There is a great deal riding, both economically and politically, on the international community’s ability to find the common ground necessary to reverse the current vicious circle in the world economy and turn it into a stronger virtuous circle of synergistic advances of living standards in rich and poor countries as they integrate.

The recent economic crisis, as well as the combination of rising inequality in many newly industrializing countries and stagnating real wages in the United States and other advanced industrialized countries, has sown doubts about whether global integration can live up to its billing as a force for shared progress. As a result, the social consensus behind free trade has frayed noticeably in recent years, particularly in developed countries.

U.S. international economic policy needs fundamental realignment to meet these challenges. Instead of expending scarce political capital on economically marginal free trade agreements, the new administration should focus on retooling and realigning the full spectrum of international aid, trade, and monetary policies so that they collectively serve to strengthen aggregate demand worldwide by building a larger, more prosperous global middle class.

Virtually every political leader around the world today perceives a vital national interest in the following:

1) Averting the worst-case scenario of a spiraling negative feedback loop of falling economic activity and deflation around the world.

2) Creating a stronger positive feedback loop of more broadly shared participation in the benefits of global economic integration among and within countries—what World Bank President Robert Zoellick calls “a more inclusive and sustainable globalization.”

This common political imperative has created the conditions for an unprecedented exercise in international economic cooperation aimed at stabilizing the world economy and placing it on a stronger and more sustainable footing through a series of structural reforms. This is precisely the approach the creators of the New Deal took to our national economic crisis in the 1930s. The Roosevelt administration instituted a series of measures aimed at stabilizing the economy in the near term, including fiscal stimulus, public works, and bank restructurings. At the same time it pursued fundamental reforms intended to rebalance the country’s underlying economic development model, including securities, banking and investment advisor reforms, the creation of Social Security and unemployment insurance, and labor law reform.

The Obama administration should rally the international community around a shared strategy to revive, sustain, and broaden the benefits of economic growth. This Global Deal should mobilize advanced and emerging economies to take coordinated, mutually reinforcing actions in two respects: measures to stabilize the world economy; and structural reforms that diversify the foundations of global growth and broaden its benefits by establishing a new paradigm of global economic integration—a Roosevelt Consensus—that places parallel and equal emphasis on liberalization and institution building.

Over the past generation, U.S. international, as well as domestic, economic policy has placed overriding emphasis on top-line growth—promoting economic efficiency through deregulation, privatization, trade liberalization, and fiscal balance. In the process, it has paid comparatively little attention to the importance of economic institutions to the fulfillment of the basic objectives of markets (resource allocation efficiency) and economies (broad-based progress in living standards).

Institutions matter to progress in rich and poor economies alike. They profoundly, albeit indirectly, influence the productivity of private investment—its contribution to sustainable labor productivity and economic growth—by shaping the incentives that investors face. Just as consequentially, but also indirectly, institutions affect the relative shares of labor and capital in national income. Arguably, the more the state retreats from the economy, the more important it is to have an effective enabling environment of investor rules and incentives such as financial supervision, corporate governance, transparency, property rights, judicial and exchange rate institutions, as well as other economic rules and incentives, such as labor, consumer, environmental, and social insurance institutions.

The fundamental political economy choice faced by modern market economies is not, as conservatives have been saying for the past generation, between big and small government. It is between functional and negligent government with respect to government’s role in maintaining an enabling environment conducive to productive private investment and broadly shared prosperity. After the mortgage and derivatives market meltdowns, toy import scares, food safety disruptions, exchange rate misalignments, and energy regulatory uncertainties of recent years, this ideological blind spot of American policymakers has become glaringly obvious to people the world over, almost irrespective of political philosophy.

The world economy needs short-term stabilization. Yet it also needs structural rebalancing through institutional reforms to allocate capital stably and productively as well as translate the growth created by integration into the broadest possible gains in living standards. This will require the international community to go beyond the roadmap of macro-prudential institution building that was the focus of the G20 leaders’ recent summit. Policymakers in the United States and elsewhere are facing a growing output gap, falling prices, and monetary policy that is rendered increasingly ineffective by the kind of liquidity trap Japan experienced in the 1990s. They should therefore be looking to exploit significant additional potential sources of aggregate demand. Helping countries with high saving rates or current account surpluses make the structural transition to greater reliance on growth in domestic demand represents such an opportunity.

The new administration should place G20 leaders on notice that, after their April 2009 summit, it will seek to focus the group on a comprehensive, well-funded initiative to strengthen and redeploy the International Labor Organization, Development Finance Institutions, or DFIs, International Monetary Fund, World Trade Organization, in particular, to help developing countries to build better labor, social insurance, investor, consumer, environmental, and anti-corruption institutions to help them shift to greater reliance on domestic demand and diffuse the benefits of their integration into the world economy among larger shares of their populations. A central part of this effort should be to provide the mandate and resources necessary for the ILO and multilateral development banks, or MDBs, to scale implementation of the Decent Work agenda, and the IMF must also be given the mandate and resources necessary for it to be a more effective bulwark against exchange rate misalignments and massive, persistent current account imbalances.

This Global Deal should have a domestic component that includes not only a major additional stimulus package, but also enactment of a set of structural reforms that expand labor’s share of national income by strengthening our domestic social contract in four areas: a universal, second tier pension program similar to that which exists in other countries; universal health insurance; major support for basic and tertiary education in less advantaged communities; and an upgraded, universal set of adjustment assistance benefits.

As we learned at an earlier stage of our own economic development, a strategy to place institution building on an equal par with integration and efficiency is a strategy to increase both equity and growth. Far from being mutually exclusive policy objectives, these can be mutually reinforcing. A Global Deal along these lines amounts to a populist approach to globalization in the best sense of the term, a concrete plan to make it work for more people.

By refocusing U.S. international economic policy on the goal of improving the quality of global economic integration and not simply its quantity, the new administration could help to avert the worst case scenario of a spiraling global recession and deflation as well as break the Gordian knot of politics on trade and globalization that has polarized Washington for far too long.