UNCTAD
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

N° 3, October 2008

UNCTAD POLICY BRIEFS

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 engineering[1].

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 overplay 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.

UNCTAD/PRESS/PB/2008/3

[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.