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Speculation and Sovereign Debt – An Insidious Interaction

Executive Summary report prepared by Gerald Epstein and Pierre Habbard for the ITUC General Council (Elewijt, Belgium, 17-18 October 2011)

FINANCIAL MARKET REALITIES – IN WHOSE INTEREST?

- key facts –

- Financial speculation is fuelled by deregulation, financial "innovation" and the growing concentration of assets and financial power – as seen in the rise of large financial conglomerates but also of lightly regulated and supervised "shadow banking" systems – and credit rating agencies riddled with conflicts of interest.

- Over-the-counter (OTC) derivatives trading – notional amounts outstanding – rose from 2.6 times world GDP in 1998 to 9 times world GDP in 2010. As a point of comparison, listed equity, debt securities and bank assets have remained in the range of 1.5-2 times world GDP during that period.

- The number of derivatives contracts on commodity exchanges grew modestly between 1993 and 2004 from 10 million to 15 million. But since 2005 it has exploded, both before and after the-crisis, reaching a level of 65 million in 2010. Over the same period commodity price volatility has increased significantly, including in 2008 when prices of many food commodities attained record highs.

- High Frequency Trading (HFT), using computer generated exchanges executing frequent but small trades in milliseconds to make profits from incremental price movements and/or exploiting differences in pricing between two separate trading venues, accounted for 25% of spot foreign exchange transactions worldwide in 2010, 56% of US equity trading (up from 21% in 2005), and 38% of European equity trading (up from 9% in 2007).

- Speculative forms were facilitated by the complicity of the three credit rating agencies that currently form a global oligopoly: Moody's, Standard & Poor's and Fitch. Their ratings are pro-cyclical – they are over-optimistic during growth cycles and over-pessimistic during downturns. As a result, they are agents of financial speculation, and yet no transparent due diligence or peer review is required as a basis for their assessments.

Speculation and Sovereign Debt – An Insidious Interaction

This paper identifies the main sources of financial speculation pre- and post-crisis 2008 and assesses how sovereign bond markets and public finances are being affected, particularly in light of the current Euro debt crisis.

What is speculation?

- *Financial speculation consists of a short term directional bet on the price movement of an asset that is guided by 'noise trading' (guessing what other traders are guessing, and buying or selling faster than they do).*

- *It leads to the mis-pricing of risks and hence the misallocation of assets through short term volatility or long term swings in asset prices (i.e., speculative bubbles). It diverts valuable resources – financial, political and human – away from productive investments in the real economy that would create jobs and incomes.*

- *It is fuelled by deregulation, financial "innovation" and the growing concentration of assets and financial power – as seen in the rise of large financial conglomerates but also of lightly regulated and supervised "shadow banking" systems – and credit rating agencies riddled with conflicts of interest.*

What's the connection between financial speculation and the sovereign debt crisis?

This paper shows a chain reaction in the sequencing of the crisis and the interaction between financial speculation and sovereign debt:

Pre-crisis and as a result of years of de-regulation and lax supervision, governments let large banks grow and diversify their activities to the point where they became too big too fail, to be governed, or to be supervised - banks like AIG, Merrill Lynch, Lehman Brothers (in 2008), Bear Stearns (in 2007). Governments also let shadow banking activities, market infrastructure and trading expand without proper supervision. As a result, financial trading and speculation has grown far larger than can be justified by the underlying needs of the real economy.

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- In all major OECD economies, assets held by the three largest banks as a share of GDP rose significantly in the run up to the crisis, and have continued to do so post-crisis. A similar process of concentration is taking place in all segments of the derivatives markets.

In the run-up to the crisis, the combination of ever-larger financial conglomerates and increasingly deregulated markets fed new forms of speculative behaviour, pre and post crisis, including "carry trade", "high frequency trading", and "naked short selling" (forms of speculation that are all explored further in this report). Massive speculation is also seen in the fast growing market for "exchange traded funds".

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In response to the global recession that followed the 2008 crisis, governments implemented economic stimulus programme which were financed by unprecedented increases in public debt. Simultaneously, in order to save the banks a massive transfer of private debt, and hence of risk and liabilities from banks to governments took place.

*- Of the USD1722bn delivered to bankers worldwide in the form of direct government support to banks (capital injections and asset purchases), USD1270bn are still outstandin*g.

Governments also provided "implicit" guarantees creating the belief in the markets that governments will bail out the banking sector if needed in the future, just as they did in 2008-2009.

- the currently A+ rated large banks in Germany would fall to the BB+ "junk bonds" category, were it not for the implicit backing of the German government.

Because the transfer from private to public was not conditioned to any proper degree on re-regulation or restructuring of the financial sector – there were "no strings attached" to the bailing out of the bankers – the cost of financial speculation in effect is being internalised on the governments' balance sheets.

- That cost can be measured by the size of the "contingent liabilities" – e.g., explicit and implicit government guarantees to the banks – to which governments are exposed and which are factored into their sovereign ratings: they represent on average 20-30% GDP for OECD economies, constituting a significant addition to existing public debt (on average slightly over 70% of GDP).

Speculative attacks continue due to governments' failure to undertake the necessary regulatory measures to control or eliminate the vehicles of financial speculation that caused the 2007-2008 crisis in the first place. The financial crisis has thus been transformed into a sovereign debt crisis.

What Can be Done About It?

In a world of robust and efficient international governance systems, governments would have cooperated in response to the above sequencing of the crisis since 2007. They would have collectivised the risks each of them faced individually and they would have accelerated financial regulation to choke off the sources of financial speculation.

But that is not what happened.

In response to the financial crisis in late 2008, G20 "Recommendations for Strengthening Financial Stability" were agreed in London in April 2009 and should have been implemented by now. In the US, the crisis led to a

parallel though connected regulatory reform process which culminated with the adoption of the Dodd-Frank Act in July 2010. Both the G20 action plan and, in the US, the Dodd-Frank Act aim at stabilising and keeping afloat the current financial system.

However, in both cases implementation has become bogged down by extremely strong lobbying efforts on the part of financial actors and their allies in politics. Actual reforms have been implemented very slowly, or they have been pushed aside altogether.

This report therefore suggests a three-tier response to tackle the destructive forces of financial speculation -

- Limit destabilizing short term bets by financial traders:

- Creating a financial transaction tax, which would go a long way toward curbing short term speculative trading, including high frequency trading;
- Requiring all forms of derivatives trading to shift to organised exchanges;
- Restricting short-term financial trading strategies, including a ban on naked short selling.

- Limit destructive risk taking by large financial firms:

- Splitting large financial conglomerates through mandatory separation of commercial and investment banking activities;
- Considering nationalisation of large financial conglomerates as part of restructuring the financial sector;
- Reforming the corporate governance of banks;
- Preventing de-stabilising leaks from the regular to the shadow banking systems by imposing strict regulations on such entities;
- Proceeding with a gradual phasing out of all government guarantees introduced post-crisis by instead creating or expanding industry-financed insurance schemes such as the IMF-proposed financial stability contribution (FSC);
- Increasing the legal liability of rating agencies, reducing reliance on them in banking and public finance prudential structures and shifting their business model back to an investor-pay model.

- Re-orientate financial institutions and markets and reverse the balance of power between democratically governments and the financial markets:

- Diversifying the financial sector through a larger array of public and cooperative financial institutions;
- Protecting financial reforms processes from regulatory capture by bankers, including through stronger regulation of political parties' financing.