



## 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 – a tenet that 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, discussion 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.

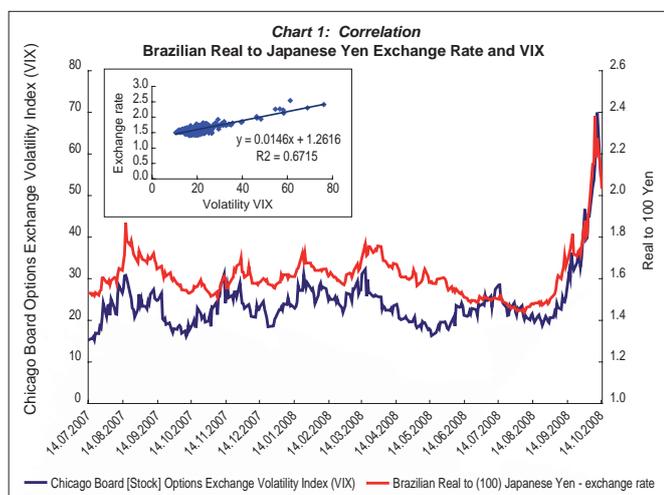
The events of recent weeks have uncovered the huge misallocation of resources that has accumulated over the past decade of unfettered financial liberalization and deliberate non-intervention by governments in anonymous and purportedly efficient financial

markets. For example, as UNCTAD has repeatedly pointed out since 2004,<sup>1</sup> 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.

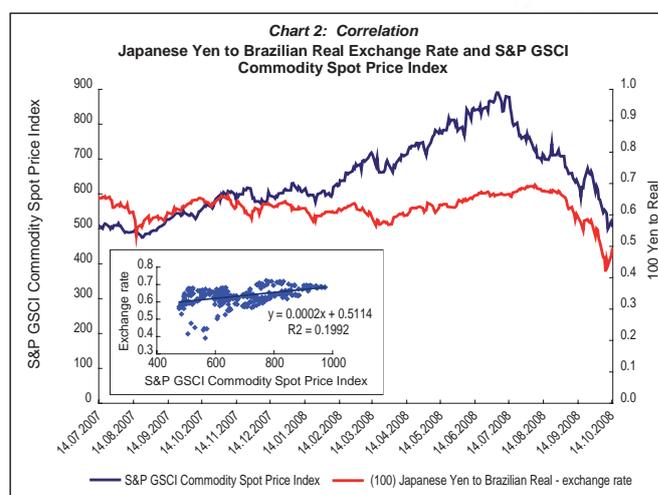
In the same vein, speculation in primary commodities, which is also unwinding, has an upside and a downside. It is increasingly clear that the tremendous rise in prices of food, metals, oil and other primary commodities since mid-2007 has been driven largely by speculative activities, mainly through so-called “indexed funds”.<sup>2</sup> 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 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.

<sup>1</sup> The first warning came in the *Trade and Development Report 2004*, and was repeated and enforced in the *Trade and Development Report 2007*. Another early treatment by UNCTAD of the crisis appeared in *Note by the UNCTAD secretariat on recent developments on global financial markets* (TD/B/54/CRP.2).

<sup>2</sup> 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*.



Source: UNCTAD secretariat calculations, based on Thomson Datastream.



## ...but only global solutions can help

The charts above 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 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.