



Coping with *financial market crisis*

Turmoil on the financial markets is back. After several years of relative calm, the turnaround in the US sub-prime mortgage market has spread uncertainty and apprehension among market participants in many countries, including some emerging markets.¹ This has prompted aggressive action by policy makers in a number of developed economies. In the first round, financial markets were calmed down by the massive provision of liquidity by several central banks and by safety operations of governments for a single bank. In the second round, the Federal Reserve's 50 basis-point cut in policy rates on 18 September led to the expectation that central banks were willing to stabilize the real economy and prevent a major outbreak of financial panic.

Despite the fact that these policy measures were effective in stabilizing the interbank market, several observers have criticized the actions of the US Federal Reserve and of the European Central Bank, arguing that monetary authorities should have adopted a hard-line policy similar to that originally adopted by the Bank of England (which, however, changed its policy stance in order to stop a run on a large British bank). These criticisms are based on four arguments: (i) Central banks should not bail out market participants who earned large returns from engaging in risky activities; (ii) Banks that require emergency lending should be penalized with higher interest rates; (iii) Central banks should not accept low-quality paper as collateral, even during crises; and (iv) Low US interest rates in the early 2000s were the main driver of the housing bubble, and lowering interest rates now may just generate another bubble and aggravate problems down the road.

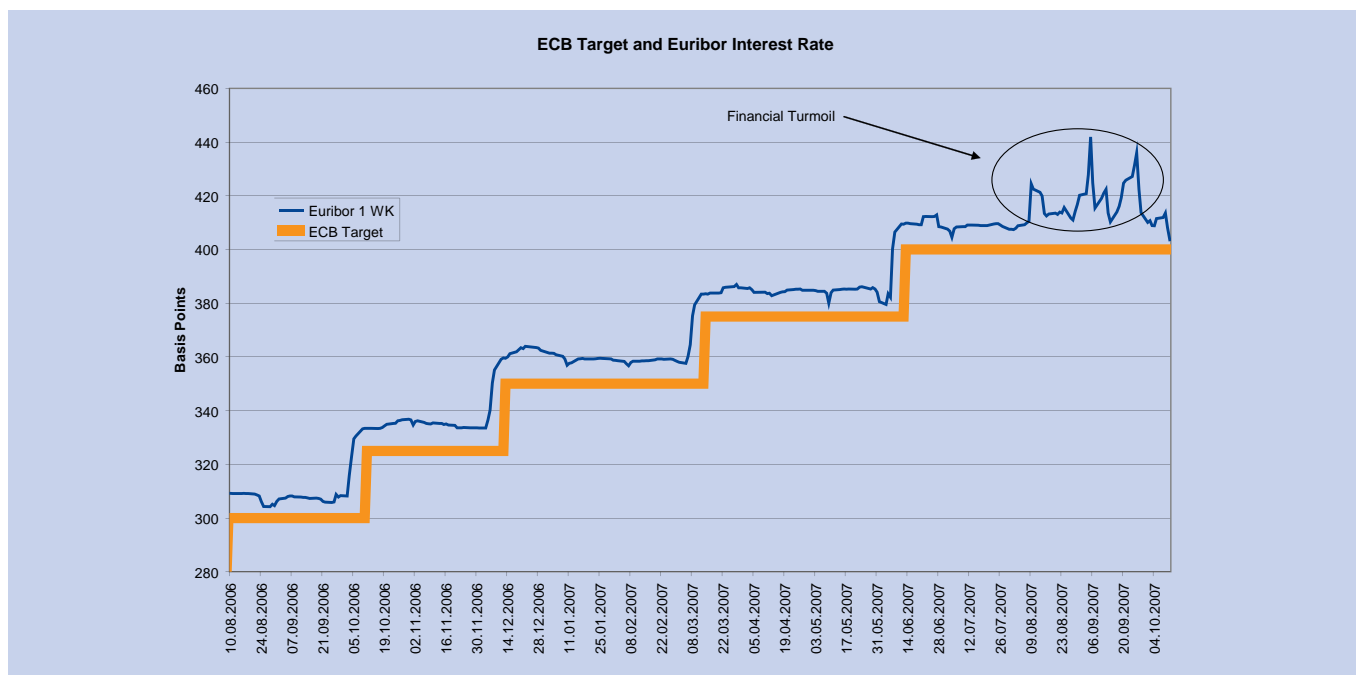
Although at first glance these criticisms may seem warranted, their fundamental thrust appears to be flawed. With respect to the first argument, providing liquidity to the markets to stabilize

a policy rate (*see figure*) does not necessarily imply a bailout operation. Individual losses following imprudent lending will appear in banks' balance sheets even if the central bank tries to avoid collateral damage by injecting liquidity during a money market crunch. **The rationale for injecting liquidity is to avoid excessive volatility** in the target interest rate, and not to bail out banks. With respect to the second argument, any **sudden increase in short-term interest rates would penalize all participants** in the money market, and not just those involved in imprudent lending activities.

As per the first two arguments, accepting a lower-quality standard for refundable paper can be justified as another way to stabilize short-term rates. Bailing out the depositors of one single bank, as happened in the UK, is more problematic, as it may indeed provoke the kind of moral hazard that led market participants to engage in overly risky business. However, bailing out the depositors of a troubled bank is not the same as bailing out the bank's owners and managers. The loss of trust in the bank will take a toll on the bank's future activities, even if government intervention protects private depositors.

With respect to the fourth argument, a cut in interest rates during financial turbulence is justified if there is a significant threat that the financial turmoil may spill over into the real sectors and threaten the employment target of the central bank directly, or its inflation target indirectly. The US housing market is one of the strongest pillars of that economy, and the danger of a sudden weakening of that pillar will inevitably affect the risk assessment of the central bank. Moreover, **there is no strong evidence that US monetary policy was too lax** after the end of the dotcom bubble. Given the dogmatic and rather restrictive stance of European monetary policy at the time, and the inability of the Japanese central bank to escape the zero-interest-rate trap of lasting deflation, the Fed's aggressive cuts played a positive role in stabilizing the world economy.

¹ See UNCTAD, Recent developments on global financial markets (TD/B/54/CRP.2, 28 September 2007). For a more general discussion of related development issues, see UNCTAD, *Trade and Development Report 2007* (UNCTAD/TDR/2007, Sales No. E.07.II.D.11).



Source: UNCTAD secretariat calculations, based on Thomson Financial Datastream and European Central Bank.

While the short-term response to the crisis was for the most part appropriate, the long-run policy responses for developed and developing countries alike require wider and deeper reflection. Obviously, **lack of transparency is at the root of the current crisis.** This is mainly because, instead of spreading risk transparently, as anticipated by economic theory, market operators chose ways to “securitize” risky assets without clearly assessing their risk. Additionally, credit rating agencies failed to understand these structured financial products, and the fact that they were rarely traded led to a situation where even their approximate value was not known.

Long-term policies should thus aim at increasing the transparency of structured financial products.

This is not an easy task because, by their very nature, structured products are complex instruments. There are, however, at least two steps that should be considered at the multilateral level:

The role of credit rating agencies: Credit rating agencies, which should solve information problems and increase transparency, seem to have played the opposite role and **made the market more opaque.** Rating agencies play an ambiguous role, as the current regulatory environment renders rating decisions important in establishing what assets can be held by certain types of financial intermediaries. Moreover, **rating agencies are not fully subject to market discipline** that would increase the accuracy of their ratings. Reform the role of such agencies in evaluating

complex financial instruments is an unavoidable step towards increasing transparency. Proponents of market-based discipline suggest that conflicts of interest could be eliminated by not requiring the use of credit ratings to determine the type of assets that can be held by regulated institutions. An alternative view favours the **establishment of a regulatory agency that would supervise the functioning of credit rating agencies** and certify that AAA assets have indeed a minimal probability of default.

Maturity mismatches in non-bank financial institutions: the recent turmoil arose in part from maturity mismatches in non-bank agencies that enjoy liquidity guarantees from parent banks. In particular, banks tried to increase profitability and escape the capital requirements imposed by the Basel agreement by setting up off-balance sheet vehicles that earned large profits from transforming short-term liabilities into long-term assets. The problem with these investment vehicles is that they had a built-in maturity mismatch, and once they lost access to the market for asset-backed commercial paper, the parent banks had to step in and provide the necessary liquidity. Thus, a liquidity crisis which originated outside the banking sector immediately spilled over into the sector. This suggests that **the involvement of banks with lightly regulated agencies that could conceivably transmit liquidity and solvency problems to the banking system should be either prohibited or reported in a fully transparent way.**



The “crisis of a century” ...

As the financial crisis continues its evolution at dizzying speed, the business model underlying a growing share of financial sector activity has been increasingly discredited. This policy brief suggests that a considerable degree of public intervention is required to avoid greater damage to the financial system and the real economy. It is also imperative to strengthen regulation and increase the transparency of financial instruments and institutions. Overall, macroeconomic policy should aim at avoiding a global recession or even depression. Ultimately, deflation and not inflation may be the main economic policy challenge.

It is now more than 13 months since the crisis first erupted, and the global economy has yet to see the proverbial light at the end of the tunnel. Things are only getting worse, as a full-fledged financial meltdown looms, the US government struggles to calm markets with the biggest financial rescue package in history, and several European governments have entered the fray. The almost daily news of collapsing banks, and the fact that a once-trumpeted business model of investment banks has disappeared down the black hole of the crisis, bodes ill for a global economy that was already on the verge of recession even before the downward financial spiral accelerated.

The threat of a meltdown has brought governments back onto centre stage. Indeed, governments and central banks are the only actors that can stabilize markets at a time when confidence has been lost and all other actors are attempting to cut expenditures or clean up their balance sheets at any price, in order to avoid bankruptcy. As one household's debt is another's asset, and one company's expenditure is another's income, in a time of uniform expectations the market cannot find the bottom without countercyclical government intervention.

For policymakers worldwide, it is more important than ever to understand that the laws applicable to the overall economy are fundamentally different from those underlying the behaviour of an individual household or firm. Governments and central banks must also recognize that a modern financial market chasing higher and higher returns based on the expectation of ever-rising prices in certain sectors or certain assets is a beast that must be tamed before it causes acute damage and threatens the whole system. Governments that have watched the huge bubbles emerging from recent leveraged speculation in the Russian or Chinese stock markets, for example, should

know that such bubbles will not burst without risking systemic crisis. For other governments – including some in Eastern Europe – speculation is resulting in currency overvaluation and huge currency mismatches on the balance sheets of domestic households and companies. They should be aware of the repercussions on their trade balances and of the possible need to devalue their currency, even if this will increase the domestic currency value of the foreign debt held by households and firms.

For purely ideological reasons, some people have criticized the emphasis that has been placed during the crisis on the rediscovered role of the State. But this is the time for pragmatic solutions, not for dogma and ideological struggle. The State is back in the limelight because financial markets in boom-or-bust phases are in no way comparable to real markets, in which independent agents supply and demand goods and services according to their individual preferences and budget constraints. Unlike real markets, financial markets are characterized by frequent herding behaviour. And when they are in full speculative swing, nearly all of their participants will have the same kind of information and follow the same pattern of expectations. The uniformity of their behaviour creates manias and panics. In a boom phase, there are too few short sellers; and in a bust phase, too many.

The standard view in economics in recent years has been that financial innovation can help diversify risk because it can allocate it efficiently to agents who are better suited to bear it. This is, however, misleading, because it does not take account of the fact that at a certain stage, nearly all actors – including the agencies entrusted with rating credit risk – become infected by the euphoria over high returns. Systematically separating risk from information about creditors



and their ability to repay has now been revealed as a major flaw of modern financial engineering¹.

The “socialization of losses” associated with the huge bailout operation proposed by the US government has drawn widespread criticism. But given the risks to financial stability and the domestic economy more generally, the government had no choice but to provide insurance for some of the largest endangered institutions. This intervention to stabilize a market system and avoid a financial and real meltdown should also be seen as an attempt to minimize the negative effects on the real economy. Of course, protecting the deposit holders and creditors of imperilled banks deserves higher priority than does protecting the shareholders. Similarly, the long-run cost for both government and taxpayer should be kept in check by giving priority to government equity stakes and not just to subsidizing banks.

...and the lessons learned.

Obviously, government insurance and rescue packages should not come for free, neither in their immediate cost to the taxpayer nor over the longer term of market restructuring. The decision to bail out a set of financial institutions – indeed, an entire market – in order to avert systemic crisis must have regulatory consequences. In future, such institutions must be treated like deposit-taking banks and subjected to tighter prudential regulation – or, as has already happened in some cases, forced to change their business model and adapt to more traditional banking arrangements. The market-fundamentalist argument against stronger regulation based on the idea that market discipline alone can most efficiently monitor banks’ behaviour has clearly been discredited by this crisis. That is why the long-term lesson has to start with the recognition that, although financial services play a key role in allocating funds to high-return activities, excessive financial innovation can generate what billionaire investor Warren Buffet has called “financial weapons of mass destruction”.

Regulatory policies should aim at increasing the transparency of financial products. To this end, there are a few quick regulatory fixes that can be taken at both the national and international levels.

The first is to reassess the role of credit rating agencies. These agencies, which should solve information problems and increase transparency, seem to have played the opposite role and made the market even more opaque. The second is to create incentives for simpler financial instruments. The current regulatory stance creates a bias in favour of sophisticated financial products which, more often than not, are poorly understood by market participants. The third step is to address maturity mismatches in non-bank financial institutions and limit the involvement of banks with lightly regulated agencies. The fourth is to limit credit deterioration linked to securitization. Banks that sell their loans off quickly are less interested in

monitoring the quality of the borrowers. This problem could be mitigated by forcing banks to keep on their books a part of the loans they make.

While the very short-term fire fighting of the past few weeks has rightly been focused on limiting the direct impact of the financial crisis on the real economy, the indirect effects are looming and must be tackled next. Since the beginning of 2008, the US government has been acting to mitigate the indirect effects and restore consumer and company confidence. However, the monetary and fiscal stimulus injected at the beginning of 2007 may have faded in light of the new downward spin of the financial spiral, the breakdown of some major banks, and the negative effect that has had on expectations of a quick resolution to the crisis.

The major global problem is that the activist stance of the US authorities in reviving the real economy is swimming against the tide of reactive, or even contractionary, macroeconomic policies in other large developed countries. While the European Central Bank is actively providing liquidity to the system and thus avoiding a collapse of the interbank market, it is not providing a much-needed monetary stimulus. In fact, the ECB decided to do just the opposite, adopting an extremely hawkish monetary stance at a time when fiscal policy remains straitjacketed by the EU’s Stability and Growth Pact.

Throughout the world, economic policymakers have apparently failed to grasp the full implications of an acceleration of the deleveraging process (i.e., the process of depreciating assets without value and reducing debt at all levels) in the United States, the weak US dollar, and the uncertainty of Americans in the aftermath of the crisis. Such forces can have tremendous negative implications for the world economic outlook as a whole. The undesirable effects of the necessary but painful unwinding of unsustainable debt can be compensated only if the surplus countries – especially Japan and the large countries in the Euro zone, where growth is already anemic or negative – reduce their surplus positions at all levels and quickly provide policy stimuli to avoid a long recession or even a depression of the global economy.

International responses to the current situation that overlay concerns about inflation are misguided. The risk of a prolonged downturn or depression is far more important, as the slowdown will further reduce commodity prices. Moreover, there is not much evidence that wage-price spirals similar to the ones that triggered inflation in the 1970s are a real threat at this point. Only in very few developing and developed countries have nominal wage increases consistently exceeded the growth rates of labour productivity by more than what is tolerable in terms of inflation. Deflation, not inflation, may actually be the main economic policy challenge.

¹ See UNCTAD, *Recent developments on global financial markets* (TD/B/54/CRP.2, 28 September 2007), and *UNCTAD Policy Brief No. 1*, October 2007.



REBUILDING FINANCIAL MULTILATERALISM

With world markets absorbing the first waves of the continuing financial crisis, attention is shifting to ways to collectively manage the unwinding of global imbalances and prevent systemic turmoil. This is something that UNCTAD has advocated even in the midst of the irrational exuberance generated by unlimited speculation. In an interconnected world, no country can act in isolation. This has been at the core of UNCTAD's message of interdependence since its inception, and cannot be overemphasized today. This policy brief argues that global cooperation and global regulation are imperative in both trade and finance, and that the United Nations is the most credible international organization to spearhead the design, deliberation and launching of such efforts.

Huge problems in local markets...

The financial crisis continues to fan out across regions, countries and sectors of activity, despite desperate attempts by governments to contain the fallout and avoid contagion. But stopping the global de-leveraging process is proving difficult, as the speculative positions of millions of independent households and companies unwind in a number of important markets. The shock of a near-meltdown in the US financial system and beyond has deeply shaken the belief that business as usual will soon return to the markets; and expectations have vanished that capital yields can be achieved without making overly risky investments.

The de-leveraging is clearly as necessary as it is unavoidable. Once the speculative positions have unwound, prices will in most cases be better aligned with the underlying fundamentals of supply and demand. However, the short-term effects of the gyrations in prices and exchange rates must not be underestimated. In many cases households and enterprises could probably adjust their balance sheets smoothly by reducing their exposure to high-risk assets and liabilities – assuming they had enough time to do so. If, on the other hand, asset prices or exchange rates overshoot in the short term, the same households and enterprises might be forced into default. Current government fire-fighting thus entails the difficult balancing act of letting the fire consume what is in any case unsalvageable, while also protecting those parts of the edifice that are most vital and that can eventually be rebuilt.

The events of recent weeks have revealed the huge misallocation of resources that has accumulated over

the past decade of unfettered financial liberalization and deliberate non-intervention by governments in anonymous and purportedly efficient financial markets. For example, as UNCTAD has repeatedly pointed out since 2004,¹ speculation on currency markets – the so-called “carry trade” – has clearly moved many exchange rates in the wrong direction over long periods of time. Contrary to the predictions of mainstream economic theory, currency markets are not effectively balancing the competitive positions of nations. Rather, they are driving them away from an overall balance by allowing uncovered arbitrage in interest rate differentials. This has intensified the global imbalances visible in several large current account deficits and surpluses and in the exposure of many households and companies to risk as a result of currency mismatches. The dramatic evolution of the situation of Iceland is only the most recently discovered tip of this huge and largely unexplored iceberg.

In the same vein, speculation in primary commodities, which is also unwinding, has an upside and a downside. It is increasingly clear that the tremendous rise in prices of food, metals, oil and other primary commodities since mid-2007 has been driven largely by speculative activities, mainly through so-called “indexed funds”.² With the long-overdue correction of those prices, however, the situation of many commodity producers in developing countries has rapidly deteriorated. In addition to reducing export revenues, this correction is devaluing a good deal of the investment in equipment and infrastructure arising from the demand boom and mushrooming revenues of recent years. For countries that depend on commodity imports, the

¹ The first warning came in the *Trade and Development Report 2004*, and was repeated and enforced in the *Trade and Development Report 2007*.

² Again, UNCTAD observed early on that the changes in “fundamentals” were not sufficient to explain the explosion in these prices over a very short time span. See *Trade and Development Report 2008* and a paper by Heiner Flassbeck and Jörg Mayer written for UNCTAD's Global Network of Development Think Tanks in July 2008.

drop in prices is welcome: It allows for greater expenditure on manufactured products or services, which may provide some relief to domestic productive sectors otherwise battered by the sustained commodity price bubbles and, more recently, the fallout from the financial crisis.

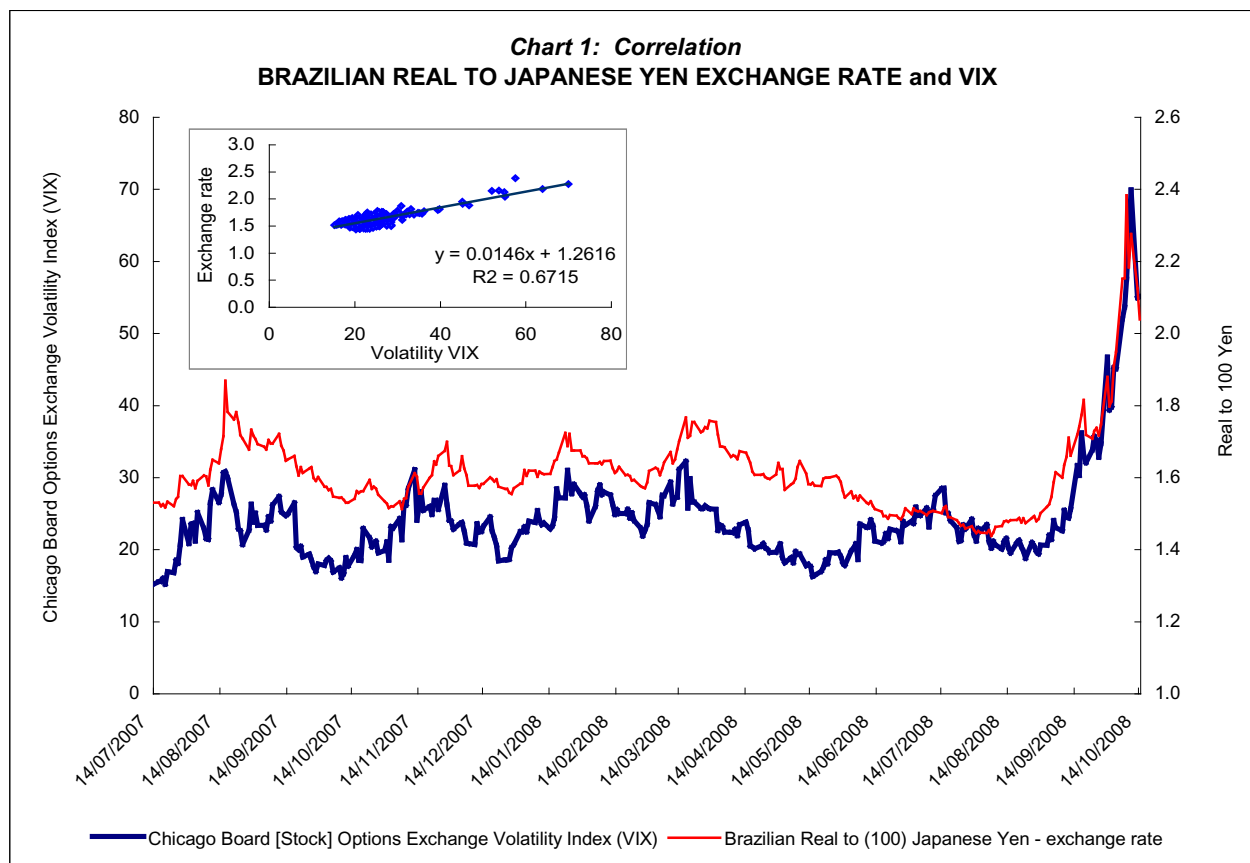
...but only global solutions can help

The charts below show a close correlation over the past few weeks between different prices – a correlation explicable solely by interrelated speculation in the commodity, currency and stock markets. The currencies of countries like Hungary, Iceland and Brazil have come under heavy devaluation pressure. Many residents of these countries hold debt in foreign currencies with low interest rates, such as the Swiss franc or the Japanese yen, while a huge amount of domestic assets is held by foreigners who had been attracted by high interest rates and currency revaluation over the past months or years – a clearly unsustainable constellation. The nominal and real appreciation of the currency led to a deterioration of the country’s competitive position, resulting in mounting current account deficits. At the same time, nearly all commodity prices and stock markets came under pressure as the perception spread that the world was on the brink of a full-blown recession and that a big drop in real activities could not be prevented by policy measures to tackle the banking and financial crisis alone.

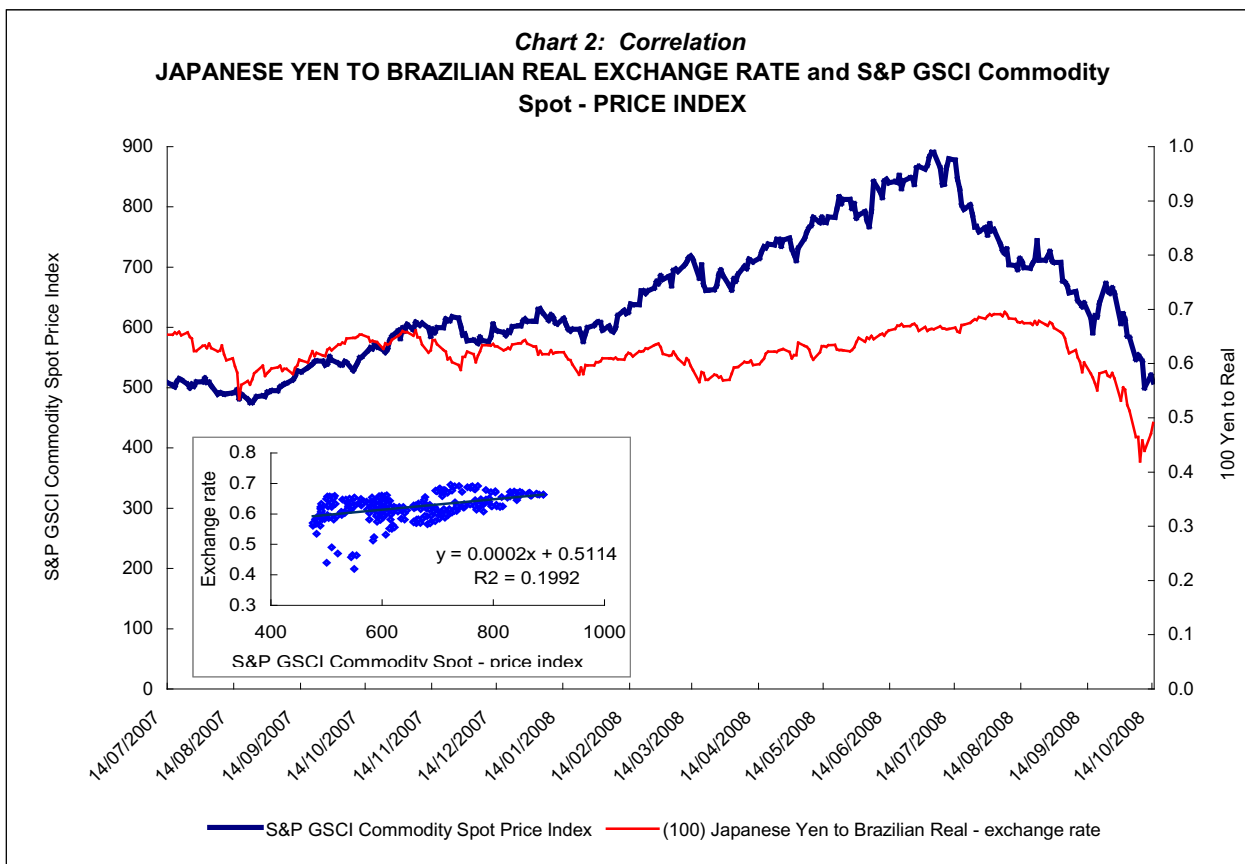
The global community must recognize that in an increasingly interdependent world where financial markets are closely interlinked by modern computer technology, no country can act in isolation. It is simply not possible today for all countries to generate current account surpluses or improve their international competitiveness simultaneously by devaluing their currency or cutting costs: One nation’s advance is another’s retreat. **Global cooperation and global regulation are imperative – not just in trade but in finance as well.** Just as international trade in goods and services requires a predictable and rules-based multilateral framework, so can a stable system for global finance be achieved only through a multilateral approach. The failure of governments to pursue such an approach is the primary reason for the current global predicament. And the implications of this predicament extend far beyond the realm of banking and financial regulation; they go to the heart of the question of how to revive and extend multilateralism in a globalizing world.

In the light of this global interdependence, once the fire-fighting in the banking sector of developed economies is over, three policy steps should follow:

- First and most urgent, the international community must assist countries whose exchange rates have come under downward pressure. These are mostly smaller countries



Source: UNCTAD secretariat calculations, based on Thomson Datastream.



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where recent unfettered speculation led to considerable currency overvaluation, and which are now unable to stabilize their exchange rate at a reasonable level, as general market panic threatens to drive the currency to levels of undervaluation that are fundamentally unjustified. In these cases, assistance should take the form of stand-by arrangements, including direct intervention in the currency markets by the counterparts – i.e., those countries whose exchange rate is appreciating.

- Second, the international community must assist those commodity-dependent countries where speculation threatens to drive prices far below the level that was reached before the full unfolding of international speculation, in the summer of 2007. Here, the support can take the form of direct intervention in markets as well as grants and loans to buffer and stabilize the sharp drop in revenues.
- Third, all countries with low and declining inflation rates must engage immediately in countercyclical measures in terms of stimulus by fiscal measures and interest rate cuts.

But even if prompt action can be envisaged in some of these areas, the likelihood of a sharp and prolonged downturn of the

world economy remains high. Fortunately, policymakers in many developed countries stand ready to fight big fires at home. Unfortunately, however, the thick smoke at home has clouded their view of their neighbours' fence. Awareness of the degree of interdependence and closely related fires in developing and transition countries has so far been minimal. But as the alarm bells start ringing and the smoke begins to clear, the needs of these trading partners may soon become apparent.

Once the biggest fires are extinguished, the international community will have to reflect carefully on the options for system reform. Given the open channels between the international trade, financial and banking systems, a truly global, cooperative and non-partisan approach to tackling the most important issues like commodity and currency speculation must be found. But developing countries have only a limited voice in international financial institutions. The global institution that possesses the most credibility for implementing such an approach is therefore, more than ever, the United Nations.

