Third World Network - Africa

Analytical Note[ℵ]

GLOBAL FINANCIAL AND ECONOMIC CRISES: ISSUES FOR ECONOMIC DEVELOPMENT IN AFRICA

In 2009, the systemic roots and inter-connections of the various crises of food, energy, commodities and finance which had emerged in the previous years finally asserted themselves in a full-blown crisis of the global economy in its entirety. The frenzy of financial speculation which had driven the prices of energy, mineral and agricultural commodities to phenomenal levels in the middle of 2008 had, by the end of that year, ran aground in the catastrophe of the credit crunch, financial collapse and seizure in real sector economic activity around the world. This unfolded throughout 2009 in the form of ever-deepening contractions in global trade, investment flows, and production. The effects are still being felt today.

The fall-outs from, and responses to, this crisis are likely to dominate the opening years of coming decade. Not only do the crisis and its afrermaths pose fundamental issues for resolution in their own right. Furthermore, by exposing the inherent limits of the current global economic system, it is forcing attention to difficult issues of re-adjustment, re-balancing, even re-organisation of the global economy. In the process, it is re-shapes existing challenges of, and debates and struggles around global governance, especially global economic governance. This applies to a wider scope of issues, including the economics and politics involved in facing up to climate change.

The crisis has illuminated the challenges and prospects of Africa's long-term developmental prospects along three interrelated lines. It has: (a) exposed new forms and organisation of global finance and economic activity of which Africa has become part, and on terms which make it is most vulnerable; (b) highlighted crucial aspects of the emerging new poles of power and accumulation of wealth in the global economic and political order which are shaping the post-crisis responses and will affect Africa's place and fortunes in this order; and above all (c) brought to fore once again the deep-seated structural constraints and systemic vulnerabilities of Africa's economies.

Neo-liberal Financial System in the Global Crisis

It is now trite knowledge that the collapse of the banking system which led to the greatest global economic downturn since World War II was triggered by the bursting of the sub-prime housing bubble in the US. But it is to the **nature** of the **financial system** itself that is owed the fact that sub-prime mortgage failures triggered the shutting down, within a matter of months, of half of all lending in the US economy –stretching from mortgages, to car loans, credit card

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ℵ BY TETTEH HORMEKU – PRESENTATION AT ITUC–AFRICA FORUM ON GLOBAL FINANCIAL AND ECONOMIC CRISIS.
EDITED EXRACT FROM LONGER TWN-AFRICA BRIEF ON GLOBAL CRISIS AND ISSUES OF AFRICA DEVELOPMENT. IT IS STILL WORK IN PROGRESS. NOT FOR WIDER CIRCULATION AND QUOTATION

receivables, commercial paper, commercial property and corporate debt – and roped in banking collapses across Europe and Asia, as well as parts of Latin America and patches in Africa.

Two dimensions of this system are relevant in this context. The first is the nature of instruments, practices, operators and animating purpose that came to embody (or at least dominate) mainstream "finance" in the advanced industrial world, pioneered in the Anglo-Saxon economies and eventually adopted in continental Europe and Japan.

Never-ending cycles of financial sector de-regulation had abolished the distinctions between commercial and investment banking, and transformed the essence of financing away from the traditional activities of (long or short term) investment for profit in real sector economic activity. Rather commercial banks and investment banks (with their special investment vehicles and conduits), hedge funds, securities firms, and insurance companies and many other operators all came to focus, as the main means of fabulous profit, on speculative arbitrage – i.e., the buying and selling financial and real assets to exploit price differences and price shifts – and the generation and blowing of asset price bubbles.

Credit and asset markets came together in a mutually re-inforcing process whereby credit expansion resulted in asset bubbles, and which in turn provided the basis for further growth in credits. Huge loans were raised on assets that did not yet exist in the ownership of the borrower, and the loans themselves became assets which were traded, with companies raising more and more debt to leverage further purchases. Direct links between finance and real sector economic activity became more tenuous. Instead finance chased itself and grew big by creating and selling billions of dollars of complicated financial instruments based on assets whose values are inflated in the very process of buying and selling the instruments linked those assets.

The instruments were pieces of jig-saw complexity, the process by which they were traded opaque, and their value established outside any objective valuation –in fact no one ever knew what they were actually worth. The instruments that were generated in one area became a means of profit in another area: housing loans became high-profit business for the insurance companies whose shares were bought by pension funds, etc. Huge sums were being made simply through this process of transforming debts into investments and shifting them around.

Everybody got in on the act, everywhere, from town halls in England to the Bank of China. Record profits were made; fabulous wealth created. Except that it was wealth that existed only on paper. And when in time the underlying assets were found wanting, the whole system came crashing down—with seizure of credit, which in turn starved production, distribution and consumption in the real economy of the needed money.

African economies have been linked into such 'financialisation' in two forms. The first is through the participation of financial operators in Africa in and/or the linking of African financial systems into the buying and selling of such instruments, and into the system of speculative arbitrage and asset bubbling. How big a challenge this poses is linked to how far down the road of financial liberalisation African countries have gone and will continue to go.

Related to this are the processes of financial re-structuring in Africa, the imbalanced integration into global financial circuits, the pressures on the availability of finance and domestic resource mobilisation for the real economy across Africa. (See Appendix I-IV) for some stylised indication of the extent and implication of this)

Secondly, and more crucially, is the transformation of primary commodities (agricultural and minerals) into the assets of financial speculation. Through the activities of speculators seeking to profit from price volatility, investment in commodity-indexed assets increased rapidly after 2003 to about $317billion in 2008. The effect has been increased volatility in commodity markets, as speculators shifted in and out of commodities or particular commodities in line with speculatory calculations. The spectacular rises in the prices of food, fuel, mineral products, up till the mid 2008; and the equally spectacular collapse in prices thereafter is related to this. Such speculation on primary commodities

dampened at the height of the crisis but is on the rise again. Unless curbed, it is likely to become a permanent feature of the international commodity trade.

Thus, on top of the 'traditional' issues about primary commodity prices stability is now added a new layer of challenges.

> In July 2010, for example, Andrew Ward, the manager of Armajaro, a London based hedge fund, purchased US$ 1 billion (€770 million) worth of futures contracts for 241,000 tons of cocoa. This represented about 7% of the world's annual output of cocoa, and is enough to supply Germany for an entire year . "Even more amazingly, the contracts were for delivery, which means that Armajaro owned almost all the cocoa beans sitting in warehouses all over Europe. Although the announcement of good harvests ensured that the spot prices did not rise as Armajaro had hoped, that such hoarding is permitted in this day and age stretches belief.
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> (FAO note published on the eve of an emergency meeting of the organisation on September 24.

(For more details on the mechanisms of financialisation and commodity price fluctuation see Appendix VI)

International Financial System, Global Flows and the Crisis

But the entire system of speculative finance grew up from and fed back into the international system for regulation of financial flows among nations that evolved over the past 30 years. The implications of this for the way economies organise trade, currencies, exchange rates, investment flows and the problems posed to the entire global system is another dimension of the crisis whose resolution is critical to Africa's future.

The collapse of the Breton Woods system of fixed exchange rates, the sweeping away of exchange controls and the privatisation of exchange-rate risk, the abolition of capital controls, these created the first elements of the financial risk-hedging and trading that spurred on further de-regulations and ever-newer and exotic instruments of financial dealing.

Liberalisation of international capital flows enabled such financial dealings and instruments to cross national borders. This opened developing country economies to the destabilising effect of unregulated capital inflows, and made them especially vulnerable to speculative movements of short-term investment, so-called 'hot money'. Hence, the bouts of financial crisis and turbulence inflicted on these economies around the world in the closing decade of the last century, from Asia to Russia and Latin America.

After the particularly catastrophic crises of the 1997-1998, the East Asian countries adopted the policies of accumulating huge foreign- (dollar) denominated reserves and managed exchange rates (effectively exchange rate under valuation) to maintain export-led growth strategy.

This has made it possible for Asia's economies to run huge trade surpluses and become net-exporters of capital. In the Western world, this has been mirrored by the finance-dominated and debt-driven US economy, reliant on bubble-driven consumption, with huge chronic trade deficits and net import of Asian capital. Feeding into this with its own contradictions is Europe with a discipline of a common currency across countries with large differences in productivity and no common fiscal policy, unable to take coherent advantage of its internal market, parts of which are as bubble-driven as the US and other parts as export-led, trade surplus, capital exporting as Asia.

This is the context of huge global imbalances which form the back-drop of "post-crisis" strategies and re-positioning in the global economy. In each region, the crisis poses a specific agenda of long-term economic re-adjustment: for Asia a shift from exports towards increased domestic consumption; in America, a shift in the opposite direction, towards more exports and away from debt-fuelled consumption; in Europe, the trick of doing both but within a more internal fiscal coherence around internal expansion and growth.

For such re-adjustment to occur with minimal destabilisation requires international co-ordination around a number of key challenges. Central to these are changes to the international financial system and architecture, and in particular (a) systemic overhaul of financialisation, and (b) the continued role of the dollar as an international reserve currency.

Alas, as the outcomes of the G20 meetings so far have shown, even the seeming consensus of barely a year ago on stimulus spending out of the depression has already unravelled. A worse fate has befallen long term issues of international financial architecture: they are side-stepped. For, as many have suggested, America's finance dominated economy is rooted in the over-privileged global position of the dollar. This in turn allows America to continue to acquire real resources through the printing of money, providing it not only with "unpaid-for imported consumer goods but the ability to deploy large military forces overseas without having to tax its citizens to do so."

Thus, instead of a co-ordinated global response based on real realignments in the global order, regionalist approaches on the basis of a lowest common international denominator. How each of the main regions go about meeting their challenges will pose external challenges for other parts of the world. But as the main effective/real economic blocs of the global economy, Asia, Europe and America are, to different degrees, able to balance the externally disruptive effects of each other's adjustments with the depth of intra-region economic organisation and resources available to each.

Further, in two of the mains economic blocs, which unlike the US are not unitary economy, but in fact a territory of economic operations integrated in regional form, the possibility of tensions are being met with an explicit strategy for further consolidation. Europe and its "Global Europe Strategy"; Asia and its Chiang Mai initiatives. Even Latin America – combines a major economy with major initiatives ~ Mercosur, ALBA…

It is in this international context that Africa will have to deal with its own problems that have been highlighted by the crisis. In this process, there are opportunities from the global re-adjustments from which Africa can benefit. For instance, a greater shift of focus to domestic consumption and migration to high technology and productivity economy may mean China may transition out of some industries that African countries can transition into in the global division of labour. Or China's necessary redeployment of its trillion-dollar reserves can release extra investment capital to Africa.

But there is a basic threat. As a political region but barely an economic bloc (or even alliance of blocs), Africa runs the risk of simply being landed with the external effects of the approaches that each of the major economic blocs of the global economy take to their own re-adjustment. A wide range of issues come at play here –from fights over rules of access to global resources to power their the dynamism of their respective economies to finance regimes, etc.

Africa and the Crisis

This gives added impetus to the need to anchor Africa's response in its own agenda, based on the imperative of structural economic transformation and in the framework of regional economic integration. The locus of this agenda is national and regional. But out of these arise a set of policies that Africa must put on the international agenda of post-crisis re-adjustments. Such an agenda must be directed at the structural rigidities of African primary commodity export dependent economies that were so cruelly exposed by the crisis.

African (and other developing) countries bore little responsibility for the crises. However, they were exposed to, and at the same time lacked the resources to address, the worst effects of these crises. At the same time, the specific trade and financial shocks through which the crisis has been transmitted to Africa also manifested the structural weaknesses of Africa's economies.

Africa's economies are structured around the dependence of these economies on the export of (a narrow basket of) primary mineral or agricultural commodities with unstable prices and on the import of most other products, especially manufactured goods; their weak or non-existent domestic industrial sector; the narrow, disarticulate base of domestic production; the shallow national and fragmented regional markets; and financial systems and services and other infrastructure geared predominantly to external trade.

These have been re-inforced by the policies followed by African governments in the past three decades, African governments have followed economic reform programmes based on the primacy of self-regulating markets, severely reduced government involvement, and the attraction of foreign investment, for promoting development. "By the end of the 1990s, the production structure of the [Africa] sub-region was reminiscent of the colonial period, consisting overwhelmingly of agriculture and mining." [UNCTAD 2010 Trade and Development Report]

Africa's dependence on primary commodity exports exposed it to the most dramatic collapse in revenues. For, with the notable exception of gold, most prices of all major commodities crashed, and continued to do so through the year. At the same time, however, the dependence of African countries on imports for most of their domestic and industrial consumption meant that their import bill remained very high.

The collapse in demand for primary commodity exports and the related closure of mines and loss of hundreds of thousands of jobs related to the primary commodity economy led to further contraction of domestic demand. This added onto decades-old structural trend of jobless growth. The policy regimes within which mining flourished made mining an into enclave activity without job-creating linkages with the rest of the economy.

More importantly, the decades of rigid and misplaced policies of (natural comparative advantage-based) export-led growth which had strengthened primary commodity export dependence had also wiped out much of domestic manufacturing and frozen growth in various sectors of the domestic economy.

To top it all, the decades of application of liberal investment and trade regimes (and related tariff and domestic fiscal policies) by African countries to attract foreign investment and promote foreign trade meant that they captured very little of the wealth of the increased trade and investment, and had few resources of their own in the face of the crisis of the magnitude that they confronted.

Thus, as the global crises deepened, African countries found themselves in a situation where, as a result of the structures of their economies and their economic policies, they had few of the resources and structural levers to apply the kind of policies called for by the crisis and being applied even in other developing country regions. They did not have the finance for the phenomenal stimulus packages being applied elsewhere. Nor were such stimulus packages, if applied, likely to have any significant effect, in the immediate term, beyond boosting imports.

Transforming African economies from this primary-commodity export-dependence is the fundamental task whose urgency is once again re-affirmed by Africa's peculiar vulnerability in the current crisis. But progress on this transformative agenda is tied to the existing struggles to protect Africa's autonomy of action and economic policy options.

Appendix I.
Typology of controls on portfolion investments and FDI in African countries

Control Type/Country	Debt		Equity and FDI	
	Inflows	Outflows	Inflows	Outflows
No controls				
Uganda	Bonds Money Market Securities Derivatives	Bonds Money Market Securities Derivatives	Shares FDI	Shares FDI
Zambia	Bonds Money Market Securities Derivatives	Bonds Money Market Securities Derivatives	Shares FDI	Shares FDI
Minimal Controls				
Nigeria	No Controls **Bonds and Derivatives** Controls Money Mart Securities	No Controls **Bonds and Derivatives** Controls Money Mart Securities (Control on resident purchases abroad)	No Control **Shares and FDI** (registration only required for FDI)	No Control **Shares and FDI**
South Africa	Selective Controls **(Resident sale or issue abroad)** Applied to Bonds, Money Mart Securities, Derivatives	Controls Bonds, Money Mart Securities, Derivatives	Controls on Resident sale or issue abroad on Shares No controls on FDI	Limits on resident purchases abroad applied to Shares controls on FDI
Controls				
Cameroun	Controls on Bonds, Money Mart Securities Derivatives: not applicable	Controls on Bonds, Money Mart Securities Derivatives: not applicable	Shares: controls on issuing, advertising, and sale of securities more tht CFAF 100mn FDI. no control below CFAF 100mn	Shares: no controls FDI. no control below CFAF 100mn

Table taken from Victor Murinde, 2009, "Capital Flows and Capital Account Liberalistion in the Post-Financial Crisis Era: Challenges, Opportunities and Policy Responses", p9

Appendix II
Examples of Capital Account Liberalisation

Status/Sequencing	Fully Open	Partially Open	Fairly Open
One-Step opening	**Uganda** (1997) Liberalization part of a broad package of market-oriented reforms, privatization and trade liberalization		
Sequenced opening	**Zambia** (1990-95) 1993-94: liberalization of capital transactions 1995: banks allowed to accept foreign currency deposits Liberalization part of broad reforms focused on economic stabilization, competitiveness, and debt restructuring, accompanied by financial market reforms	**Ghana** (1995-2006) Mid-1990s: partial liberalization of portfolio and direct investment 2006: Foreign Exchange Act, allowing nonresidents to buy government securities with maturities of three years or longer, minimum holding period of one year Liberalization following economic stabilization and debt restructuring: parallel reforms in the primary government debt and stock markets; efforts to develop interbank money and foreign exchange markets and to strengthen financial sector supervision and soundness	**Cameroon** (2000 to present) 2000: Harmonization of national foreign exchange regulations and liberalization of capital flows within CEMAC Prudential limits on banks' net open foreign positions Residents' foreign exchange deposits prohibited Continued administrative restrictions remain on most capital outflows No immediate plans for further opening
	Nigeria (1985-2006) Economic reforms initiated in the mid-1980s and subsequently reinvigorated in the mid-1990s, starting with treatment of dividends and profit repatriation, then later removal of controls in other areas such as derivatives and real estate; some remaining administrative restrictions Foreign exchange market reformed at various points from the mid-1980s to wholesale Dutch auction system initiated in 2006, along with growing importance of interbank market, and the effective unification of the parallel and official		

	exchange rates		
		Tanzania (1990) 1990: start of FDI liberalization 1997: full liberalization of FDI flows 1998: supporting foreign exchange regulations Continuing restrictions on portfolio investments (government securities) FDI liberalization coinciding with privatization program, creation of one-stop shop, and investment promotion policy	**Senegal** (1999 to present) 1999: elimination of controls on inward FDI and foreign borrowing by residents Continuing administrative restrictions remain on capital outflows to non-WAEMU countries

Table taken from Victor Murinde, 2009, "Capital Flows and Capital Account Liberalistion in the Post-Financial Crisis Era: Challenges, Opportunities and Policy Responses", p10

Appendix III

Appendix III
Impact of the crisis on selected African Financial Markets in an international context

Country/Region	Index name	Index code	Benchmark 31.07.2008	Value, at end week 12.02.2009	Losses during financial crisis (%)
AFRICA					
Cote d'Ivoire	BRVM Composit Index	BRVM CI	242.54	169.34	-30.18
Egypt	CASE 30 Index	CASE 30	9251.19	3600.79	-61.08
Kenya	Kenya Stock Index	KSE	4868.27	2855.87	-41.34
Mauritius	Mauritius AllShares	SEMDEX	1735.77	1005.69	-42.06
Morocco	Casa All Share Index	MASI	14134.70	10352.81	-26.76
Nigeria	NSE All Share Index	NSE	52916.66	23814.46	-55.00
South Africa	All Share Index	JALSH	27552.65	20650.38	-25.05
Tunisia	Tunis se Tnse Index STK	TUNINDEX	3036.87	3049.60	0.42
BRIC					
Brazil	Bovespa Index	IBOVESPA	59505.00	41674.00	-29.97
Russia	RTS Index	RTSI	1966.68	624.21	-68.26
India	BSE SENSEX 30	BSESN	14355.75	9634.74	-32.89
China	Shanghai Composite	SHANGHAI COMPOSIT	2775.72	2320.79	-16.39
OECD					
UK	FTSE Index	FTSE 100	5411.90	4189.60	-22.59
USA	Dow Jones Industrial	DJ Index	11378.02	7850.41	-31.00
France	CAC 40 Index	CAC40	4392.36	2997.86	-31.75
Japan	Nikkei 225 Index	N225	13376.81	7779.40	-41.84

Table taken from Victor Murinde, 2009, "Capital Flows and Capital Account Liberalistion in the Post-Financial Crisis Era: Challenges, Opportunities and Policy Responses", p17.

Appendix IV
Exchange rates for selected African Countries
(local currenct per US dollar)

Country	December 2006	December 2008	February2009	% change (Dec 2008 - Feb 2009)
Botswana	6.03	7.52	7.96	5.89
Ghana	0.92353	1.21	1.34115	10.84
Nigeria	126.5	130.75	145.35	11.17
South Africa	6.9737	9.3035	9.9498	6.95
Tanzania	113.209	128.030	130.246	1.73

Table taken from Victor Murinde, 2009, "Capital Flows and Capital Account Liberalistion in the Post-Financial Crisis Era: Challenges, Opportunities and Policy Responses", p18.

Appendix V

International Reserves excluding gold for African and BRIC countries

AFRICA	2000	2001	2002	2003	2004	2005	2006
Burundi	32.9	17.7	58.8	67	65.8	100.1	130.5
Kenya	897.7	1064.9	1068	1481.9	1519.3	1798.8	2415.8
Malawi	243	202.5	161.5	122	128.1	158.9	133.8
Mauritius	897.4	835.6	1227.4	1577.3	1605.9	1339.9	1269.6
Mozambique	723.2	713.2	802.5	937.5	1131	1053.8	1155.7
Rwanda	190.6	212.1	243.7	214.7	314.6	405.8	439.7
Uganda	808	983.4	934	1080.3	1308.1	1344.2	1810.9
Tanzania	974.2	1156.6	1528.8	2038.4	2295.7	2048.8	2259.4
Zambia	244.8	183.4	535.1	247.7	337.1	559.8	719.7
Cameroon	212	331.8	629.7	639.6	829.3	949.4	1716.2
Algeria	12024	18082	23238	33125	43246	56303	77913.8
Egypt	13118	12926	13242	13589	14273	20609	24461.5
Morocco	4823.2	8473.9	10133	13851	16337	16188	20340.7
Tunisia	1811	1989.2	2290.3	2945.4	3935.7	4436.7	6773.2
Botswana	6318.2	5897.3	5473.9	5339.8	5661.4	6309.1	7992.4
Lesotho	417.9	386.5	406.4	460.3	501.5	519.1	658.4
Namibia	259.8	234.3	323.1	325.2	345.1	312.1	449.6
South Africa	6082.8	6045.3	5904.2	6495.5	13141	18579	23056.9
Swaziland	351.8	271.8	275.8	277.5	323.6	243.9	372.5
Benin	458.1	578.1	615.7	717.9	640	656.8	912.2
Burkina Faso	243.6	260.5	313.4	752.2	669.1	438.4	554.9
Gambia	109.4	106	106.9	59.3	83.8	98.3	120.6
Ghana	232.1	298.2	539.7	1352.8	1626.7	1752.9	2090.3
Nigeria	9910.9	10457	7331.3	7128.4	16956	28280	42298.8
Senegal	384	447.3	637.4	1110.9	1386.4	1191	1334.2
Sierra Leone	49.2	51.3	84.7	66.6	125.1	170.5	183.9
Togo	152.3	126.4	205.1	204.9	359.7	194.6	374.5
Brazil	32434	35563	37462	48847	52462	53245	85156.1
China	168277	215605	291128	408151	614500	821514	1068493
India	37902	45871	67666	98938	126593	131924	170737

Table taken from Victor Murinde, 2009, "Capital Flows and Capital Account Liberalistion in the Post-Financial Crisis Era: Challenges, Opportunities and Policy Responses", p19.

Appendix VI

Financialisation and Commodity Price Volatility

Over the 78 months from early-2002 to mid-2008 the IMF's overall commodity price index rose steadily and nominal prices more than quadrupled. During the same period, UNCTAD's non-fuelcommodity index tripled in nominal terms and increased by about 50 per cent in real terms. Sincepeaking in July 2008, oil prices have dropped by about 70 per cent, while non-fuel prices havedeclined by about 35 per cent from their peak in April 2008. This reversal is considerable; however, itcorresponds only to about one seventh of the previous 6-year increase, so that commodity pricesremain well above their levels of the first half of this decade. While the timing differed from commodity to commodity, both the surge in prices and their subsequent sharp correction affected allmajor commodity categories, and they affected both exchange-traded commodities and those that areeither not traded on commodity exchanges or not included in the major commodity indices(figure 3.1). It is this latter category that many financial investors use for their investment incommodities.

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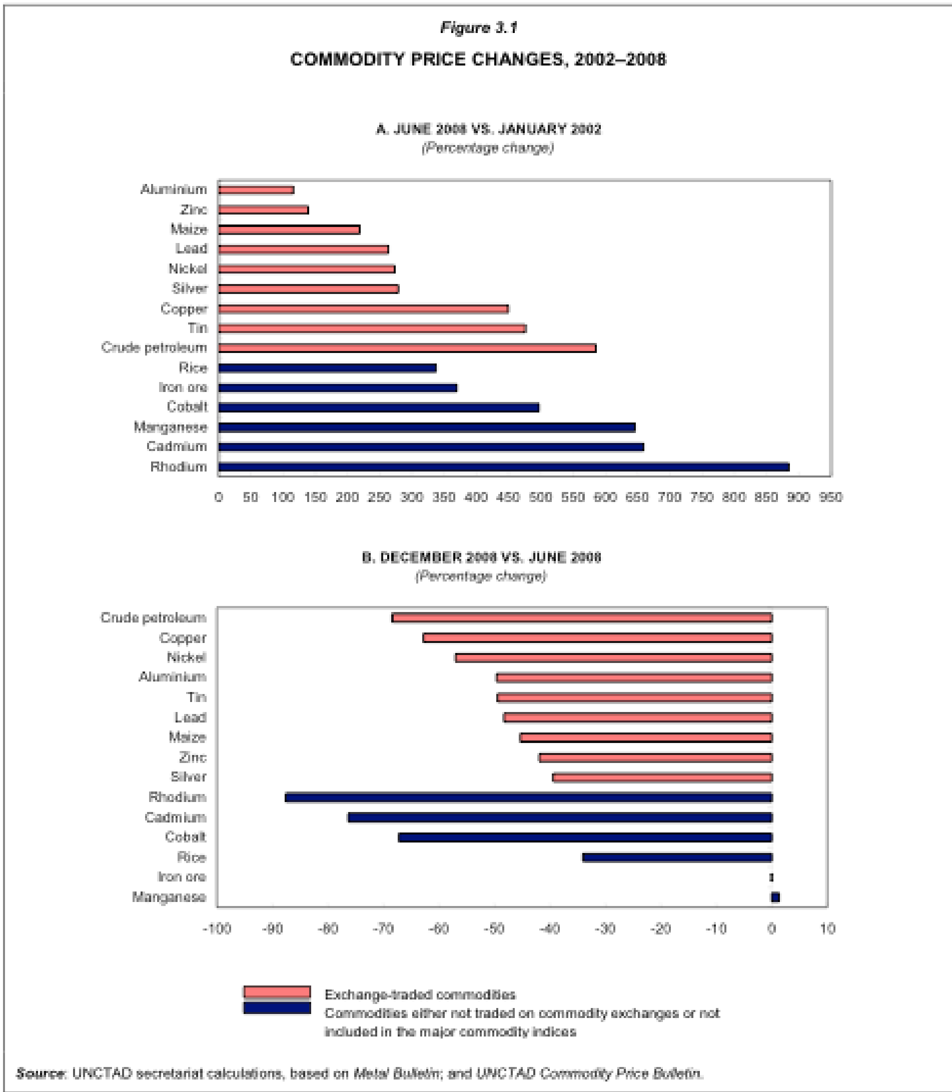
The sometimes extreme scale of changes in recent commodity price developments and the fact that prices had increased and subsequently declined across all major categories commodities suggests that, beyond the specific functioning of commodity markets, broader macroeconomic and financial factors which operate across a large number of markets need to be considered to fully understand recent commodity price developments. The depreciation of the dollar clearly was one suchgeneral cause for the surge in commodity prices. But a major new element in commodity trading over the past few years is the greater weight on commodity futures exchanges of financial investors that consider commodities as an asset class. Their possible role in exacerbating price movements away from fundamentals at certain moments and for certain commodities is the focus of the following sections.

Financial investors have been active in commodities since the early 1990s. Initially, they mainly comprised hedge funds that have short-term investment horizons and often rely on technical analysis. The involvement of financial investors took on new proportions in the aftermath of the dotcom crash in 2000 and started a meteoric rise in early 2005. Most of this financial investment in commodities uses swap agreements to take long-term positions in commodity indexes. Two common indexes are the Standard & Poor's Goldman Sachs Commodity Index (S&P GSCI) and the Dow Jones-American International Group Commodity Index (DJ-AIGCI), which are composites of weighted prices of a broad range of commodities, including energy products, agricultural products, and metals.[9]

Investors in commodity indexes aim at diversifying portfolios through exposure to commodities as an asset class. Index investors gain exposure in commodities by entering into a swap agreement with a bank which, in turn, hedges its swap exposure through an offsetting futures contract on a commodity exchange. All index fund transactions relate to forward positions – no physical ownership of commodities is involved. Index funds buy forward positions, which they sell as expiry approaches and use the proceeds from this sale to buy forward again. This process – known as "rolling" – is profitable when the prices of futures contracts with a long maturity are below the prevailing price of the futures contract with a remaining maturity of one month (i.e. in a "backwardated" market) and negative when the prices of futures contracts with longer maturities are higher (i.e. in a "contango" market). Trading volumes on commodity exchanges strongly increased during the recent period of substantial commodity price increases. The number of futures and options contracts outstanding on commodity exchanges worldwide increased more than fivefold between 2002 and mid-2008 and, during the same period, the notional value of over-the-counter (OTC) commodity derivatives has increased more than 20-fold, to $13 trillion (figures 3.2 and 3.3).[10] But financial investment sharply declined starting in mid-2008. This parallel development of commodity prices and financial investment on commodity futures markets is a first indicator for the role of large-scale speculative activity in driving commodity prices first up and then down

UNCTAD: *The Global Economic Crisis: Systemic Failures and Multilateral Remedies,* 2009, P23-24



Source: UNCTAD secretariat calculations, based on *Metal Bulletin*; and *UNCTAD Commodity Price Bulletin*.