

Chapter I

A crisis foretold

A. Introduction

The global economic crisis, which first emerged as a financial crisis in one country, has now fully installed itself with no bottom yet in sight. The world economy is in a deep recession, and the danger of falling into a deflationary trap cannot be dismissed for many important countries. Firefighting remains the order of the day, but the urgent search for means to prevent the global economy from falling over the precipice must not be at the expense of a sober analysis of the reasons for the crisis, even in the short term.

The following chapters highlight three specific areas in which the global economy experienced systemic failure. While there are many more facets to the crisis, UNCTAD examines here some of those that it considers to be the core areas to be tackled immediately by international economic policy-makers because they can only be addressed through recognition of their multilateral dimensions. This report investigates three interrelated issues of importance to developed and developing countries alike, and proposes measures to address the systemic failures they have entailed:

- (a) how the ideology of financial deregulation within and across nations allowed the build-up of pressures whose unwinding has damaged the credibility and functioning of the market-based models that have underpinned financial development throughout the world;
- (b) how the growing role of large-scale financial investors on commodities futures markets has affected commodity price volatility and fed speculative bubbles; and
- (c) the role of widespread currency speculation in exacerbating global imbalances and fuelling the current crisis in the absence of a cooperative international system to manage exchange rate fluctuations to the benefit of all nations.

B. What went wrong: blind faith in the efficiency of financial markets

To be sure, the causes of the crisis are more complex than some simplistic explanations based on government failure suggest. For example, if it were true that “too much liquidity” as the result of “expansionary monetary policy in the United States” was responsible for the crisis, the attempt to fight the short-term crisis with a new wave of cheap liquidity would amount to throwing oil on the fire (see box 1.1). The same is true for individual misbehaviour. No doubt, without greed, without the attempt of too many agents to squeeze double-digit returns out of an economic system that grows only in the lower single-digit range, the crisis would not have erupted with such force. But good policies should have anticipated that human beings can be greedy and short-sighted. Many people, if promised 25 per cent return on equity (or a paradise on earth) tend to believe it possible without posing critical questions about individual risk and much less about the risk of systemic failure. Such behaviour has been evident time and again in modern history and it always ended in economic downturn and crash. The problem is much more that policy makers forget the lessons of the past and are easily seduced by the idea that the economic system could care for itself.

Mainstream economic theory of the past decades even suggested that efficient financial markets would smoothly and automatically solve the most complex and enduring economic problem, namely the transformation of today’s savings into tomorrow’s investment. It assumed that efficient financial markets were sufficient to convince some people to put money aside and others to invest it into the future despite the fact that in the real world the investor is faced by “objective uncertainty”

(Keynes, 1930) concerning the returns he can expect and despite the fact that the more people save the lower would be the actual returns (UNCTAD, *TDR 2006*, annex 2 to chapter I).

Box 1.1

Is Greenspan's monetary policy to blame?

Among the different analyses of the causes of the crisis is the assertion that too much liquidity or excessively cheap liquidity fuelled the United States housing market boom and the subsequent speculation with newly created financial products based on residential mortgage-backed securities (RMBS).

It is certainly true that over the last decade or so the Federal Reserve System (FED) widely ignored warnings about inflating stock markets and house prices at the end of a long boom, and more appropriate macroeconomic policies might have prevented the crisis from fully unfolding. However, with its approach of ignoring specific prices the FED followed the almost globally accepted rule that monetary policy can and should only control the price level of a basket of goods.

It is also true that very low interest rates after the collapse of the dot.com bubble in 2001 fuelled the prolongation of the housing boom. Increasing home ownership at affordable prices was laid down as a political target as in the "National Homeownership Strategy" (Whalen, 2008). Low interest rates were an important instrument to favour investment in fixed capital, including housing, over purely financial investment. Housing bubbles by themselves have been a regular by-product of expansionary economic policy and lasting boom phases, but this doesn't explain the speculative excesses in their financing which occurred in the build-up to this financial crisis.

Moreover, it is difficult to understand how the willingness to take on more risk by using the lever of low equity ratios for a given investment might have been driven by low policy interest rates. Under normal circumstances the opposite is more likely: low rates reduce the need for excessive risk-taking. An investor trying to squeeze a certain return over equity (say 25 per cent) out of an investment that yields only 5 per cent can use a smaller lever, i.e. a less risky strategy when policy and lending rates are low. More risk-taking is called for in a situation where policy rates and the rates to be paid for additional longer-term debt are high. In the same vein, low interest rates do exactly the opposite of fuelling financial investment: they normally reduce the attraction of purely financial investment and increase the attractiveness of real investment. That is why the – now obsolete – monetarist school of monetary theory assumed that "too much money chasing too few goods" would lead to overinvestment and inflation in the goods market. Obviously, recent experience and evidence has shown that the real world economy is not functioning on such simple terms. But the opposite proposition, namely that too much money will lead to too much financial investment, is not convincing at all.

Last but not least, low interest rates or too much liquidity in the United States cannot explain the infection of large parts of the rest of the world. With floating exchange rates, liquidity does not flow between countries and cannot spill over into regions where the dollar is not legal tender. Other economies, whose financial sector has been directly infected by the crisis, such as euro area and the United Kingdom, had a fully independent monetary policy after 2001, without dollar inflows and with much higher interest rates. Japan has had a zero interest rate policy for many years now to fight deflation, but this has not stimulated speculative bubbles such as those in the United States.

Efficient financial markets are expected to overcome the uncertainty about the future and the frequency of crisis in these markets may be the result of the "mission impossible" that is expected from them. Or is their vulnerability mainly due to their scale (which nominally dwarfs the real economy) and their vital role for all other markets at the national and international level? Or do financial markets function in a different way than goods markets, perhaps in a way that systematically encourages the emergence of asset-price bubbles through a herding effect induced by the activity of large-scale investors? Obviously, there are strong arguments for all these hypotheses. However, a brief comparison of the logic of investment in fixed capital in a dynamic evolutionary setting (through traditional banking, i.e. lending money as an intermediary between central banks and savers on the one side and borrowers on the other) and investment in financial markets (through the now-crippled investment banks, for example) explains why capital markets seem bound to fail the more

“sophisticated” they are, whereas for the markets for goods and services efficiency can never be too much.

Investment in fixed capital is profitable for the individual investor and society at large if it increases the future availability of goods and services. No doubt, replacing an old machine by a new and more productive one, or replacing an old product by a new one with higher quality or additional features, is risky because the investor cannot be sure that the new machine or the new product will meet the needs of the potential clients. If it does, the entrepreneur gains a temporary monopoly rent until others are in a position to copy his invention. Even if an innovation finds imitators very quickly, this doesn't create a systemic problem: it may deprive the original innovator more rapidly of parts of his entrepreneurial rent, but for the economy as a whole the quick diffusion of an innovation is always positive as it increases overall welfare and income. The more efficient the market is regarding the diffusion of knowledge, the higher is the increase in productivity and the permanent rise in the standard of living - at least if institutions allow for an equitable distribution of the income gains and the demand that is needed to market smoothly the rising supply of products.

However, the accrual of rents through “innovation” in a financial market is of a fundamentally different character. Financial markets are about the effective use of existing information margins concerning existing assets and not about technological advances into hitherto unknown territory. The temporary monopoly over certain information or the better guess of a certain outcome in the market of a certain asset class allows gaining a monopoly rent based on simple arbitrage. The more agents sense the arbitrage possibility and the quicker they are to make their disposals, the quicker the potential gain disappears. In this case, too society is better off, but in a one-off, static sense. Financial efficiency may have maximized the gains of the existing combination of factors of production and of its resources, but it has not reached into the future through an innovation that shifts the productivity curve upwards and that produces a new stream of income.

The fatal flaw in financial innovation that leads to crises and collapse of the whole system is demonstrated whenever herds of agents on the financial markets “discover” that rather stable price trends in different markets (which are originally driven by events and developments in the real sector) allow for “dynamic arbitrage”, which entails investing in the probability of a continuation of the existing trend. As many agents disposing of large amounts of (frequently borrowed) money bet on the same “plausible” outcome (such as steadily rising prices of real estate, oil, stocks or currencies) they acquire the market power to move these prices far beyond sustainable levels. In other words, as seemingly irrefutable evidence, such as “rising Chinese and Indian demand for primary commodities”, is factored into the decisions of the market participants and confirmed by analysts presumed to be experts, the media and politicians, betting on ever rising prices seems to be rather riskless.

Contrary to the mainstream view in the theoretical literature in economics, speculation of this kind is not stabilizing, but rather destabilizes prices on the targeted markets. As the equilibrium price or the “true” price simply cannot be known in an environment characterized by objective uncertainty, that main condition for stabilizing speculation is not realized. Hence, the majority of the market participants just extrapolate the actual price trend as long as “convincing” information that justifies the hike allows for a certain degree of self-delusion.

The bandwagon created by uniform, but wrong, expectations about price trends inevitably hit the wall of reality because funds have not been invested in the productive base of the real economy where they could have generated higher real income. Rather, it has only created the short-term illusion of continuously high returns and a “money-for-nothing mentality”. Sooner or later consumers, producers or Governments and central banks will no longer be able to perform at the level of exaggerated expectations because hiking oil and food prices cut deeply into the budgets of consumers, appreciating currencies send current account balances into unsustainable deficit, or stock prices lose touch with any reasonable profit expectation. Whatever the specific reasons or shocks that trigger the turnaround, at a certain point of time market participants begin to understand that “if something

cannot go on forever, it will stop”, as it was once put by United States presidential advisor Herbert Stein.

At this point, the harsh reality of a slowly growing real economy catches up with the insistent enthusiasm of financial markets such that an adjustment of expectations becomes inevitable. Hence, the short-term development of the economy is largely hostage to the amount of outstanding debt. The more households, businesses, banks, and other economic agents are directly involved in speculative activities with borrowed funds, the greater the pain of deleveraging, i.e. the process of adjusting the level of borrowing to diminished revenues. A “debt deflation” (Fisher, 1933) sets in that fuels further painful adjustment because debtors try to improve their financial situation by selling assets and cutting expenditure, thereby driving asset prices further down, cutting deep into profits of companies and forcing new debt deflation elsewhere. The result of debt deflation if not stopped early on will be deflation of prices of goods and services as it constrains the ability to consume and to invest for the economy as a whole. Thus, in a debt deflation, the attempts of some to service their debts makes it more difficult for others to service their debts.¹ Only Governments can step in and stabilize the system by “government debt inflation”.

“Investment banking”, which became synonymous with “financial modernization”, is only a new term for an old phenomenon. The contribution of investment banks to real economic growth was mostly of the zero sum game type and not productive at all for society at large. Much of “investment banking” was unrelated to investment in real productive capacity; rather, it masked the true, speculative character of the activity and presented what appeared to be an innovation in finance. In fact, there was nothing new in the build-up or the unwinding of markets for the financial instruments that investment banks created. What was new, however, was the dimension through which private households, companies and banks have collectively engaged in what amounts to gambling. This can only be explained by the effects of massive deregulation, driven by the conviction that the freedom of capital flows and the efficient allocation of “savings” is the most important ingredient of successful economies.

C. What made it worse: global imbalances and the absent international monetary system

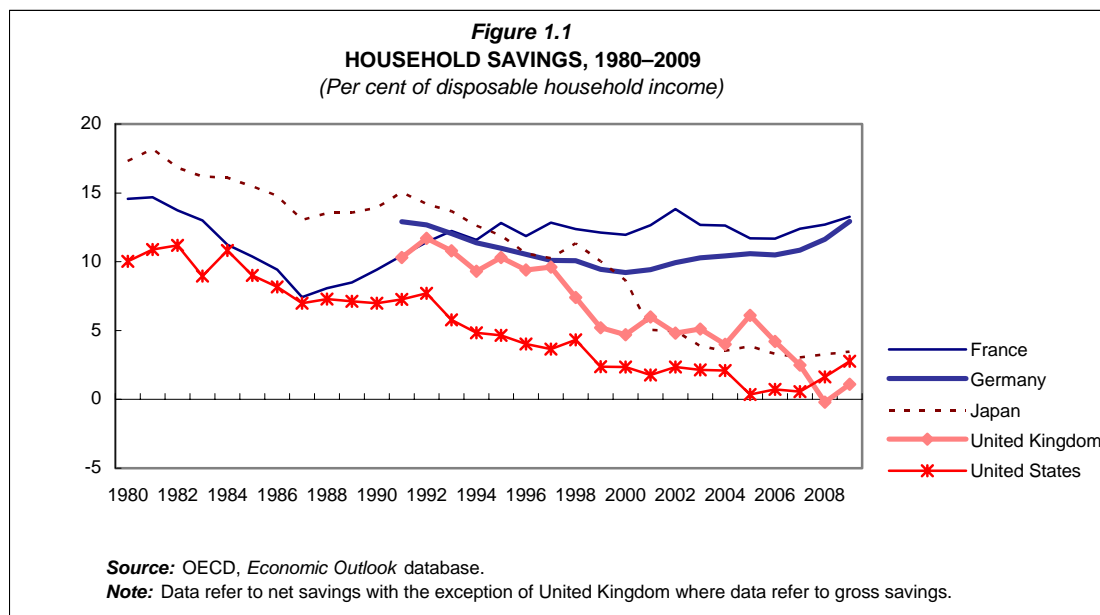
Analysis of the economic crisis which first erupted in the developed economies has to begin by recalling the end of the global system of “Bretton Woods”, which had rendered possible two decades of rather consistent global prosperity and monetary stability. Since then it has become possible to identify an “Anglo-Saxon” part of the global economy on the one hand, where economic policy since the beginning of the 1980s was comparatively successful in stimulating growth and job-creations, and a Euro-Japanese component, where growth remained sluggish and economic policy wavered with no clear or consistent view on how to use the greater monetary autonomy that the end of the global monetary system had made possible.

That the crisis originated in the Anglo-Saxon part of the developed countries was the logical outcome of the full swing towards unrestricted capital flows and unlimited freedom to exploit any opportunity to realize short-term profits. The financial crisis has demonstrated the damaging impact of this “short-termism” on long-term growth. But at the same time it has been the major driving force of the world economy in the last three decades. Without the high level of consumption in the United States, today most of the developed world and many emerging-market economies would have much lower standards of living, and unemployment would be much higher.

Indeed, the consumption boom in the United States since the beginning of the 1990s was not well funded from real domestic sources. To a significant degree it was fuelled by the speculative bubbles that inflated housing and stock markets. The “wealth effect” of higher prices for housing or

¹ Paul de Grauwe, *Financial Times*, 23 February 2009.

stocks led households in the United States and in the United Kingdom to borrow and consume far beyond the real incomes that they could realistically expect, given the productivity growth of the real economy and the dismal trends in personal income distribution. With overall household saving rates to close to zero (figure 1.1) consumer demand in both countries expanded rapidly but at the same time the growth process became increasingly fragile because it meant that many households could only sustain their level of consumption by further new borrowing. With open markets and increasing international competition in the markets for manufactures the spending spree eventually boosted borrowing on international markets and led to large current account deficits.

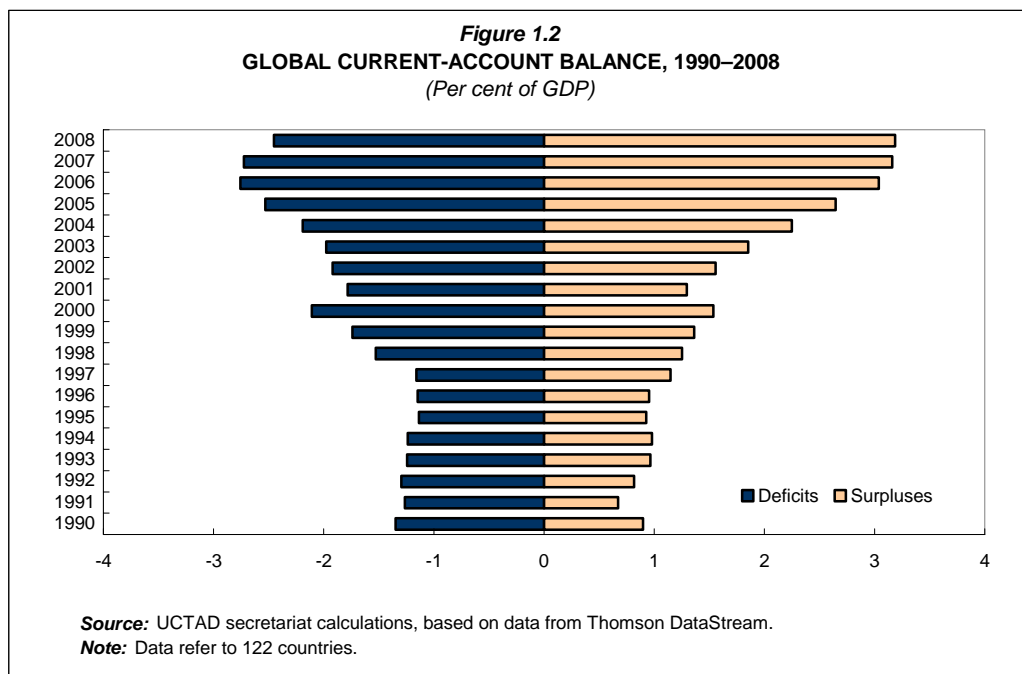


Juxtaposed against the current account deficits and overspending in the Anglo-Saxon economies was thrift elsewhere. Parts of continental Europe, in particular Germany, and Japan engaged in belt-tightening exercises that resulted in slow or no wage growth and sluggish consumption. But, since this policy stance also implied increased cost competitiveness, it yielded excessive export growth and ballooning surpluses in current accounts, thereby piling up huge net asset positions vis-à-vis the overspending nations. In both cases international competitiveness was additionally tuned by temporary exchange rate depreciations fuelled by speculative capital flows triggered by interest rate differentials.

These global imbalances served to spread quickly the financial crisis that originated in the United States to many other countries, because current-account imbalances are mirrored by capital account imbalances: the country with a current-account surplus has to credit the difference between its export revenue and its import expenditure to deficit countries. Financial losses in the deficit countries or the inability to repay borrowed funds then directly feed back to the surplus countries and imperil their financial system.

This channel of contagion has even greater potency owing to the lack of governance in financial relations between countries trading with one another in the globalized economy. The dramatic increase of debtor-creditor relations between countries (figure 1.2) goes far beyond the fallout from the Anglo-Saxon spending spree and has to do with a phenomenon that is sometimes called “Bretton Woods II” (Folkerts-Landau et al., 2004; and UNCTAD, *TDR 2004*). Bretton Woods II refers to how developing economies emerging from financial crises since the mid-1990s tried to shelter against the cold winds of global capital markets. For these economies, the only way to combine sufficient stability of the exchange rate with domestic capacity to handle trade and financial shocks and with successful trade performance was to unilaterally stabilize the exchange rate at an undervalued level. This applies to most of the Asian countries that were directly involved in the Asian

financial crisis and a number of Latin American countries, but also to China and, to a certain extent, India. The latter two experienced financial crises at the beginning of the 1990s and devalued their currencies significantly before fixing it to the dollar – in the case of China – or engaging in managed floating – in the case of India. Increasing unilateralism around the world in dealing with the implications of global imbalances at the national level further aggravated the crisis (see box 1.2).



Box 1.2**Is the savings glut responsible?**

Many observers have pointed to the willingness of the world and some developing countries, in particular China, to finance American profligacy at very low interest rates, due to their abundant “savings” (Krugman, *New York Times*, 1 March 2009). In other words, the huge deficit of the United States is interpreted as being the result of the decision of American households to consume more than they could afford and the decision of the Chinese households to save much more than the country could invest domestically. However, this explanation is rooted in a brand of macroeconomic theory (where savings lead the process of investment and growth and not the other way round) that has been refuted by evidence in many cases in the past.

If current account disequilibria are approached mainly from the side of trade flows instead of the capital flows, the observation that since the beginning of this century capital has been flowing “uphill”, becomes much less mysterious. If capital flows from poor to rich countries, while at the same time an increasing number of developing countries that are net capital exporters have achieved high growth rates, the traditional theory on which the “Chinese savings” culpability hypothesis is based loses all its persuasive power (UNCTAD, *TDR 2008*).

By contrast, explanations of the relationship between savings and investment based on the work of Schumpeter and Keynes focus on the role of profits in the adjustment of savings and investment. An implication is that most of the adjustment to new price signals or changed spending behaviour is primarily reflected in profit swings, which influence the investment behaviour of firms. Improvements of the current account are possible which are due to price changes in favour of domestic producers. By increasing domestic profits, higher net exports will trigger additional domestic investment, and the income effects of higher exports and higher investment will generate higher savings.

In this view, an increase in savings is no longer a prerequisite for either higher investment or a current-account improvement and vice versa. Neither the American deficit nor the Chinese surplus in the current account is the result of voluntary decision of households and companies but the result of a complex interplay of prices, quantities and political decisions. For many reasons it is wrong to assume that a complex economy, with millions of agents with diverging interests, functions in a way that would be found in a Robinson Crusoe world. Hence, to blame “countries” for their “willingness” to provide “too much savings” compounds the neoclassical error of analysing the world economy based on the expected rational behaviour of “one representative agent”. Such an approach cannot do justice to the complexity and the historical uniqueness of events that may lead to phenomena like those that have come to be known as the global imbalances.

Another important reason for growing imbalances is movements of relative prices in traded goods as a result of speculation in currency and financial markets (“carry trade”). The growing disconnection of the movements of exchange rates with their “fundamentals” (mainly the inflation differential between countries) has produced widespread and big movements in the absolute advantage or the level of overall competitiveness of countries vis-à-vis other countries. These changes in the real exchange rates are clearly associated with the growing global imbalances (UNCTAD, *TDR 2008*).

Speculation in currency markets due to interest rate differentials has produced a specific form of overspending that is now unwinding. In many countries, especially in Eastern Europe, but also in Iceland, New Zealand and Australia, it was profitable for private households and companies to borrow in foreign currencies with low interest rates, such as the Swiss Franc and the yen. With inward capital flows searching for high yield, the currencies of capital-importing countries (which were high-inflation countries at the same time) appreciated in nominal and in real terms, and this led to a deterioration of these countries’ competitiveness. With losses of market shares and rising current account deficits their external position became more and more unsustainable. The outbreak of the global financial crisis triggered the unwinding of these speculative positions, depreciated the currencies formerly targeted by carry trade, and forced companies and private households in the affected countries to deleverage their foreign currency positions or to default, which poses a direct

threat to the (mainly foreign) banks in these countries. A case in point is the situation that has recently emerged between East European debtors and their Austrian lenders.

In addition to all these factors, overshooting of commodity prices led to the emergence of – partly very large – current account surpluses in commodity exporting countries over the past five years. When the “correction” came, however, the situation of many commodity producers in the poorer and smaller developing countries rapidly deteriorated. In addition to reduced export revenues, this correction devalues investment in equipment and infrastructure that was directly induced by the demand boom and mushrooming revenues of the last years.

D. What should have been anticipated: the illusion of risk-free greed and profligacy

The global financial crisis arose amidst the neglect of international governance – the failure of the international community to give the globalized economy credible global rules. The sudden unwinding of speculative positions in the different segments of the financial market was triggered by the bursting of the house price bubble in the United States. But all these bubbles were unsustainable and would have burst sooner or later. For policy makers who should have known better than to continuously bet on “beating the bank” to now assert (with the benefit of hindsight) that greed ran amok, or that regulators were “asleep at the wheel”, is simply not credible.

The housing price bubble itself was the result of the deregulation of financial markets on a global scale, widely endorsed by Governments around the world. The spreading of risk and the severing of risk and the information about it was promoted by the use of “securitization” through instruments like residential mortgage-backed securities (RMBS) that seemed to satisfy investors’ hunger for double-digit profits. It is only at this point that greed and profligacy enter the stage. Without the economic “lifestyle” of deregulation of the last decades, and in the presence of more appropriate regulation, expectations on returns of purely financial instruments in the double-digit range would simply not have been possible (Kuttner, 2007; Davidson, 2008).

In real economies with single-digit growth rates those expectations are misguided from the beginning. However, human beings tend to believe that in their generation things may happen that never happened before, ignoring, at least temporarily, the lessons of the past. This happened in most recent memory during the stock market booms of the “new economy”. Despite the dot.com crash of 2000 a wide range of investors began to invest their funds into hedge funds and “innovative financial instruments”. These funds needed to ever increase their risk exposure for the sake of higher yields with more sophisticated computer models searching for the best bets, which actually added to the opaqueness of many instruments. It should have been clear from the outset that *everybody can't be above average* (Kuttner, 2007: 21) and that the capacity of the real economy to cope with exaggerated real estate and commodity prices or misaligned exchange rates is strictly limited, but it is only now, through the experience of the crisis, that this is coming to be understood by many actors and policymakers.

A more important driver of this kind of “financial innovation”, however, was the naive belief in efficient market theories that did not recognize objective uncertainty but mistakenly assumed well-informed buyers and sellers and hence promised minimal risk (Davidson, 2008). But “securitization” of investment vehicles led to further risk concentration because it converted debtor-creditor relations (or insurer-insured relation) into capital flow transactions by packing different types of debt for onward sale to investors in form of bonds all around the world (Fabozzi et al., 2007), whose interest and return of principal are based on the value of the underlying assets. Due to the opaqueness of these complex bundled “products”, many “securitized” assets found their way into instruments qualified as low-risk. A global clientele invested in these bonds because the global imbalances had intensified the global financial relations and had created the need for financial institutions located in the countries with current account surpluses to hold much of the toxic paper. In the first flush of financial liberalization, the global distribution of these papers was seen as an indication of successful risk

diversification. But eventually the opposite happened: financial “innovation” resulted in a concentration of risk since most of the “vehicles” were “securitized” by using assets that had similar default risks (Kuttner, 2007: 21–22).

Needless to mention, that credit-rating agencies totally failed. But it is mainly due to the microeconomic approach they usually take and their ignorance concerning macroeconomic and systemic factors on a global scale that they misunderstood the risk of so many participants playing on the same fragile bridge between the small real economy and a bloated financial sector.