages, and increasing opportunities for renting.
- Provide jobs at decent wages for all who need them through public investment, fiscal expansion and employer of last resort programs.

- Provide financing to state and local governments so they can maintain employment and continue to provide the basic services central to the well being of families, such as education, police and fire protection, and the maintenance of local infrastructure.
- Make available affordable, universal health insurance coverage, to help families prosper and businesses restore competitiveness.
- Provide a basic standard of living for all.
- Promote the transition to a green economy through a series of public investments, tax credits, and loan guarantee programs.
- Create a stable and efficient financial system that provides for the needs of people, communities and businesses, rather than serving as a safe harbor for gambling, fraud and abuse that enriches a few while destroying the economy.
- Restore income, economic power and security to the vast majority of people (the bottom 80%) who have fared so poorly under decades of unjust and inefficient economic practices and policies by supporting workers' rights to unionize.
- Rebuild the nation's infrastructure through a massive public investment program.
- Promote economic cooperation and aid to poor countries which will suffer most from this crisis and where prosperity can help restore long-run health to the global economy.

OUTLINE OF STATEMENT

We first outline a program for economic recovery that helps in the very short term to promote economic recovery but also contains elements that will work only in the medium and longer term. Most of the focus of this recovery plan is on the U.S. economy, but we also note the need for global economic coordination. The next section discusses monetary and financial policies and regulations, again discussing both short-term issues as well as longer-run questions of monetary and financial reform. The fourth section focuses on the international dimensions of economic recovery and financial reconstruction, and the last section presents a proposal for Congressional hearings and our conclusions.

IMMEDIATE RESPONSES TO REVIVE THE ECONOMY

INTRODUCTION

As the Obama economic team and most economists now recognize, an immediate and massive economic recovery program is needed to break the downward economic spiral we are in. It must be large, targeted and serve the real needs of people in both the short run and longer run. This program has to be primarily a fiscal stimulus, and must work primarily through spending initiatives and financial guarantees. The main macroeconomic role for Federal Reserve monetary policy must be to support this fiscal package.

The package should be designed to work quickly, save and create the maximum number of jobs in the most efficient way, provide incomes and aid to those who are most vulnerable, maintain important services for families and communities, and facilitate the longer-term goals of making the transition to a greener economy, providing health care for all, and repairing the nation's infrastructure.

The size of the stimulus package

Views about the necessary size of the economic stimulus package have diverged dramatically in recent months, and no one knows the size that will be needed to promote recovery. The Obama team has suggested spending \$600 – \$800 billion over two years, but these numbers are in flux. The forces of recession are deepening and raising the likely size necessary to break the downward spiral. According to the *Flow of Funds Accounts* released in December 2008, household net worth – the difference between the value of assets and liabilities – fell by \$2.8 trillion dollars between July and October 2008. This represented a loss of almost 5% of household net worth in just three months. Taking a slightly longer perspective, over the last twelve months, household net worth has fallen by \$7 trillion dollars. Down drafts have also come from the seizing up of the financial sector: bank lending for mortgages has collapsed, and terms have tightened significantly for loans to consumers and small businesses. State and local governments face a \$100 to \$200 billion dollar shortfall over the coming year, according to the Rockefeller Institute of Government. The global reach of the recession is also significantly reducing export demand. This accumulating set of downward pressures suggests that the (positive) multipliers associated with increased spending are almost certainly lower than in more normal periods. Hence, the stimulus package may need to be significantly larger than many would have believed even several months ago.

In such an environment, a number such as \$600 billion dollars per year does not seem unrealistic. But given the uncertainty, we will not promote a particular number but rather describe some necessary actions and suggest some numbers that might be needed. Indeed, one of the principles of a spending package is that it must be structured so that it starts with a large number, and then has automatic or semi-automatic mechanisms to increase or decrease it as needed. Thus, increasing automatic stabilizers, such as unemployment insurance, welfare spending, Social Security and grants to state and local governments must be a significant part of the package in order to defeat this economic crisis.

We are aware that the government does not have an infinite capacity to borrow, so that considerations of a safe level of deficit spending cannot be ignored. Still, in the current circumstances, that capacity is large, and measures can be undertaken to enhance that capacity. These include appropriate Federal Reserve monetary policy and wise management of the Federal debt, such as the possible creation of new securities with which to borrow. In the current period, the U.S. government can borrow for five years for less than 1.5% and for ten years for less than 2.2%. At these rates, a major increase in debt financing, of the level suggested here, is manageable. Below we discuss global reforms necessary for a more balanced fiscal policy in the longer term.

Elements of the recovery program

Timing issues are crucial in the development of the recovery program. Some elements of the program described below, such as automatic stabilizers like grants for state and local governments, can work immediately to keep people in their jobs and increase incomes and spending. Other proposals, such as major increases in public investment, may take longer to work. So attention to the timing of these spending programs is crucial to ensure that enough of the spending is front loaded to break the downward spiral, preserve existing jobs and create new ones.

1. Keep state and local services flowing and state and local workers employed

The Federal Government should aid state and local governments so they can maintain public services and employment. A reasonable estimate is that \$75 billion per year for 2 years (a total of \$150 billion) in direct aid to state and local governments will be needed to prevent layoffs and maintain crucial services. An additional \$50 billion in reserve should be allocated to be dispersed as needed.

The background for this policy is as follows: state and local governments are facing an estimated \$29 billion in mid-year budget gaps this year. This is on top of a \$49 billion gap already faced for fiscal year 2009 (see McNichol and Lav 2008). From the experience of previous recessions, this is likely to get considerably worse. Experts from the Rockefeller Institute of Government estimate that states will face revenue shortfalls of \$150 - \$200 billion dollars or more over the next two years. This should be one of the top priorities of the economic recovery package. It is highly inefficient and costly to lay off workers providing needed services (education, police and fire protections, health services) and then try to employ these skilled workers elsewhere (infrastructure development, for example).

2. Keep people in their homes

Keeping people in their homes is crucial for preventing communities, families and the entire social fabric from tearing apart, and will work immediately to break the downward spiral of spending. There are a number of policies that should be seriously considered for immediate implementation or to be phased in the near future.

- i. Implement a one year moratorium (minimum) on home foreclosures.
- ii. Require that banks give homeowners the option of renting. As outlined in the plan developed by Dean Baker, this would work as follows: the government would change the foreclosure process so that homeowners facing foreclosure have the option to remain in their house as

renters paying the market rent for a substantial period of time (e.g. 10– 20 years). This measure would immediately give homeowners security in their homes, and would provide banks with real incentives to renegotiate terms to allow homeowners to stay in their houses as owners.

iii. Implement a major program of mortgage restructuring to dramatically reduce home foreclosures, keep people in their homes, and eventually help restore homeowners' equity. Many proposals are being developed to accomplish this, including reviving the New Deal era Home Owners Loan Corporation (HOLC) along the lines developed by Alan Blinder and others. The modernized HOLC would buy mortgages from banks and then issue more affordable new loans to struggling homeowners. It is estimated that this plan might cost \$300 - \$400 billion over two years. The money must be carefully targeted to ensure that banks take appropriate shares of the losses.

There are many other proposals that have been suggested but these seem to us to be the most promising. In any case, a solution to the housing foreclosure crisis is key to protecting people's standards of living and keeping the economy from unraveling further.

3. Invest in public infrastructure, education and green spending initiatives

We support the public investment/ green jobs program developed by Robert Pollin and his colleagues at the Political Economy Research Institute, a program that has become a centerpiece of the Obama administration's recovery package. Pollin and his colleagues estimate that a \$300 billion initiative would create 6 million new jobs in the fairly short term and an additional 800,000 jobs over the medium term as public investment stimulates additional private investment (known as 'crowding in'). The green components of this could focus, for example, on building retrofitting programs in the short run, and investments in public transportation over the longer term. Expanding research funding in green technology development would also have an immediate impact on incomes and spending. Other public transportation initiatives would increase real incomes and reduce greenhouse gases in the short to medium term. For example, simply lowering public transportation fares would raise working class living standards and increase ridership on public transportation, thereby lowering carbon emissions.

4. Protect key industries such as the automobile industry

A fund of loan guarantees and direct loans should be established to help key firms and industries, such as the automobile industry, that play a crucial role in the economy. This should be done immediately, and in the medium term the program could be made part of a separate institution, similar to the Reconstruction Finance Corporation of the 1930s. The initial fund should have significant resources, on the scale of \$100 billion. Though the Bush administration has given a short-term loan to the auto industry out of the Troubled Assets Relief Program funds, it is well understood that this initial loan will not be sufficient.

These auto company loans, like all others, must have conditions attached to ensure that the companies do not use the crisis as an opportunity to shred labor contracts and avoid investing in technology and the capacity to serve longer-term objectives. The government has two roles: mitigate harm and promote new social policy. Achieving these goals requires two different timing cycles and debates. The companies should get enough money to maintain operations. Further funds should depend on whether the auto companies move towards energy-efficient and low-emissions vehicles and restructure dealership and

delivery systems. The conditions should also strengthen the safety net (funding, training, placement services) for workers who will be displaced even without a cataclysmic failure. As a related initiative, lowering the age of Medicare eligibility to 62 or 55 would help these workers, along with all industries with a large proportion of older workers.

5. Make government an employer of last resort

Starting immediately, people should be able to get government jobs at prevailing or living wages (whichever is higher) to engage in useful work for the community. These programs can be linked to ongoing state, local and federal government activities that already have management and institutional infrastructure up and running so that this can be done relatively quickly and efficiently. If successful, this policy can be renewed beyond the crisis period.

6. Reverse extreme inequality and restore family and community health

The extreme inequality and tattered social care system that have developed in recent decades have not only been unjust, but have also contributed to the crisis itself. Many households cannot easily afford to pay for basic goods such as health care and housing because of stagnating wages. Many turned to heavy debt in order to maintain their standards of living. This increasing debt burden proved unsustainable, and when the housing bubble burst, accelerated the speed and ferocity of the downturn. Excessive health care costs have burdened American industry and eroded people's standards of living. Tax cuts for the wealthy have undermined government revenues. Increased costs of child care and education relative to wages have burdened families and reduced their buying power and their inclination to take on unsustainable debt.

Policies to reverse this extreme inequality must restore the power of workers to bargain for decent wages and benefits and increase the services available to children and families. Hence, the administration should:

- i. Pass laws to enhance workers' rights to organize into unions such as the Employee Free Choice Act.
- ii. Provide access to affordable child care for all families.
- iii. Reform the health care system to make it dramatically more efficient, less costly, and provide universal coverage.
- iv. Protect pensions by mandating a supplement to Social Security that guarantees a minimum rate of return on workers' contributions and moves away from the commercial, individual-directed account systems which make workers' retirement savings too exposed to the vagaries of the financial markets.

7. The Federal Reserve should support the fiscal expansion and be subject to more oversight

In the last several months, the Federal Reserve has dramatically lowered interest rates and has injected billions of dollars of liquidity into the economy. It seems clear that the Fed cannot lower interest rates further as short-term rates approach zero. In this context, the main role of the Federal Reserve should be to support the fiscal stimulus. First, the Federal Reserve should buy longer-dated Treasury (and related)

debt as the government and its agencies borrow to pay for the stimulus package. This will help break the decline of the U.S. and global economies and help promote recovery. Second, as discussed by Robert Pollin, Thomas Palley and others, the Federal Reserve System can use a system of carrots (loan guarantees) and sticks (asset-backed reserve requirements) to help channel bank credit to investments with high social priorities, such as public infrastructure, employment creation, and green transition investments. Asset-backed reserve requirements create lower reserve penalties for banks to lend to high priority areas, and thus encourage lending consistent with government goals.

As the Federal Reserve has become much more involved in credit allocation in recent months, it becomes all the more important to strengthen democratic safeguards and oversight of Federal Reserve management. At the minimum, Congress should employ the oversight capabilities to which it is constitutionally entitled with significantly more rigor than it has in the past. The boards of regional Reserve Banks should also institute more oversight of the Federal Reserves activities in order to enhance transparency and accountability.

8. Promote international coordination of expansionary policies

The recession is global, so the economic stimulus must extend globally. The United States and the People's Republic of China are committed to significant fiscal recovery packages, but in Europe, economic recovery is hindered by the growth and stability pact and the reluctance of some governments to engage in significant fiscal stimulus. Likewise, in developing countries, aid from the IMF and World Bank must contribute to economic recovery, and not be saddled by austerity conditionality that will undermine the expansionary purpose of the aid itself.

To promote these global recovery policies, the Obama administration should immediately conduct aggressive economic diplomacy to advocate for a global recovery policy lead by fiscal actions. This economic diplomacy would address IMF and regional bank conditionality, in order to encourage more expansionary impacts.

Of course, global solutions must go well beyond these short-term measures. Below we discuss measures and reforms that will be needed in the medium to long term.

Debt implications and concerns

As economists, we are aware of the debt implications of the large economic recovery program. However, most economists agree that in the current emergency, the U.S. should not hesitate to implement a massive recovery program. Failure to reverse the deepening recession will, itself, lead to major government borrowing when tax revenues decline and required payments for unemployment benefits and other social transfer payments increase. To help ameliorate any possible longer-term debt concerns, a major goal of the short-term program should be to make investments that will pay off in the longer run. Increased economic capacity and productivity will significantly reduce any longer-term debt concerns that might otherwise arise.

The scale of this proposed economic recovery program in relation to the size of the economy should not raise significant concerns when viewed in a historical context. A \$600 billion expenditure sustained over

several years, for example, could lead to a government deficit to GDP ratio of 6 to 7%, and a debt to GDP ratio of somewhere between 40% and 45%. This can be compared to a deficit to GDP ratio in 1945 of 18.9% and the publicly held debt to GDP ratio of 101% in that same year. As recently as 1983, the deficit to GDP ratio was 6%, and in 1995 the debt to GDP ratio was over 49%. So this expenditure plan would be well within historical ranges. Still, it is crucial that the money be well spent to generate jobs, productivity increases and promote the long-run health of the economy in order to reduce debt burdens on future generations.

As mentioned earlier, currently, the U.S. government is able to borrow at very low interest rates from its own citizens and from the rest of the world, around 2% for long-term debt. This ability is likely to be sustained for a substantial period of time, because the dollar is a safe haven and world reserve currency, and because world investors believe that the U.S. has the tools and capacity to restore the health of its economy. There appears to be a tacit agreement that if the world continues to lend to the U.S., the U.S. will promote global economic recovery first and foremost. In that sense, the U.S. has a moral obligation to use this power to help stave off global economic calamity.

In addition, there are other tools that can be brought to bear to manage the increased government deficit. The Treasury might need to develop additional types of Treasury securities to keep borrowing costs down, should foreign lenders begin to balk at lending to the U.S. at very low rates. The role of the Federal Reserve will also be important here, supporting the fiscal expansion as described earlier.

In the longer run, the government will need to reduce the size of the current account deficit relative to the economy. As we describe below, a set of adjustments must be made to the global economy so that countries with large current account surpluses such as China and poor countries can expand their economies and reduce the burden facing the U.S. and other current deficit countries. Successfully making this transition will be crucial over the long term.

RESTRUCTURING AND RE-REGULATING THE FINANCIAL MARKETS

INTRODUCTION

Though most economists and policy makers recognize that we are in an emergency situation and therefore emergency measures are required, many are also calling for as quick a return to ‘normalcy’ as possible: a return of financial institutions to private ownership and standard market practices, a return to the labor market and tax practices of the past, only marginal changes in health care policies, and so forth. Yet it was these practices and institutions that have created this crisis, and to return to them would be to set in motion activity that will lead us down this path again. Moreover, many aspects of the financial system have been irrevocably changed. Concerted attempts to return to the past can only fail. In the 1920s and 1930s, governments in Europe and elsewhere made many destructive attempts to restore the economic conditions existing prior to World War I, including reinstating the gold standard, in a disastrous attempt to hold on to the old order. We must not make the same mistake again.

There must be more public control and oversight over financial institutions to enhance transparency and ensure that these institutions are contributing to the creation of jobs, home ownership, education and other goods that people want and need. Unless the government starts exerting its authority and control, the public legitimacy of the bailouts—already thin—will most likely collapse. As a result, one of the major tools that the Federal authorities hold for stimulating economy recovery will be eliminated. The government must exert this authority through, for example, its regulatory oversight, and/or by demanding seats on the boards of companies to which it has made major loans or investments. The actions of the government with respect to this enhanced leverage must be transparent and accountable, and broad citizen representation must be included on financial oversight boards.

REFORMING THE BAILOUT PROCESS

The Federal Reserve and the Treasury Department have spent, promised or guaranteed up to several trillions of dollars to try to prevent financial institutions from failing, depositors from losing their funds, and restore the flow of credit to households, businesses, non-profits and governments. While deposits have been protected, the financial system has not restored the flow of credit to the economy where it is most needed.

Moreover, despite spending billions of dollars of public money, the government has exerted little control over the financial institutions to force them to undertake actions in the public interest, such as reducing interest rates and increasing lending to key areas, eliminating excessive pay packages and dividends, discontinuing unproductive stock buy-backs, or increasing the flow of lending to households, communities and governments, while closing the avenues for high risk, exotic investments. As shown in a recent Government Accounting Office report on the Troubled Asset Relief Program (TARP), the Treasury Department has not even instituted mechanisms to enforce and monitor the modest requirements on

executive pay implemented with that legislation, much less created a clear mechanism for identifying what the recipients of funds actually do with the money (see U.S. GAO 2008.). Clearly, new structures of accountability and control must be implemented.

Principles and specific suggestions for managing financial institutions and assets subsidized and acquired by the government

1. Utilize leverage provided by partial ownership

Partial government ownership of financial institutions provides, in principle, a greater degree of leverage over those institutions. The government should take full advantage of this arrangement to insist that these financial institutions operate effectively and support socially needed investments in line with the government's economic recovery and reconstruction programs. This should be done with complete accountability and transparency. Some specific suggestions along those lines are presented below.

2. Establish codes of conduct for all financial institutions receiving government aid

These codes of conduct will restrict executive compensation, limit dividends, and eliminate lobbying.

3. Empower financial regulators to identify and reduce fraud

As William Black has argued, deregulation allowed a tsunami of control fraud to engulf the financial sector. Financial regulators must be given the resources and mandates to go into financial institutions, make their books transparent, and bring fraud cases where justified. This will be crucial to cleaning out the financial institutions and restoring their health.

More specific suggestions for reform

1. Restructure TARP

The Troubled Asset Relief Program must stop supplying case-by-case bailouts and establish a systematic approach in which all the major banks are forced to participate in restructuring and government oversight. TARP should be structured so its operations are completely transparent, and representatives from a broad range of labor, community, government and business interests can monitor its operations. The government must also establish rules to ensure that creditors and stock holders pay a fair cost for these funds.

Managers who were responsible for the poor investments that have now cost taxpayer money should be replaced or be made to pay substantial fines. It is not enough, as is present in the current legislation, for funds to be returned if they are earned as a result of fraud. Moral hazard will only be minimized if poor decisions are penalized as well. Along these lines, it may be necessary to establish a Resolution Trust Corporation -type entity outside of the Treasury Department to manage the acquired assets from financial bailout activities if the Treasury department does not institute a set of transparent and accountable policies.

2. Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac have been essentially nationalized. The decision about the future of Fannie and Freddie—whether a return to the old government-sponsored enterprises (GSE) structure, privatization or permanent nationalization—has been put off until the next administration and the next Congress. We argue that permanent nationalization is likely to be superior to the other two alternatives for three reasons. First, it is widely recognized that under the old GSE structure, Fannie and Freddie had dual and conflicting goals: public policy objectives and profit maximization. Permanent nationalization would eliminate this conflict, and allow Fannie and Freddie to focus on the single goal of its public policy objectives (e.g. affordable housing). Second, by contrast, total privatization would open the home mortgage market once again to perverse incentives, excessive risk taking, and more financial crises. A government-run Fannie and Freddie would provide greater stability in the home mortgage market, the housing construction industry and the economy as a whole. For example, Fannie and Freddie could continue to provide financing for the mortgage market even in downturns and times of financial stress, as they have in recent months. Third, a nationalized Fannie and Freddie would allow the use of profits generated to provide more affordable housing.

3. The creation of a reconstruction finance corporation-type agency

We recommend considering creation of a government corporation similar to the reconstruction finance corporation of the 1930s, which would manage programs to support loan guarantees and programs for key industries. A broadly based management board with accountability and complete transparency would be required.

RE-REGULATE THE FINANCIAL MARKETS

Introduction

In recent decades, the U.S. and global economies have faced an ever worsening cycle of financial deregulation, financial explosion, financial crash and bailout, followed by a renewal of the cycle at a higher and more dangerous level. This cycle was described well by Hyman Minsky. Each cycle is punctuated not only by costly financial mistakes, but by widespread financial fraud and malpractice.

In this process, the financial sector in most developed countries has become bloated, and is now too big relative to the size of the real economy. To correct this, the size of the financial sector will have to contract, but it needs to be done in an orderly fashion without contributing to an economic collapse.

This current, and most serious crisis in memory, stemmed from fatal flaws in the lightly regulated financial system: 1) asymmetric and perverse incentives that led financial actors to take on excessive risk; 2) a regulatory framework that was lax at best, and virtually non-existent in the case of the ‘shadow banking system,’ allowing excessive risk taking (as discussed in D’Arista and Griffith-Jones 2008) and widespread fraud; 3) financial innovations and structures that were murky and opaque; and 4) a system that was at root pro-cyclical in its underlying dynamics.

A financial regulatory system must be put in place to address these problems. For any serious regulatory reform to work, however, at least two conditions must be met. First, financial institutions must come under much more significant regulatory oversight that demands absolute transparency in operations to avoid fraud and other forms of financial malpractice. Second, the financial regulatory institutions must have the capacity, authority and desire to implement and enforce these regulations.

Numerous proposals for financial re-regulation have been developed. Examples of regulatory reforms taken from Crotty and Epstein, Pollin, and D'Arista and Griffith-Jones include the following:

Policies to reduce destructive incentive structures and moral hazard

1. Transform financial firm incentive structures that induce excessive risk taking.

A perverse incentive structure for top decision makers in important financial firms is a major cause of the current crisis. One mechanism to make the payoff structure more symmetrical, and thus reduce incentives for risk seeking, would be to implement 'claw-backs,' through which excessive salaries and bonuses paid during an upturn would have to be repaid in a downturn. Such claw-backs could be required in compensation contracts or could be implemented via the tax system, through a series of escrow funds and limitations on deductions from losses. An alternative is to hold on to bonuses until a financial cycle is completed, and it is clear that they are warranted based on the results of a full cycle.

Ratings agencies also played a key role in this crisis. One possibility to eliminate the conflicts of interest faced by ratings agencies is for the government to create independent public ratings agencies.

Policies to broaden and strengthen regulatory reach

1. Extend regulatory oversight to the 'shadow banking system'

The 'shadow banking system' of hedge and private equity funds and bank-created structured investment vehicles had become increasingly powerful. These institutions must be brought under adequate regulatory control. Broadly, all financial institutions should have similar solvency and liquidity requirements.

2. Restrict or eliminate off-balance sheet vehicles

All risky investments should be moved back onto bank balance sheets and adequate capital should be required to support them. Capital requirements should be sufficient to protect bank solvency even during the liquidity crises that occur from time to time.

3. Implement a financial precautionary principle

Once the financial regulatory structure is extended to all important financial institutions, it would be possible to implement a regulatory precautionary principle with respect to new products and processes created by financial innovation, similar in principle to the one used by the U.S. Food and Drug Administration to determine whether new drugs should be allowed on the market.

Policies to increase transparency and reduce fraud

1. Prohibit the sale of financial securities that are too complex to be sold on exchanges

Eighty percent of all derivative products and one hundred percent of the complex collateralized debt obligations, credit default swaps and other exotic financial instruments implicated in the current crisis are traded off-markets or over-the-counter. If regulators were to insist that all derivative securities must be traded on exchanges, those exotic securities that could be simplified and commodified would shift to exchanges where they would be transparent, involve less counter-party risk, and be cheaper sources of finance.

Policies to reduce pro-cyclicality

1. Restrict the growth of financial assets through counter-cyclical capital requirements

A number of the previous suggestions could help restrict the excessive growth of financial assets in a boom. But they might not, by themselves, eliminate the excessive growth of financial assets. To assure control of the rate of expansion of financial assets, regulators should impose *counter-cyclical* capital-asset ratios and/or provisions, as implemented, for example, in Spain. This would mean that as the value of assets increased due to, for example, a speculative bubble, capital requirements would increase, thereby restricting the degree to which financial institutions could increase their lending, drive up asset prices and further expand the bubble.

2. Create a bailout fund financed by Wall Street

When the FDIC rescues failing commercial and savings banks, it uses insurance funds paid for by the banks themselves, not by the taxpayer. A similar insurance scheme should be created to finance bailouts for other kinds of financial institutions. The government should impose a small transactions tax on all security sales (see Pollin et. al. 2003 for a general discussion of the transaction tax.) The tax rate might be calibrated to generate about \$100 billion in annual tax revenue. The fund would typically accumulate hundreds of billion of dollars in normal and boom times prior to the outbreak of a financial downturn. If effective regulations are put in place to prevent a truly dangerous risk buildup in an expansion phase of the financial cycle, the fund should have more than enough money to rescue those institutions that fail in a downturn.

GLOBAL REFORM, COORDINATION AND CO-OPERATION IN THE MEDIUM AND LONG TERM

INTRODUCTION

The roots of the current crisis are complex, but they include the global imbalances that have dominated world economic growth over the last several decades. The state of affairs in which the U.S. serves as the buyer of last resort and the world serves as dollar accumulators of first resort cannot any longer be the basis for the long-run trajectory of the global economy. For the short term, the U.S. economy must continue to run significant current account deficits and act as a buyer of last resort, while the rest of the world accumulates dollars. But in the long term, it is neither feasible nor desirable for the rest of the world nor the U.S. to continue in these roles.

This means two things: first, the surplus countries of China, Japan and Germany must play a bigger role as providers of global aggregate demand. Second, the approach of the IMF, the World Bank and other institutions toward developing countries must fundamentally shift away from the high conditionality, export-led, free capital mobility approach embodied in the neoliberal philosophy, and towards an approach that gives developing countries more policy autonomy and more resources to bolster domestic demand and capacity. To further these goals, the Obama administration and partners must initiate a dialogue to implement a major reform of global institutions and practices.

PRINCIPLES FOR INTERNATIONAL REFORM

As a start, the process of global reform must adhere to several principles (see Griffith-Jones et al 2008, Ocampo 2008 and South Centre 2008).

Inclusive and comprehensive reform

The process of reform should be inclusive, including representative voices from the world's smaller and poorer countries. The process of reform cannot be restricted to the G-20 or similar associations that exclude so many of the world's countries.

Financial regulatory reform must be global

A global discussion of financial regulation must be reinvigorated. Issues such as global or regional policies for financial regulation, counter-cyclical automatic stabilizers such as capital requirements, global regulation of derivatives and hedge funds, and coordinated lender of last resort activities, among other issues must be considered. An international financial regulatory body or a college of regional supervisors is likely to be necessary to make sure these reforms are global and coordinated.

Strengthen international policy coordination

In face of an imminent threat of a global debt-deflation spiral, there is heightened need for international policy coordination. The best approach would be asymmetric adjustments, with surplus countries taking more aggressive steps to bring their surpluses down so that the deficit countries would find it easier to manage their own disequilibria.

The IMF should be significantly revamped

Revamping the IMF must include changing its lending policy, policy advice, structure and operations.

1. Conditionality and lending advice must be changed and policy space increased

In the past, IMF lending policy and conditionality has promoted the neoliberal ideology that has now been discredited and has contributed so significantly to the economic crisis. Yet the IMF has not yet fundamentally changed its policy advice or approach. Countries borrowing from the IMF or seeking global debt relief should be allowed and even encouraged to use capital management techniques to protect themselves from financial contagion; they should be allowed to follow more employment-targeted monetary and financial policies; and they should be allowed the discretion to engage in country-appropriate macroeconomic and financial policies.

2. Promote policy reform for globally counter-cyclical policy

Global policies and institutions must be altered to avoid promoting global booms and busts. This set of reforms should include: 1) the creation of a meaningful and truly global reserve currency, which could be based on the IMF special drawing rights; 2) rapid IMF lending during balance of payments crises without overburdening conditionality, particularly when the sources of the crises are a rapid reversal of capital flows and a sharp deterioration in the terms of trade; 3) establishment of a preventive credit line for capital account crises (such as the defunct contingency credit line). Overall, this implies that the IMF would act more like a central bank, providing counter-cyclical liquidity in an agile way, the way central banks have actually been providing funds in industrial countries on a massive scale in recent months.

Expand financing for development

Adequate financing facilities for realization of the U.N.'s Millennium Development Goals should not be put on hold because of the financial crisis. Given that expansionary policies for the developing world are necessary to help global recovery, there is now even greater incentive for advancing the goal of OECD countries transferring 0.7% of their GDP to the poorest countries. One way to achieve this would be to creating special drawing rights for this purpose and allocating them directly to governments to support productive public investment.

ESTABLISH HEARINGS ON CAUSES OF THE CURRENT CRISIS AND REGULATORY REFORM

Instituting these complex and significant changes in regulatory and economic structure requires intense and structured public dialogue. One mechanism to institute such a dialogue would be to establish a set of comprehensive hearings and a select committee to organize the inquiry and discussion (see Seligman 2008). One model for such an inquiry is the stock exchange practices hearings conducted by the Senate Banking Committee between 1932 and 1934. Popularly known as the Pecora Hearings after the Committee's special counsel Ferdinand Pecora, this investigation looked into the financial industry practices that helped trigger the Great Depression. It provided a documentary record, a coherent narrative and a forum for public education that were critical to building the framework of financial regulation and supervision that emerged from the New Deal.

During 2007 and 2008, committees in the House and Senate have held numerous hearings on matters related to the current collapse of the financial system. While several of these hearings unearthed useful information, none of them, separately or collectively, came close to achieving the scope, penetration, educational impact or policy reform salience of Pecora's investigation. However, the 111th Congress will assuredly conduct further examination of the causes and consequences of the ongoing financial meltdown and the official responses to this debacle. It will also investigate the need for a comprehensive restructuring of the financial economy along with the rules, institutions and public oversight mechanisms through which it functions. This process should be comprehensive and open to considered views from a broad range of groups and citizens.

These hearings could tackle some of the longer-run regulatory and management issues that we have identified. The crisis and bailouts have now transformed the financial sector in unimaginable ways, including the massive consolidation and restructuring of the U.S. financial system. A new regulatory structure will be required. What should the financial system look like in the future? Should banks be regulated like public utilities, ensuring they provide the key functions society requires from banking? Should financial conglomerates be broken up into functional sub-units so they are easier to monitor and regulate? Should government continue to have a major role in those institutions that have been bailed out? How can comprehensive, counter-cyclical regulation best be introduced? Should some institutions be fully nationalized? These are examples of the issues that formal Congressional hearings should address.

CONCLUSIONS

It is time to close the book on the neoliberal era of macroeconomic and financial management, a set of policies and practices that has led the world to the brink of disaster. We have outlined here a group of feasible policy initiatives that can be taken by the Obama administration and coordinated globally to put people first, make the transition to a greener economy, and place front and center the important roles

government and social management of markets must play to restore health, stability and fairness to the nation's and world's economies.

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