Executive summary

The global economic crisis has yet to bottom out. The major industrial economies are in a deep recession, and growth in the developing world is slowing dramatically. The danger of falling into a deflationary trap cannot be dismissed for many important economies. Firefighting remains the order of the day, but it is equally urgent to recognize the root causes for the crisis and to embark on a profound reform of the global economic governance system.

To be sure, the drivers of this crisis are more complex than some simplistic explanations pointing to alleged government failure suggest. Neither "too much liquidity" as the result of "expansionary monetary policy in the United States", nor a "global savings glut" serves to explain the quasi-breakdown of the financial system. Nor does individual misbehaviour. No doubt, without greed of too many agents trying 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. The sudden unwinding of speculative positions in practically all segments of the financial market was triggered by the bursting of the United States housing price bubble, but all these bubbles were unsustainable and had to burst sooner or later. For policymakers who should have known better to now assert that greed ran amok or that regulators were "asleep at the wheel" is simply not credible.

Financial deregulation driven by an ideological belief in the virtues of the market has allowed "innovation" of financial instruments that are completely detached from productive activities in the real sector of the economy. Such instruments favour speculative activities that build on apparently convincing information, which in reality is nothing other than an extrapolation of trends into the future. This way, speculation on excessively high returns can support itself – for a while. 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). As expectations are confirmed by the media, so-called analysts and policymakers, betting on ever rising prices appears rather risk-free, not reckless.

Contrary to the mainstream view in the theoretical literature in economics, speculation of this kind is not stabilizing; on the contrary, it destabilizes prices. As the "true" price cannot possibly be known in a world characterized by objective uncertainty, the key condition for stabilizing speculation is not fulfilled. Uniform, but wrong, expectations about long-term price trends must sooner or later hit the wall of reality, because funds have not been invested in the productive capacity of the real economy, where they could have generated increases in real income. When the enthusiasm of financial markets meets the reality of the – relatively slow-growing – real economy, an adjustment of exaggerated expectations of actors in financial markets becomes inevitable.

In this situation, the performance of the real economy is largely determined by the amount of outstanding debt: the more economic agents have been directly involved in speculative activities leveraged with borrowed funds, the greater the pain of deleveraging, i.e. the process of adjusting the level of borrowing to diminished revenues. As debtors try to improve their financial situation by selling assets and cutting expenditures, they drive asset prices further down, cutting deeply into profits of companies and forcing new "debt-deflation" elsewhere. This can lead to deflation of prices of goods and services as it constrains the ability to consume and to invest in the economy as a whole. Thus, *the attempts of some actors to service their debts make it more difficult for others to service their debts*. The only way out is government intervention to stabilize the system by "government debt inflation".

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It is instructive to recall the end of the Bretton Woods system, under which the world had enjoyed two decades of prosperity and monetary stability. Since then, the frequency and size of

imbalances and of financial crises in the world economy have dramatically increased, culminating in the present one. Since current-account imbalances are mirrored by capital account imbalances, they serve to spread quickly the financial crisis across countries. Countries with a current-account surplus have to credit the difference between their export revenue and their import expenditure to deficit countries, in one form or another. The dramatic increase of debtor–creditor relations between countries also has to do with the way in which developing economies emerging from financial crises since the mid-1990s tried to shelter against the cold winds of global capital markets.

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 particularly great potency in today's world, with its glaring lack of governance of international monetary and financial relations. Another important reason for growing imbalances is movements of relative prices in traded goods as a result of speculation in currency and financial markets, which leads to considerable misalignments of exchange rates. Speculation in currency markets due to interest rate differentials has led to overspending in the capital-receiving countries that is now unwinding. With inward capital flows searching for high yield, the currencies of capital-receiving countries (with higher inflation and interest rates) appreciated in nominal and in real terms, leading to large movements in the absolute advantages or the level of overall competitiveness of countries vis-à-vis other countries.

The growing disconnection of the movements of nominal exchange rates with the "fundamentals" (mainly the inflation differential between countries) has been a main cause of the growing global imbalances. For rising economic welfare to be sustainable, it has to be shared without altering the relative competitive positions of countries. Companies gaining market shares at the expense of other companies are an essential ingredient of the market system. But if nations gain at the expense of other nations because of their superior competitive positions, dilemmas can hardly be avoided. If the "winning" nations are not willing to allow a full rebalancing of competitive positions over the long run, they force the "loser" nations into default. This is a phenomenon that J. M. Keynes some 80 years ago called the "transfer problem"; its logic is still valid.

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. There is growing evidence that financialization of commodities futures markets played an important role in the scale and degree of market volatility. Prices in many physical markets for commodities can be driven up by the mere fact that everybody expects higher prices, an expectation that may itself be the result of futures prices that are driven up by shifts of speculative power between financial markets, commodity futures and currency markets.

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The global financial crisis arose amidst the failure of the international community to give the globalized economy credible global rules, especially with regard to international financial relations and macroeconomic policies. The speculative bubbles, starting with the United States housing price bubble, were made possible by an active policy of deregulating 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 – were promoted by the use of "securitization" through instruments such as residential mortgages-backed securities that seemed to satisfy investors' hunger for double-digit profits. It is only at this point that greed and profligacy enter the stage. In the presence of more appropriate regulation, expectations on returns of purely financial instruments in the double-digit range would not have been possible.

With real economic growth in most developed countries at under 5 per cent, such expectations are misguided from the beginning. It may be human nature to suppress frustrations of the past, but

experts, credit rating agencies, regulators and policy advisors know that everybody cannot gain above average and that the capacity of the real economy to cope with incomes earned from exaggerated real estate and commodity prices or misaligned exchange rates is strictly limited. The experience with the stock market booms of the "new economy" should have delivered that lesson, but instead a large number of financial market actors began to invest their funds in 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 is only now, through the experience of the crisis, that the relevance of real economic growth and its necessary link to the possible return on capital is slowly coming to be understood by many actors and policymakers.

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 similar events in the future 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.

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In financial markets, the similarity of the behaviour of many financial market participants and the limited amount of information that guides their behaviour justify considerably greater government intervention. Contrary to atomistic goods and services markets and the colossal quantity of independent data that help form prices, most of the information that determines the behaviour of speculators and hedgers is publicly accessible and the interpretation of these data follows some rather simple explanatory patterns. Neither market participants nor Governments can know equilibrium prices in financial markets. But this is not a valid argument against intervention, as we have learnt now that financial market participants not only have no idea about the equilibrium, but their behaviour tends to drive financial prices systematically away from equilibrium. Governments do not know the equilibrium either, but at some point they are the best positioned to judge when the market is in disequilibrium, especially if functional/social efficiency is to be the overriding criterion of regulation.

If the failure of financial markets has shattered the naïve belief that unfettered financial liberalization and deliberate non-intervention of Governments will maximize welfare, the crisis offers an opportunity to be seized. Governments, supervisory bodies and international institutions have a vital role, allowing society at large to reap the potential benefits of a market system with decentralized decision-making. To ensure that atomistic markets for goods and for services can function efficiently, consistent and forceful intervention in financial markets is necessary by institutions with knowledge about systemic risk that requires quite a different perspective than the assessment of an individual investor's risk. Market fundamentalist *laissez-faire* of the last 20 years has dramatically failed the test. A new start in financial market regulation needs to recognize inescapable lessons from the crisis, such as:

- Financial efficiency should be defined as the sector's ability to stimulate long-term economic growth and provide consumption smoothing services. A key objective of regulatory reform is to devise a system that allows weeding out financial instruments which do not contribute to functional, or social, efficiency;

- Regulatory arbitrage can only be avoided if regulators are able to cover the whole financial system and ensure oversight of all financial transactions on the basis of the risk they produce;

- Micro-prudential regulation must be complemented with macro-prudential policies aimed at building up cushions during good times to avoid draining liquidity during periods of crisis;

- In the absence of a truly cooperative international financial system, developing countries can increase their resilience to external shocks by maintaining a competitive exchange rate and limiting currency and maturity mismatches in both private and public balance sheets. If

everything else fails, back-up policies, such as market-friendly capital controls, can limit risk accumulation in good times;

- Developing countries regulators should develop their financial sectors gradually in order to avoid the boom-and-bust cycle;

- Regulators based in different countries should share information, aim at setting similar standards and avoid races to the bottom in financial regulation.

As for the growing presence of financial investors on commodity futures exchanges, several immediate areas are suggested for improved regulation and global cooperation:

- Comprehensive trading data reporting is needed in order to monitor information about sizeable transactions in look-alike contracts that could impact regulated markets, so that regulators can understand what is moving prices and intervene if certain trades look problematic;

- Effective regulatory reform should also close the swap dealer loophole to enable regulators to counter unwarranted impacts from over-the-counter markets on commodity exchanges. Therefore, regulators should be enabled to intervene when swap dealer positions exceed speculative position limits and may represent "excessive speculation";

- Another key regulatory aspect entails extending the product coverage of detailed position reports of United States-based commodity exchanges and requiring non-United States exchanges that trade look-alike contracts to collect similar data. Stepped-up authority would allow regulators to prevent bubble-creating trading behaviour from having adverse consequences for the functioning of commodity futures trading;

- Renewed efforts are needed to design a global institutional arrangement supported by all concerned nations, consisting of a minimum physical grain reserve (to stabilize markets and to respond to emergency cases and humanitarian crises) as well as an intervention mechanism. Intervention in the futures markets should be envisaged when a competent global institution considers market prices to differ significantly from an estimated dynamic price band based on market fundamentals. The global mechanism should be able to bet against the positions of hedge funds and other big market participants, and would assume the role of "market maker".

In a globalized economy, interventions in financial markets call for cooperation and coordination of national institutions, and for specialized institutions with a multilateral mandate to oversee national action. In the midst of the crisis, this is even more important than in normal times. The tendency of many Governments to entrust to financial markets again the role of judge or jury in the reform process – and, indeed, over the fate of whole nations – would seem inappropriate. It is indispensable to stabilize exchange rates by direct and coordinated government intervention, supported by multilateral oversight, instead of letting the market find the bottom line and trying to "convince" financial market participants of the "credibility of policies" in the depreciating country, which typically involves pro-cyclical policies such as public expenditure cuts or interest rate hikes.

The problems of excessive speculative financial activity have to be tackled in an integrated fashion. For example, dealing only with the national aspects of re-regulation to prevent a recurrence of housing bubbles and the creation of related risky financial instruments assets would only intensify speculation in other areas such as stock markets. Preventing currency speculation through a new global monetary system with automatically adjusted exchange rates might redirect the speculation searching for quick gains towards commodities futures markets and increase volatility there. The same is true for regional success in fighting speculation, which might put other regions in the spotlight of speculators. Nothing short of closing down the big casino will provide a lasting solution.