



EMBARGO
The contents of this Report must not be quoted or summarized in the print, broadcast, or electronic media, before **19 March 2009 17:00 hours GMT**

The Global Economic Crisis:

Systemic Failures and Multilateral Remedies



Advance copy



UNITED NATIONS

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

The Global Economic Crisis: Systemic Failures and Multilateral Remedies

Report by the UNCTAD Secretariat Task Force on
Systemic Issues and Economic Cooperation



UNITED NATIONS

New York and Geneva, 2009

Note

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

Material in this publication may be freely quoted or reprinted, but acknowledgement is requested, together with a reference to the document number. A copy of the publication containing the quotation or reprint should be sent to the UNCTAD secretariat.

UNCTAD/GDS/2009/1
UNITED NATIONS PUBLICATION
<i>Sales no. E.09.II.D.4</i>
ISBN 978-92-1-112765-2

Copyright © United Nations, 2009
All rights reserved

Key messages

UNCTAD's longstanding call for stronger international monetary and financial governance rings true in today's crisis, which is global and systemic in nature. The crisis dynamics reflect failures in national and international financial deregulation, persistent global imbalances, absence of an international monetary system and deep inconsistencies among global trading, financial and monetary policies.

National and multilateral remedies

- **Market fundamentalist *laissez-faire* of the last 20 years has dramatically failed the test. Financial deregulation created the build-up of huge risky positions whose unwinding has pushed the global economy into a debt deflation that can only be countered by government debt inflation:**
 - *The most important task is to break the spiral of falling asset prices and falling demand and to revive the financial sector's ability to provide credit for productive investment, to stimulate economic growth and to avoid deflation of prices. The key objective of regulatory reform has to be the systematic weeding out of financial sophistication with no social return.*
- **Blind faith in the efficiency of deregulated financial markets and the absence of a cooperative financial and monetary system created an illusion of risk-free profits and licensed profligacy through speculative finance in many areas:**
 - *This systemic failure can only be remedied through comprehensive reform and re-regulation with a vigorous role by Governments working in unison. Contrary to traditional views, Governments are well positioned to judge price movements in those markets that are driven by financial speculation and should not hesitate to intervene whenever major disequilibria loom.*
- **The growing role and weight of large-scale financial investors on commodities futures markets have affected commodity prices and their volatility. Speculative bubbles have emerged for some commodities during the boom and have burst after the sub-prime shock:**
 - *Regulators need access to more comprehensive trading data in order to be able to understand what is moving prices and intervene if certain trades look problematic, while key loopholes in regulation need to be closed to ensure that positions on currently unregulated over-the-counter markets do not lead to "excessive speculation".*
- **The absence of a cooperative international system to manage exchange rate fluctuations has facilitated rampant currency speculation and increased the global imbalances. As in Asia 10 years ago, currency speculation and currency crisis has brought a number of countries to the verge of default and dramatically fuelled the crisis:**
 - *Developing countries should not be subject to a "crisis rating" by the same financial markets which have created their trouble. Multilateral or even global exchange rate arrangements are urgently needed to maintain global stability, to avoid the collapse of the international trading system and to pre-empt pro-cyclical policies by crisis-stricken countries.*

Global economic decision-making

- **The crisis has made it all too clear that globalization of trade and finance calls for global cooperation and global regulation. But resolving this crisis and avoiding its recurrence has implications beyond the realm of banking and financial regulation, going to the heart of the question of how to revive and extend multilateralism in a globalizing world.**
- **The United Nations must play a central role in guiding this reform process. It is the only institution which has the universality of membership and credibility to ensure the legitimacy and viability of a reformed governance system. It has proven capacity to provide impartial analysis and pragmatic policy recommendations in this area.**

Contents

Key messages	iii
Foreword by the Secretary-General of UNCTAD	ix
Executive summary	xi
Chapter I – A crisis foretold	1
A. Introduction	1
B. What went wrong: blind faith in the efficiency of financial markets	1
C. What made it worse: global imbalances and the absent international monetary system	4
D. What should have been anticipated: the illusion of risk-free greed and profligacy	8
Chapter II – Financial regulation: fighting today’s crisis today	11
A. It was not supposed to end like this	11
1. Financial efficiency and gambling	12
2. Avoiding regulatory arbitrage and the role of securitization	13
3. Micro and macro prudential bank regulation	16
4. The need for international coordination	17
5. Financial regulation and incentives	17
B. Lessons for developing countries	18
1. Financial development requires more and better regulation	19
2. There is no one-size-fits-all financial system	20
C. Conclusion: closing down the casino	20
Chapter III – Managing the financialization of commodity futures trading	23
A. Introduction: commodity markets and the financial crisis	23
B. The growing presence of financial investors in commodity markets	25
C. The financialization of commodity futures trading	26
D. Financialization and commodity price developments	32
E. The implications of increased financial investor activities for commercial users of commodity futures exchanges	35
F. Policy implications	36
1. Regulation of commodity futures exchanges	36
2. International policy measures	37
G. Conclusions	38
Chapter IV – Exchange rate regimes and monetary cooperation	41
A. Introduction: currency speculation and financial bubbles	41
B. The history of different exchange rate regimes is of a series of failures	44
C. Global exchange rate management, trade and investment	47
D. Currency crisis prevention and resolution	50
E. A multilateral approach to global exchange rate management	51
F. Conclusion	54
Chapter V – Towards a coherent effort to overcome the systemic crisis	55
A. More and better coordinated countercyclical action is needed	55
B. The State is back but national action is not sufficient	57
1. Preventing the competition of nations	57
2. Intervention in financial markets is indispensable	58
C. No “crisis solution” by markets	59
References	61

List of figures, tables and boxes

Box 1.1	Is Greenspan's monetary policy to blame?
Figure 1.1	Household savings, 1980–2009
Figure 1.2	Global current-account balance, 1990–2008
Box 1.2	Is the savings glut responsible?
Figure 2.1	Leverage of top 10 United States financial firms by sector
Figure 2.2	The shadow banking system, 2007, Q2
Figure 2.3	Outstanding credit default swaps, gross and net notional amount
Figure 2.4	Equity market dollar returns, 2008
Figure 2.5	Emerging market spread, January 2007–December 2008
Figure 3.1	Commodity price changes, 2002–2008
Figure 3.2	Futures and options contracts outstanding on commodity exchanges, December 1993–December 2008
Figure 3.3	Notional amount of outstanding over-the-counter commodity derivatives, December 1998–June 2008
Figure 3.4	Correlations between the exchange rates of selected countries and equity and commodity price indices, June 2008–December 2008
Table 3.1	Commodity futures trading behaviour: traditional speculators, managed funds and index traders
Table 3.2	Futures and options market positions, by trader group, selected agricultural commodities, January 2006–December 2008
Figure 3.5	Commodity futures prices and financial positions, selected commodities, January 2002–December 2008
Figure 4.1	Yen-carry trade on Icelandic krona and the Brazilian real since 2005, overlapping quarterly returns
Box 4.1	Fixed exchange rate regimes and the overvaluation trap
Box 4.1 figure B.1	Experiences with fixed exchange rate regimes, selected economies, 1994–2006
Box 4.2 figure B.2	Overvaluation trap and current account effects in Argentina
Figure 4.2	Volatility of REER, PEER and NEER changes, selected country groups, simple averages, 1993–2008
Figure 4.3	Interest rates, selected countries, January 2007–December 2008
Figure 4.4	Example of a currency system with “planets” and “satellites”

Abbreviations

BIS	Bank for International Settlements
CBOT	Chicago Board of Trade
CDO	collateralized debt obligations
CDS	Credit Default Swaps
CEA	Commodity Exchange Act
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CITs	commodity index traders
CFTC	Commodity Futures Trading Commission
COT	Commitments of Traders
DJ-AIGCI	Dow Jones-American International Group Commodity Index
ECB	European Central Bank
FED	Federal Reserve System
FSA	Financial Services Authority
GDP	gross domestic product
ICE	Intercontinental Exchange
IMF	International Monetary Fund
LTCM	Long-term Capital Management
OTC	over-the-counter
NEER	nominal effective exchange rate
PEER	price component of REER (PEER=NEER/REER)
PPP	purchasing power parity
REER	real effective exchange rate
RMBS	residential mortgage-backed securities
SIVs	Structured Investment Vehicles
S&P GSCI	Standard & Poor's Goldman Sachs Commodity Index

Foreword by the Secretary-General of UNCTAD

The global deleveraging that first hit the world economy in mid-2007 and that accelerated in autumn 2008 could not have been possible without the rare coincidence of a number of market failures and triggers, some reflecting fundamental imbalances in the global economy and others specific to the functioning of sophisticated financial markets. Chief among these “systemic” factors were the full-fledged deregulation of financial markets and the increased sophistication of speculation techniques and financial engineering. Other determinants were also at play, particularly the systemic incoherence among the international trading, financial and monetary systems, not to mention the failure to reform the global financial architecture. Most recently, the emergence of new and powerful economic actors, especially from the developing countries, without the accompanying reform needed in the framework governing the world economy, accentuated that incoherence.

For many years, even when the global economic outlook was much more positive than today, UNCTAD stressed the need for systemic coherence. It has regularly highlighted the shortcomings of the international economic system and has defied mainstream economic theory in its justification of financial liberalization without a clear global regulatory framework. UNCTAD has drawn attention to the fact that the world economy was overshadowed by serious trade imbalances and has questioned how they could be corrected without disrupting development. We have warned that, in the absence of international macroeconomic policy coordination, the correction could take the form of a hard landing and sharp recession. In recent years, we noted the growing risk that the real economy could become hostage to the whims and volatility of financial markets. Against this background, UNCTAD has always argued in favour of stronger international monetary and financial governance.

A better understanding is required of how lack of proper financial regulation set the scene for increasingly risky speculative operations in commodities and currency markets and of how across-the-board financial deregulation and liberalization have contributed to global imbalances. In doing so, a clearer vision may emerge of how these and other systemic shortcomings can only be remedied by vigorous reform of the international monetary and financial systems through broad-based multilateral cooperative processes and mechanisms that strengthen the role of developing countries in global governance.

Against this backdrop, I established in October 2008 an UNCTAD interdivisional Task Force on Systemic Issues and Economic Cooperation, chaired by the Director of the Division on Globalization and Development Strategies. This group of UNCTAD economists was tasked with examining the systemic dimensions of the crisis and with formulating proposals for policy action nationally and multilaterally. Needless to say, the development dimension and the appropriate responses are at the forefront of UNCTAD’s concerns and the issues addressed in this report were identified with that in mind.

There can be no doubt that, apart from the need to strengthen financial regulation at the national level, the current problems of the global economy require global solutions. The United Nations must play a central role in this reform process, not only because it is the only institution which has the universality of membership and credibility to ensure the legitimacy and viability of a reformed governance system, but also because it has proven capacity to provide impartial analysis and pragmatic policy recommendations in this area.



Supachai Panitchpakdi
Secretary-General of UNCTAD