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“Experience shows that when policies falter in managing capital flows, there is no limit to the damage that international finance can inflict on an economy.”

Yilmaz Akyüz, “Capital Flows to Developing Countries in a Historical Perspective: Will the current Boom End with a Bust?”

Today, as speculation and leverage in global, financialised commodity markets reach manic levels; as we witness an ‘epic rout’ (FT 5 May, 2011) in commodity prices, and as the boom in capital flows peaks, is another crash inevitable? And is it coming soon?

I know from experience that while it may be possible to analyse fundamentals, it is always difficult to predict precisely what dynamic will trigger the next crisis, and when it will happen. Back in 2003, together with colleagues at the new economics foundation in London, and with very little funding, I assembled and edited a series of essays on the ‘outlook’ for the global economy. We titled it: ‘Real world economic outlook’, and added a subtitle, ‘the legacy of globalization: debt and deflation’. We intended the report to be annual, and to act as a counter to the IMF’s annual World Economic Outlook, which in our view was irrationally optimistic about developments in the global economy.

We were pretty pessimistic about global imbalances, and predicted a crash. Sadly, our timing was way out: the crash was four years away. It does not always help to be right on the fundamentals. Given the inevitability of the then forthcoming crash, we argued that there was once more a need for a ‘great transformation’ of the global economy. The starting point we wrote ‘will be to reverse the most pernicious elements of the ‘globalization’ experiment’ by the ‘taming of financial markets through the re-introduction of capital controls; restraints in the growth of credit; the establishment of an International Clearing Agency; and a Tobin Tax’.

Back then it was hard to talk/write about these matters – and be heard. Our cheerfully-titled report and predictions did not hit the best-seller lists. Funding for the project was withdrawn, and the project wound down. It’s major flaw? We had breached areas of economic debate that at the time were carefully circumscribed. It took the financial crisis of 2007-9 to loosen the intellectual chains to which orthodox economics had so heavily tied economic debate. Today the Tobin Tax, or Robin Hood Tax is a high-profile issue, with some signs that EU governments are considering implementation of such a tax. (See point 8 of Euro leaders’ statement, March 11, 2011). So that taboo has been broken.
Another taboo subject then - control over capital flows (now re-designated as ‘capital flows management’ by the IMF) is now, in contrast to 2003, actively discussed, even though debate is limited to controls on inward flows. Debate on controls over outward flows – illicit capital flight that makes it so easy for corporations and elites to export their gains – are still taboo.

The big change came in February, 2010, when to the surprise of many, IMF staff accepted that ‘capital controls are part of the policy mix’. And by April, 2011, the Fund had developed a ‘framework’ to help countries manage capital flows.

This framework was promptly rejected by the G24, led by India and Brazil, for several reasons. First because the IMF was dealing with symptoms, not causes – i.e. the easy money policies of the Federal Reserve. Quantitative easing (QE) was and is, intended to pump liquidity into the US economy; to allow funds to cascade down through the banking system, for lending to companies that would, in turn, invest in infrastructure and the creation of jobs. Because, as Prof. Chick has noted, there is neither economic debate about the money supply, nor overt management of the money supply, there is no control over how banks deploy low-interest rate funds generated by the Fed. US and US-based foreign banks are free to ignore the Fed’s mandate or the US administration’s priorities. Like the public utilities they effectively are, banks instead are free to draw down from the Fed’s easy and cheap money-creation – QE - to speculate, and accrue private gains in mainly developing and emerging markets (DEEs). The IMF shows little interest in the implications for the global money supply of credit-creation by central banks and, in the view of many, turns a blind eye to these de-stabilising activities. Instead fund staff lecture poor countries on the management of capital inflows. The G24 will have none of this, and instead demands that a light be shone on the causes of the boom in speculative capital flows.

Second, as Lesetja Kganyago, chairman of the G-24 and director-general of South Africa’s National Treasury told the Wall St Journal: the group opposed the IMF framework because the fund proposed to integrate it into its surveillance program and policy recommendations. G24 leaders – especially those leading some of the world’s biggest democracies - rightly expect to enjoy the same policy autonomy privileges usually reserved for leaders of the G8.

All of this makes a recent paper on the current boom in capital flows by Yilmaz Akyüz of the South Centre so timely, comprehensive and insightful. Akyüz is chief economist at the South Centre, Geneva and former director of the Division on Globalization and Development Strategies at UNCTAD, where he edited a range of UNCTAD’s annual reports.

Akyüz begins by noting that there have been three generalised boom-bust cycles in private capital flows since the end of the Second World War: all with devastating impacts on developing and emerging markets. The first started in the late 1970s, and ended with the Latin American debt crisis in the early 1980s. The second started in the early 1990s and was followed by the East Asian financial crisis of 1997/8; and by defaults in Latin America and Russia. ‘The third cycle’ argues Akyüz ‘started in the early years of the new millennium and ended in the second half of 2008 with the subprime crisis. This was soon followed by a new boom, the fourth in the post-war era, which started in the first half of 2009 and is continuing with full force as of early 2011.’
Akyüz argues that this current cycle will most likely end with a reversal in the upswing in commodity prices, because commodity “markets have become more like financial markets...with several commodities treated as a distinct asset class, attracting growing amounts of money in search for profits from price movements.”

The commodity bubble began with a new financial instrument invented by Goldman Sachs – the Goldman Sachs’ Commodity Index (GSCI) - so argues Frederick Kaufman in the April, 2011 edition of Foreign Policy. Next, commodity price inflation received a boost in 1999, when the US Commodities Futures Trading Commission deregulated futures markets. “All of a sudden, bankers could take as large a position in grains as they liked, an opportunity that had, since the Great Depression, only been available to those who actually had something to do with the production of our food” writes Kaufman. “Since the bursting of the tech bubble in 2000, there has been a 50-fold increase in dollars invested in commodity index funds. In the first 55 days of 2008, speculators poured $55 billion into commodity markets, and by July, $318 billion was roiling the markets.”

“Any market where a $2,000 down payment will buy you a futures contract on a $1-million Treasury bill promises the customer action that can match any packed casino for electrifying excitement.”


As has been well documented, rising commodity markets have enriched the few, but impoverished millions of people. Driven in part by higher fuel costs, global food prices are 36 percent above their levels a year ago and remain volatile, the World Bank argued in a recent report: “A further 10 percent increase in global prices could drive an additional 10 million people below the $1.25 extreme poverty line. A 30 percent price hike could lead to 34 million more poor. This is in addition to the 44 million people who have been driven into poverty since last June as a result of the spikes. The World Bank estimates there are about 1.2 billion people living below the poverty line of US$1.25 a day.”

Falling commodity prices, therefore, are central to any strategy for reducing global poverty.

Have they begun to fall? As I write this (6 May, 2011) global commodity markets have been subject to what the FT calls an ‘epic rout’ “...the worst sell-off for many commodities since the collapse of Lehman Brothers and, in dollar terms, the biggest-ever for Brent crude.”

While these markets may well stabilise, and be talked up (and down) again, it daily becomes clear to even the most orthodox economists that, in the real world, the global economic
‘recovery’ is very weak indeed. As that reality dawns on speculators (and long before it dawns on policy-makers) will there follow a collapse in index-traded commodity prices?

Furthermore, margin debt — the amount that speculators borrow for speculative purposes — is rising quickly, just as it did in advance of the 1929 stock market crash, the Nasdaq bubble and the subprime crash of 2006/7. Indeed, as the blogger, Cullen Roche of ‘Pragmatic Economist’ notes, margin debt is now at ‘manic levels’. Debit balances at margin accounts skyrocketed to $20.7 billion in February. ‘Only two other times historically have we seen leverage rise so much so fast and both times it was during a manic phase – during the tech bubble of the late 1990s and the credit bubble just a short four years ago.’

These debit balances, as an anonymous player at an investment boutique notes:

‘increase speculative volatility in things like oil, which goes from $40 to $150 to $50 to $130 over and over. Paper profits change accounts but the real economy is not theoretically affected, except that it is held hostage to this casino game of rapidly changing prices for basic materials and necessities that businesses and consumers use to make decisions. So the economy is in actuality disrupted by the casino, the casino creates no net wealth, and everyone is worse off as this charade continues.’

We’ve been here before. Akyüz argues that the post-2000 ‘swings in commodity markets show strong correlation with those in capital flows’ to developing and emerging markets (DEEs) and with it ‘the exchange rate of the dollar’. After rising constantly, both commodity prices and flows declined in 2008, when falling prices triggered the exit of capital from commodity-rich economies. Both recovered rapidly afterwards.

These factors are reinforcing with ‘greater force’ argues Akyüz, the ‘macroeconomic imbalances and financial fragility in several DEEs….Imbalances that started with the subprime bubble but were interrupted by the Lehman collapse.’

Akyüz cautions that the continued boom in commodity prices could eventually cause rampant inflation in China, which could lead to a sizeable slowdown. ‘This, together with the global oversupply built during the boom, would bring down commodity prices, and the downturn would be aggravated by an exit of large sums of money from commodity futures. This would make investment in commodity-rich countries unviable and loans non-performing, leading to risk aversion, flight to safety and a reversal of capital flows to DEEs.’ The most vulnerable of these are countries in Latin America and Africa that have enjoyed the twin benefits of global liquidity and the boom in commodity prices. They could be hit twice – by falling capital flows and commodity prices, he argues. South East Asian economies are less vulnerable, because they have built up substantial current account surpluses and large stocks of reserves.

Akyüz concludes correctly that these unstable capital flows and commodity price booms show that ‘the international monetary and financial system needs urgent reforms’. He quotes Ben Bernanke’s speech to the Banque de France in February, 2011:

“Looking back on the crisis, the US, like some emerging-market nations during the 1990s, has learned that the interaction of strong capital inflows and weaknesses in...
the domestic financial system can produce unintended and devastating results. The appropriate response is...to improve private sector financial practices and strengthen financial regulation, including macroprudential oversight. The ultimate objective should be to be able to manage even very large flows of domestic and international financial capital in ways that are both productive and conducive to financial stability."

Fine words indeed. But words are not enough. Akyüz argues that ‘macroprudential regulations, as usually defined, would not be sufficient to contain the fragilities that capital flows can create’. Instead, controls over both inflows and outflows should be part of the arsenal of public policy, used as and when necessary and in areas and doses needed, rather than introduced as *ad hoc*, temporary measures.

And we do not have to re-invent the wheel. ‘The instruments are well known and many of them were widely used in the advanced economies during the 1960s and 1970s.’

While politicians, economists and regulators may be more alert than they were in advance of the 2007-9 slump, they remain submissive to a global banking lobby and passive at the wheel of the global economy. This leaves commodity speculators unfettered by regulation and free to steer the global economy towards another financial precipice. Only this time central bankers and governments will have fewer tools and resources (i.e. taxpayer largesse) available with which to rescue bankers and speculators from their reckless and worthless endeavours.

Nevertheless, soon after this coming crisis – which will again cause massive economic failure and dislocation, intense human suffering and pain - controls on capital flows will finally be applied. Be sure of that. But by then, it will be too late.