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Chapter I

CURRENT TRENDS AND ISSUES IN THE WORLD ECONOMY

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A. Recent trends in the world economy

1. Global growth

The pace of global economic recovery has been slowing down in 2011, following a rebound from its nosedive worldwide in 2009. This year, world gross domestic product (GDP) is expected to grow by 3.1 per cent, compared with 3.9 per cent in 2010. Although the economic slowdown will affect developed and developing countries alike, growth rates will remain much higher in the developing economies (at close to 6.3 per cent) than in the developed ones (at around 1.8 per cent), while the transition economies of the Commonwealth of Independent States are set to grow at an intermediate rate of close to 4.5 per cent (table 1.1). This continues the "two-speed recovery" witnessed in 2010, and the more rapid growth rates of all developing regions since 2003 compared with that of developed countries. More importantly, it may be indicative of some specific obstacles to an economic revival in the developed countries that are not affecting most developing countries.

As forecast in the *Trade and Development Report 2010*, inventory rebuilding and the fiscal stimulus programmes have been gradually ending since mid-2010. Hence, as the initial impulses from temporary factors are waning, the fundamental weakness of the recovery in developed economies has become apparent, namely that the growth of private demand is not sufficiently strong to maintain the momentum of the upturn. This is partly due to the persistently high levels of household indebtedness in several countries, and the reluctance on the part of banks to provide new credit. But a major reason is that consumers do not expect their incomes to rise consistently over the medium term. In Europe, Japan and the United States, the current recovery is characterized not only by jobless growth – a feature common to previous recoveries – but also by stagnating wages, which hitherto had been a phenomenon observed mainly in Japan. Unemployment remains high and is dragging down wage growth. This effect is compounded by more flexible labour markets, and could reach a point where negative expectations of wage-earners could hinder the return to normal patterns of consumption, and consequently, of investment in fixed capital. Profits rebounded in the first phase of the recovery, as a result of the positive demand effects from government programmes, but developed economies lack the energy for sustainable expansion due to the continuing weak demand of wage-earners.

Another factor that could delay or endanger economic recovery is the implementation of tighter fiscal and monetary policies based on the questionable diagnosis that private-sector-led economic growth

Table 1.1

WORLD OUTPUT GROWTH, 2003–2011

(Annual percentage change)

Region/country	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011[a]*
World	**2.7**	**4.1**	**3.6**	**4.1**	**4.0**	**1.7**	**-2.1**	**3.9**	**3.1**
Developed countries	**1.9**	**3.0**	**2.5**	**2.8**	**2.6**	**0.3**	**-3.6**	**2.5**	**1.8**
of which:									
Japan	1.4	2.7	1.9	2.0	2.4	-1.2	-6.3	4.0	-0.4
United States	2.5	3.6	3.0	2.6	2.1	0.4	-2.6	2.9	2.3
European Union (EU-27)	1.4	2.5	2.0	3.2	3.0	0.5	-4.2	1.8	1.9
of which:									
Euro area	0.8	2.2	1.7	3.1	2.8	0.5	-4.1	1.7	1.8
France	1.1	2.5	1.9	2.2	2.4	0.2	-2.6	1.5	2.1
Germany	-0.2	1.2	0.8	3.4	2.7	1.0	-4.7	3.6	3.0
Italy	0.0	1.5	0.7	2.0	1.5	-1.3	-5.0	1.0	0.9
United Kingdom	2.8	3.0	2.2	2.8	2.7	-0.1	-4.9	1.3	1.3
European Union (EU-12)[b]	4.3	5.5	4.7	6.5	6.2	4.0	-3.6	2.2	3.2
South-East Europe and CIS	**7.2**	**7.7**	**6.5**	**8.3**	**8.6**	**5.4**	**-6.7**	**4.1**	**4.4**
South-East Europe[c]	4.1	5.6	4.7	5.2	6.1	4.3	-3.7	0.5	2.2
CIS, incl. Georgia	7.6	7.9	6.7	8.7	8.8	5.5	-7.0	4.5	4.5
of which:									
Russian Federation	7.3	7.2	6.4	8.2	8.5	5.6	-7.9	4.0	4.4
Developing countries	**5.4**	**7.5**	**6.9**	**7.6**	**8.0**	**5.4**	**2.5**	**7.4**	**6.3**
Africa	5.2	8.0	5.3	6.0	5.9	5.4	1.8	4.4	3.5
North Africa, excl. Sudan	6.6	4.9	5.1	5.4	4.7	4.8	1.5	4.1	0.2
Sub-Saharan Africa, excl. South Africa	5.5	13.0	5.4	6.8	7.2	6.8	4.2	5.5	5.8
South Africa	2.9	4.6	5.3	5.6	5.5	3.7	-1.8	2.8	4.0
Latin America and the Caribbean	1.8	5.8	4.6	5.5	5.6	4.0	-2.2	5.9	4.7
Caribbean	3.0	3.7	7.5	9.4	5.9	3.0	0.3	3.3	3.4
Central America, excl. Mexico	3.8	4.2	4.8	6.5	7.1	4.3	-0.5	3.6	4.3
Mexico	1.4	4.1	3.3	4.8	3.4	1.5	-6.5	5.5	4.0
South America	1.9	6.9	5.1	5.5	6.7	5.3	-0.4	6.4	5.1
of which:									
Brazil	1.1	5.7	3.2	4.0	6.1	5.2	-0.6	7.5	4.0
Asia	6.9	8.1	8.1	8.7	9.1	5.8	4.2	8.3	7.2
East Asia	7.1	8.3	8.6	10.0	11.1	7.0	5.9	9.4	8.0
of which:									
China	10.0	10.1	11.3	12.7	14.2	9.6	9.1	10.3	9.4
South Asia	7.8	7.5	8.2	8.4	8.9	4.5	5.8	7.2	6.9
of which:									
India	8.4	8.3	9.3	9.4	9.6	5.1	7.0	8.6	8.1
South-East Asia	5.6	6.5	5.8	6.2	6.6	4.2	1.0	7.8	5.0
West Asia	6.3	9.4	7.8	6.7	5.2	4.8	-0.8	6.0	6.4
Oceania	2.4	2.0	2.2	1.4	2.8	2.5	1.4	2.9	3.5

Source: UNCTAD secretariat calculations, based on United Nations, Department of Economic and Social Affairs (UN/DESA), *National Accounts Main Aggregates* database, and *World Economic Situation and Prospects (WESP) 2011: Mid-year Update;* ECLAC, 2011; *OECD.Stat* database; and national sources.

Note: Calculations for country aggregates are based on GDP at constant 2005 dollars.

a Forecasts.

b New EU member States after 2004.

c Albania, Bosnia and Herzegovina, Croatia, Montenegro, Serbia and The former Yugoslav Republic of Macedonia.

is already under way. For example, the International Monetary Fund (IMF) believes fiscal expansion is no longer needed since "private demand has, for the most part, taken the baton" (IMF, 2011a: xv). Moreover, the Bank for International Settlements (BIS) argues that inflation is presently the main risk in an otherwise recovering world economy, and therefore suggests "policy [interest] rates should rise globally" (BIS, 2011: xii). According to these views, economic policy should no longer aim at stimulating growth, but instead should focus on controlling inflation and reducing fiscal deficits and public debt. But with nearly all the governments of the large developed economies trying to curb public expenditure, including cutting or freezing public sector wages, the consequent diminished expectations of private households threaten to derail recovery of the world economy. With weak labour market indicators in the United States, risks of financial contagion in Europe and a deterioration in some leading indicators for global manufacturing (JP Morgan, 2011), the implementation of restrictive macroeconomic policies increases the probability of a prolonged period of mediocre growth, if not of an outright contraction, in developed economies.

Developing economies present a different picture. Rapid recovery from the crisis and the subsequent sustained growth have been the result of various factors, including countercyclical measures, the recovery of commodity prices since mid-2009 and an expansion of real wages. Some analysts suggest that higher commodity prices have been the main cause of recovery in developing countries (IMF, 2011a). However, while the higher prices have been essential for commodity exporters, commodity-importing developing countries have also grown at a rapid pace. A major factor that should not be underestimated is that in many developing countries the Great Recession has not led to cuts in real wages; on the contrary, domestic income and demand have remained on a growth trajectory. In that sense, the recovery in many developing countries, which has been largely wage-led, contrasts with that of developed economies, which is associated with wage stagnation. In addition, since the financial systems in developing countries were largely unaffected by the most recent crisis, their domestic demand is further supported by the availability of domestic credit. Therefore, their growth has become increasingly dependent on the expansion of domestic markets, which may explain the continuing growth and resilience of these economies, despite slow growth in developed countries.

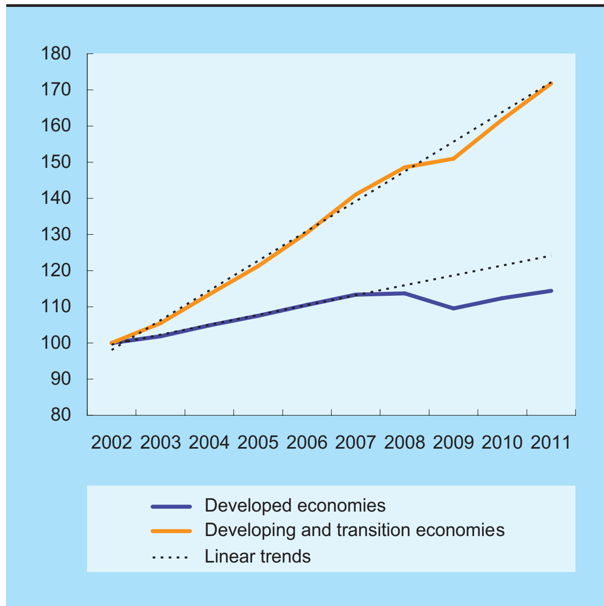
However, economic expansion in developing countries faces several challenges. Paradoxically, some of their problems result from their resistance to financial contagion during the recent crisis. In particular, because emerging market economies appeared to be less risky, they attracted even more short-term capital inflows. Such flows may generate asset bubbles and pressures for exchange rate appreciation, which would erode their competitiveness. Moreover, higher inflation in several of these countries, owing largely to commodity price increases, has led them to tighten monetary policy and raise interest rates, which further attract foreign capital in the form of carry-trade operations. At the same time, volatility in highly financialized commodity markets suggests that a negative shock originating in developed economies might exert a strong downward pressure on the prices of primary commodity exports, as already happened in 2008 (see chapter V of this *Report*). Hence, despite the greater role of domestic markets in driving growth, there are significant external risks to sustained economic expansion in developing countries due to economic weaknesses in developed economies and the lack of significant reforms in international financial markets.

It is therefore evident that the widely varying pace of economic recovery is one of the main characteristics of the post-crisis world economy. While developing and transition economies, as a group, have regained their pre-crisis growth trend following the 2008–2009 slowdown, growth in developed economies remains very sluggish, which suggests that their economic output is currently well below potential (chart 1.1). In the *United States*, economic recovery has been stalling since early 2011, so that growth is too slow to significantly reduce unemployment. Labour indicators deteriorated sharply between the end of 2007 and mid-2009, with steep increases in both unemployment and underemployment rates, and they did not improve with the subsequent economic recovery. In the first quarter of 2011, payroll employment remained below its level of the first quarter of 2009 (at the trough of the economic cycle), and real hourly wages remained stagnant. As a result, wage-earners did not profit at all from the economic recovery; between the second quarter of 2009 and the first quarter of 2011, it was corporate profits that captured 92 per cent of the accumulated growth in national income. Such a recovery, which has been referred to as "jobless and wageless" (Sum et al., 2011), implies little, if any, contribution of consumer

Chart 1.1

REAL GDP AT MARKET PRICES, 2002–2011

(Index numbers, 2002 = 100)



Source: UNCTAD secretariat calculations, based on UN/DESA, *National Accounts Main Aggregates* database, *World Economic Situation and Prospects 2011: Mid-year Update*; ECLAC (2011); *OECD.Stat* database; and national sources.

Note: Linear trends correspond to 2002–2007.

spending to GDP growth. In addition, continued weakness in the housing market will delay recovery in residential investment and personal credit. Despite this lack of dynamism in private demand, macroeconomic policies have shifted to a less supportive stance. Government spending fell in late 2010 and early 2011, and, given the political differences over how to deal with the fiscal deficit and public debt ceiling, there is unlikely to be any further fiscal stimulus. The second round of quantitative easing, which ended in June 2011, failed to translate into increased credit for domestic economic activities: indeed, between the first quarters of 2008 and 2011, bank credit to the private sector fell by 11 per cent in real terms. Monetary policy will remain accommodative overall, with interest rates remaining at historically low levels, but the monetary authorities do not envisage new rounds of quantitative easing.

Natural disasters badly affected *Japan, Australia and New Zealand*. The Japanese economy, which had already been on a downward trajectory since mid-2010, owing to declining household consumption, government expenditure and net exports, fell officially back into recession in the first quarter of 2011. In March, its manufacturing sector suffered unprecedented supply-chain and energy disruptions due to the massive earthquake and tsunami. Preliminary figures point to a rapid revival of manufacturing, owing to fewer electricity shortages. In addition, strong public and private demand for reconstruction will continue to boost economic activity in the second half of the year and into 2012. While this will not prevent an overall GDP contraction in 2011, it will certainly lead to a significant recovery next year. However, pre-existing obstacles to growth, including shrinking real wages, an appreciating currency and attempts to reduce the huge public debt through fiscal tightening, will need to be addressed in the medium term. By contrast the negative effects of Australia's floods and New Zealand's earthquake are expected to be more short-lived, and are unlikely to push these two countries into recession.

In the *European Union (EU)*, growth is forecast to improve slightly, from 1.8 per cent in 2010 to around 1.9 per cent in 2011, although with significant variations among the different member countries. Germany and France experienced a quarter-on-quarter acceleration in early 2011. In Germany, growth relied on investment and net exports – as in 2010 – while private consumption remained subdued because of stagnating real wages. In France, fixed investment and stocks are still recovering from the crisis, but household consumption appeared relatively weak in the first months of 2011, partly due to rising energy prices and partly to the withdrawal of public incentives to boost consumption. In the United Kingdom, declining domestic demand in the context of rising inflation and slow wage growth, as well as stagnant corporate investment resulted in meagre positive GDP growth during the first quarter of 2011, only just offsetting its previous decline in late 2010. The situation seems even grimmer in peripheral Europe: public debt crises, such as in Greece, Ireland and Portugal, have increased the costs of debt rollovers. These countries have been forced to implement fiscal austerity measures, as a precondition for emergency financing by the IMF and the EU. Other countries that face the risk of contagion (e.g. Italy and Spain) are also implementing fiscal tightening in an attempt to maintain the confidence of financial markets. The restrictive policy stances, combined with the already high levels of unemployment, may cause these countries to remain in recession

in 2011 or, at best, record weak positive GDP growth. The policy dilemmas faced by European countries are further discussed in section B below.

In developing countries, growth rates are also expected to slow down in 2011, but this is due to the higher comparison base of 2010 and, in some cases, to slow growth in developed economies rather than to endogenous obstacles to growth. *Asian* economies continue to record the highest GDP growth rates. However, recent high-frequency indicators, such as those relating to industrial production and trade, suggest that economic growth in *East* and *South-East Asia* moderated in the second quarter of 2011, following a strong first quarter. The slowdown reflects a number of short-term factors, including the supply-chain effects of the Japanese earthquake and the impact of tighter monetary policies on domestic economic activity, as well as more long-lasting factors such as weaknesses in some major export markets, notably Japan and the United States. As a result, the contributions of exports – and to some extent investment – to growth are expected to weaken in 2011, affecting a number of export-oriented countries, for example Malaysia, Singapore and Thailand. Countries with large domestic markets and growing household consumption, such as China and Indonesia, will register only a mild, if any, slowdown. In China, net exports have reduced their contribution to GDP growth in comparison with the pre-crisis situation. Fixed investment (in the first place) and private consumption are the two major factors driving growth. The increased role of domestic demand is in line with the Government's aim to rebalance growth, but the relative share of consumption vis-à-vis investment still remains to be adjusted.

In *South Asia*, India continues to pursue rapid economic growth (close to 8 per cent), based mainly on strong domestic consumption and investment, but also on the positive contribution of net exports. A good winter harvest added to domestic activity, which remained solid. Most other countries in this region are also experiencing growth, but at slower rates, largely due to domestic demand. Rising import prices since the last quarter of 2010 have been affecting trade balances and increasing inflationary pressures, which could prompt more restrictive macroeconomic policies in the near future.

West Asia is set to keep growing at a relatively high rate, although with wide differences among the countries of the region. In several countries, political unrest is expected to adversely affect short-term growth prospects because of its impact on investment and tourism. In other, mainly oil-rich countries, however, political risks have led governments to implement expansionary measures, including tax cuts, higher wages in the public sector and new infrastructure programmes, in order to prevent social or political unrest. The resultant massive amounts injected into the economy are likely to boost GDP growth. In Turkey, which has not been affected by political instability, growth will remain high this year. Its current-account deficit is expected to reach 9 per cent of GDP in 2011, as hot money from abroad has fuelled credit growth – which increased by 35 per cent in real terms over the past year – and accentuated currency appreciation. Consequently a capital reversal could adversely affect the entire economy.

Growth in *Africa* is forecast to decline, almost entirely due to political turmoil in a number of *North African* countries. Growth in Egypt and Tunisia will slow down significantly in 2011, owing to plummeting investments and a slowdown in the vital sector of tourism. However, the most serious impact of conflict has been in the Libyan Arab Jamahiriya, where much of the economic activity has ground to a halt, including oil production and exports. This contrasts with *sub-Saharan Africa*, where overall GDP growth rates are projected to continue at their 2010 pace. Investments in infrastructure and expansionary fiscal policies should boost economic growth in the subregion. Rapid development in services such as telecommunications will provide a further impetus. While mineral- and energy-exporting countries have recorded improvements in their terms of trade as a result of strong demand for raw materials from other large developing economies, in many of the countries there are other sectors that have been the main contributors to growth. In Nigeria, for instance, where the sturdy output growth of 7.6 per cent in 2010 continued into early 2011, the non-oil sector grew at about 8.5 per cent, compared with about 3 per cent in the oil sector. In South Africa, GDP growth accelerated during the first quarter of 2011, owing to strong growth of the manufacturing sector. Several service industries have also been expanding, although not as rapidly. Even though open unemployment remains high, at 25 per cent, real wages have been growing significantly, and private consumption remains the most important driver of economic growth.

Latin America and the Caribbean recovered rapidly from the crisis, with a GDP growth of almost 6 per cent in 2010 – one of the highest in decades. Growth in several countries even accelerated in late 2010 and early 2011, on a quarter-to-quarter basis. However, compared with the relatively high benchmark of 2010, growth is likely to slow down in 2011 to below 5 per cent. Growth will be driven mainly by domestic demand, both in terms of consumption and investment, boosted by the significant improvement in labour conditions and the expansion of credit. In general, governments are likely to moderate their economic stimulus programmes, but there may be only a few countries that shift to a restrictive fiscal stance. Economic growth has kept fiscal deficits and public debts in check. The volume of exports will not increase as fast as in 2010, but commodity exporters will continue to benefit from significant terms-of-trade gains. This in turn will enable an expansion of imports, in particular of capital goods. Higher commodity prices are pushing up inflation rates: by May 2011, the regional average reached 7.5 per cent, while core inflation (excluding food and fuels prices) was only 5.5 per cent (ECLAC, 2011). In response, several central banks have tightened their monetary policy stance, although this has further encouraged undesired inflows of short-term capital. Governments thus face a policy dilemma, and some of them have established or strengthened capital controls in order to mitigate macroeconomic disturbances and currency appreciation resulting from such flows.

Growth in Brazil is declining, from 7.5 per cent in 2010 to around 4 per cent this year, as fiscal and monetary policies have been tightened with the aim of increasing the primary budget surplus and curbing inflation. This contrasts with Argentina, where growth is expected to exceed 8 per cent owing to double-digit growth in private consumption and fixed capital investment. The Andean countries, which are important fuel or mineral exporters, are forecast to either improve their growth rate (the Bolivarian Republic of Venezuela, Bolivia, Chile, Colombia and Ecuador) or maintain rapid growth (Peru), owing to significant terms-of-trade gains. On the other hand, most of the small economies of Central America and the Caribbean will likely continue to experience lacklustre growth, due to their dependence on the United States economy and to a deterioration in their terms of trade and competitiveness which hamper their sustained development. However, in Panama, significant infrastructure projects will boost economic activities and stimulate employment creation. Mexico will experience an estimated growth of about 4 per cent, with a recovery of private consumption and investment, although growth might lose momentum in the second half of the year due the slowdown in the United States economy.

The transition economies of the *Commonwealth of Independent States* (CIS) should continue their economic upturn, with GDP growing by more than 4 per cent, as in 2010. Terms-of-trade gains are expected to continue to improve the scope for fiscal stimulus in the fuel- and mineral-exporting countries, including the largest economies (the Russian Federation, followed by Ukraine and Kazakhstan). In these economies, GDP growth has relied mainly on domestic factors, with the recovery of investment and relatively robust household demand as a result of some improvement in employment. The monetary authorities in the Russian Federation have been facing several challenges related to non-performing loans in a number of large banks, high levels of capital outflows and inflationary pressures due to rising food prices. These have led to several rounds of monetary tightening, which, nevertheless, should not affect growth in the short run. After a strong economic contraction in 2009 and a moderate recovery in 2010, Ukraine is benefiting from steady external demand for its minerals, which account for 40 per cent of its total exports. In Kazakhstan, where the 2009 recession was much milder, economic growth is being bolstered by public and private expenditure, including domestic and foreign investment. Improved economic conditions in the Russian Federation have been supporting most of the energy-importing CIS economies, by providing a market for their exports and through increased workers' remittances. In addition, growth in Central Asia is supported by substantial, officially funded investment, especially in the energy-exporting economies. However, in Belarus, growth is slowing down after the local currency was devalued by 36 per cent in May 2011, which caused product shortages and prices to shoot up in the domestic market.

Growth is slower in the economies of *South-Eastern Europe*, which are unlikely to return to their 2008 GDP level before 2012. Croatia's economy contracted again in 2010. Elsewhere, there was a mild rebound, but recovery is expected to be slow owing to weak domestic demand. Unemployment continues to be a critical problem in the region, with Croatia and Serbia facing a rise in unemployment in early 2011.

2. International trade

International trade rebounded sharply in 2010, after having registered its greatest downturn since the Second World War. The volume of world merchandise trade recorded a 14 per cent year-on-year increase, which roughly offset its decline in 2009 (table 1.2). The upturn in global trade started in the second half of 2009 and was particularly strong until the end of the first half of 2010, as firms refilled their inventories. Thereafter, it lost some traction as inventory cycles moved to a new phase and economic activities ran out of steam in several developed countries. In 2011, the growth of international trade is expected to return to a single-digit figure, in the range of 7–8 per cent.

Although the World Trade Organization (WTO) has identified new restrictive measures on imports taken by G-20 countries, these remain modest, and they only affect 0.6 per cent of total G-20 imports (WTO, 2011a). So far, they do not represent any significant increase in trade barriers, but they are fuelling fears that, at a time of high unemployment and fiscal belt-tightening in developed economies, and complaints of "currency wars" by developing economies, governments may impose more import controls.

Mirroring the differences in strength of domestic aggregate demand, the revival of trade has also been uneven among countries and income groups of countries. In developed countries, trade (in terms of volume) has yet to bounce back to a level above its

Table 1.2

EXPORT AND IMPORT VOLUMES OF GOODS, SELECTED REGIONS AND COUNTRIES, 2007–2010

(Annual percentage change)

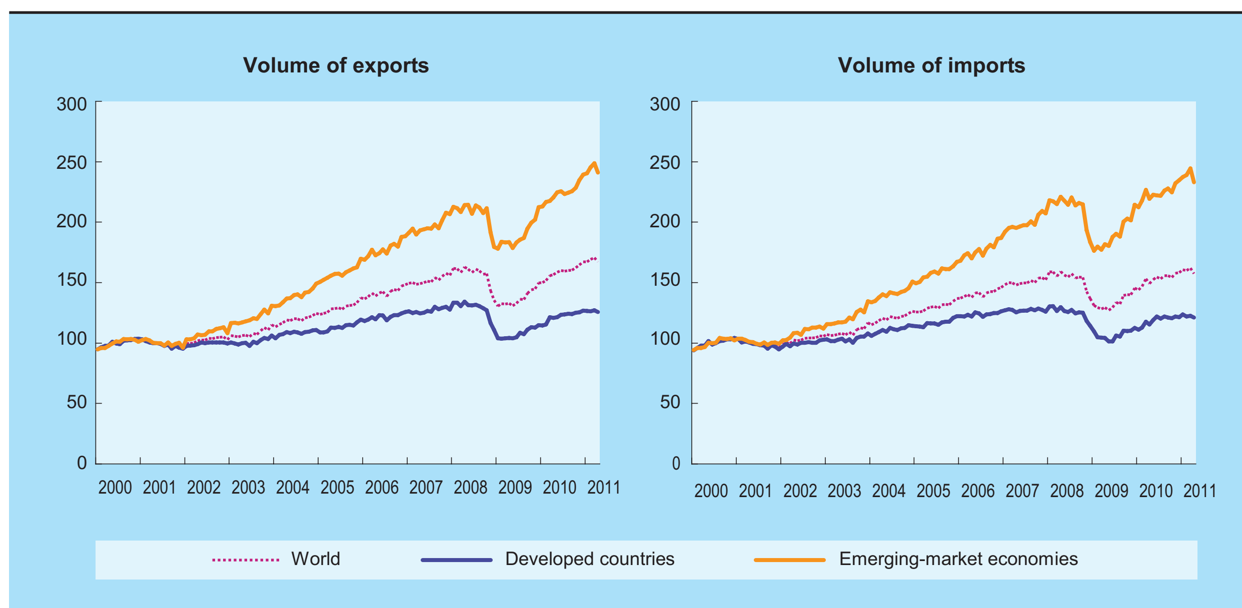
	Volume of exports				*Volume of imports*			
Region/country	*2007*	*2008*	*2009*	*2010*	*2007*	*2008*	*2009*	*2010*
World	**6.0**	**2.4**	**-13.3**	**14.0**	**6.6**	**2.6**	**-13.4**	**13.6**
Developed countries	**4.1**	**2.5**	**-15.1**	**12.6**	**3.8**	**-0.1**	**-14.5**	**10.3**
of which:								
Japan	8.9	2.3	-24.9	27.9	0.8	-0.6	-12.4	10.3
United States	6.8	5.5	-14.9	15.3	1.1	-3.7	-16.4	14.7
European Union	3.2	2.4	-14.3	11.2	4.9	0.8	-14.3	9.0
South-East Europe and CIS	**9.3**	**-0.2**	**-14.3**	**11.7**	**26.7**	**15.5**	**-28.1**	**15.6**
South-East Europe	17.9	-13.5	-20.6	11.5	23.7	-9.4	-20.7	-5.3
CIS	8.8	0.5	-13.9	11.8	27.3	18.4	-28.9	18.3
Developing countries	**8.8**	**3.2**	**-10.3**	**16.7**	**10.4**	**6.7**	**-9.9**	**18.9**
Africa	6.6	-2.1	-10.7	9.0	12.6	10.2	-2.5	1.3
Sub-Saharan Africa	6.9	-2.2	-9.6	10.4	11.5	2.8	-2.6	0.4
Latin America and the Caribbean	2.4	-0.5	-11.2	11.0	11.5	8.8	-18.4	25.0
East Asia	15.6	7.2	-10.5	24.1	10.2	0.4	-5.3	24.6
of which:								
China	21.8	10.5	-13.6	29.4	14.1	2.3	-1.7	30.0
South Asia	5.6	7.0	-5.6	10.3	9.7	20.8	-2.9	6.9
of which:								
India	6.9	16.8	-6.6	12.7	14.7	29.7	-0.8	4.2
South-East Asia	7.1	1.6	-10.7	18.6	7.0	8.2	-16.5	22.2
West Asia	1.8	4.3	-4.7	7.3	14.1	13.3	-13.8	10.6

Source: UNCTAD secretariat calculations, based on *UNCTADstat*.

Chart 1.2

WORLD TRADE VOLUME, JANUARY 2000–APRIL 2011

(Index numbers, 2000 = 100)



Source: UNCTAD secretariat calculations, based on the CPB Netherlands Bureau of Economic Policy Analysis, *World Trade* database.

pre-crisis levels. These countries recovered part of their previous trade losses between mid-2009 and mid-2010, but there has been no growth since then (chart 1.2). Similarly, transition economies' trade also failed to reach its pre-crisis level by the end of 2010. The situation was even worse in South-Eastern Europe, where imports contracted even further in 2010, in the context of weaker aggregate demand and rising overall unemployment in the region. In sharp contrast, the volume of both imports and exports in most groups of developing countries already exceeded their 2008 peak in the course of 2010, with East Asia leading the upturn.

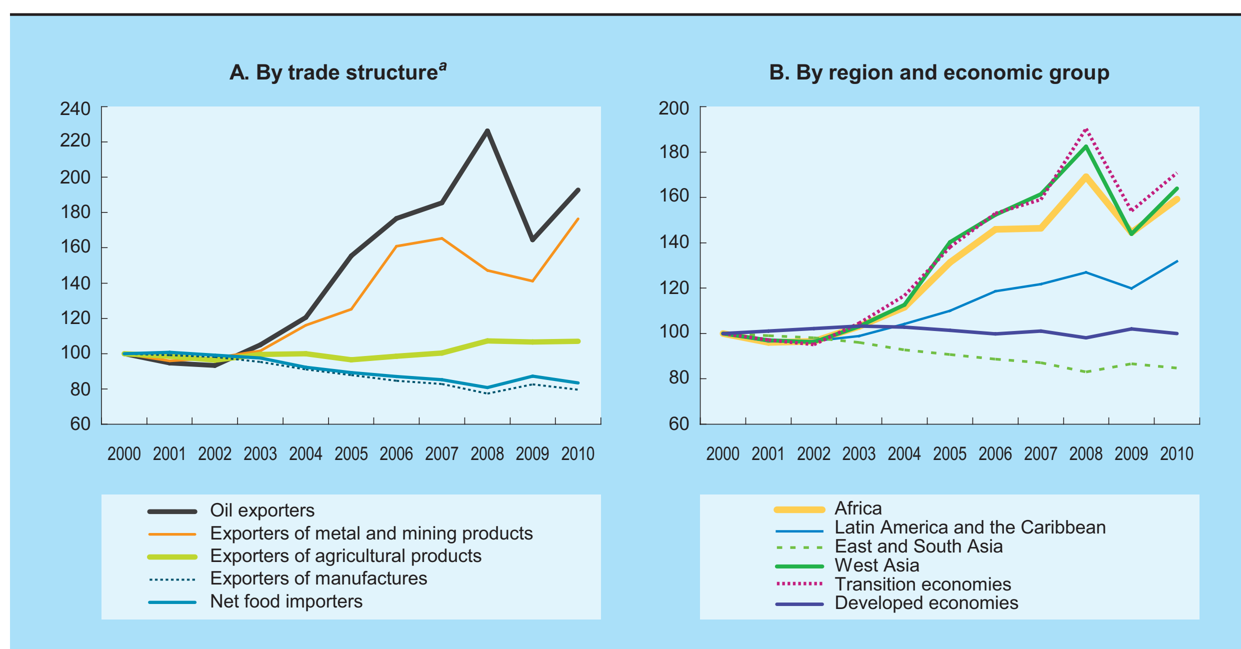
On the export side, differences arise mostly from the composition of countries' exports. In countries that produce durable and capital goods (demand for which is typically postponed during crises), such as China and Japan, exports increased in volume by almost 30 per cent as their industrial production recovered from the crisis. On the other hand, in developing economies that export mainly primary commodities, the volume of exports has been relatively stable. Unlike durable manufactured goods whose markets adjust mostly through quantity, primary commodity markets adjust more through prices, while their volume is frequently determined by supply-side conditions. Therefore, as their trade flows generally contracted less in 2009, they also experienced a milder expansion the year after, with percentage changes of only one digit in both cases. For some products (e.g. food products), this was related to the low elasticity of demand, while for other products changes in inventories followed a countercyclical pattern, as some leading importers took advantage of the lower prices of commodities in 2009.

Import volumes normally change in parallel with those of exports in countries or regions that trade mainly manufactures, and where the industrial system is highly integrated in global trade and exports incorporate a large share of imported inputs (e.g. in the EU and South-East Asia). However, in other cases, export and import volumes may evolve at quite different rates, in particular when countries use previously accumulated international reserves or

Chart 1.3

NET BARTER TERMS OF TRADE, 2000–2010

(Index numbers, 2000 = 100)



Source: UNCTAD, secretariat calculations, based on *UNCTADstat*.
Note Net food importers are low-income food-deficit countries, excluding exporters of fuels, metal and mining products.
a Developing and transition economies.

international aid to finance imports of final goods, or when gains or losses from the terms of trade significantly affect the purchasing power of exports. African countries, China and Japan are examples of the first case, as their imports in 2009 fell at a much lower rate than their exports, and consequently tended to recover at a slower pace in 2010. Latin America is a good example of how terms-of-trade losses and gains accentuated import contraction in 2009 and expansion in 2010 (table 1.2).

In 2010, the evolution terms of trade mostly returned to its pre-crisis pattern (chart 1.3). Among developing countries, oil and mineral exporters experienced significant gains; in the latter, terms-of-trade indices even exceeded their previous 2007 peak. In contrast, exporters of manufactures lost part of their 2009 gains. Examining terms of trade by geographical region, they improved markedly in Africa, West Asia and the transition economies in 2010, owing to higher prices for fuel and minerals. The terms of trade in countries in Latin America and the Caribbean reached unprecedented high levels, owing to gains in South American countries. On the other hand, in East and South Asian countries the terms of trade declined by some 2 per cent in 2010. However, this did not significantly affect the purchasing power of their exports, which increased by nearly 20 per cent.

Trade in services has followed a similar pattern to trade in goods, although with smaller fluctuations. With regard to travel and tourism services – which accounts for approximately 25 per cent of trade in services and for 6 per cent of all trade in goods and services – international tourist arrivals grew by nearly 7 per cent in 2010 to reach 940 million, compared with 882 million in 2009 and 917 million in 2008. In the first few months of 2011, tourism continued to grow at an annual rate of nearly 5 per cent. Indeed, growth was positive in all subregions of the world during January and February 2011, except in West Asia and North Africa, where it fell by about 10 per cent. Similar to overall economic activities, growth rates in international tourism arrivals were, on

average, the highest in developing countries. They increased by 15 per cent in South America and South Asia, and by 13 per cent in sub-Saharan Africa. In the Asia-Pacific region, growth in tourist arrivals slowed down to 6 per cent, although from a very strong performance in 2010. Europe also experienced a 6 per cent expansion in tourist arrivals, much of which was due to higher travel activity in Central and Eastern Europe, which grew by 12 per cent, and to the temporary diversion of travel from North Africa and West Asia to destinations in Southern Europe. Meanwhile growth was rather weak in North and Central America (World Tourism Organization, 2011a). In 2011, it is expected that world tourism will grow by 4–5 per cent (World Tourism Organization, 2011b).

Transport services, the second largest category of commercial services, mirror merchandise trade. Preliminary data indicate that world seaborne trade – which carries about four fifths of all traded goods – bounced back in 2010 after contracting the previous year, and grew by an estimated 7 per cent. The total load of goods amounted to 8.4 billion tons – a level that exceeds the peak reached in 2008 (UNCTAD, 2011). However, these aggregate figures hide substantial variations in types of cargo. Container shipping followed a V-shape recovery, expanding by 13 per cent in 2010 after plummeting by 10 per cent in 2009, whereas the volume of tanker trade expanded by 4.2 per cent in 2010, which slightly more than offset its decline in 2009. Growth in the volume of major dry bulk shipments remained positive in 2009 and strongly accelerated in 2010 with an increase of 11.3 per cent. This diversity highlights the responsiveness of trade in manufactures to changes in the global economic situation, and particularly to manufacturing growth in countries of the Organisation for Economic Co-operation and Development (OECD). Interestingly, it also reflects the resilience of trade in some primary commodities, even during the global crisis, with demand from China playing an important role.

Maritime freight prices – unlike oil prices – declined steadily throughout 2010. The strong positive correlation observed from early 2008 until mid-2009 between the two price aggregates started to reverse in 2010 owing to an oversupply of vessels. In 2011, maritime freight prices are expected to stay low in comparison with their historically high levels of the previous decade.

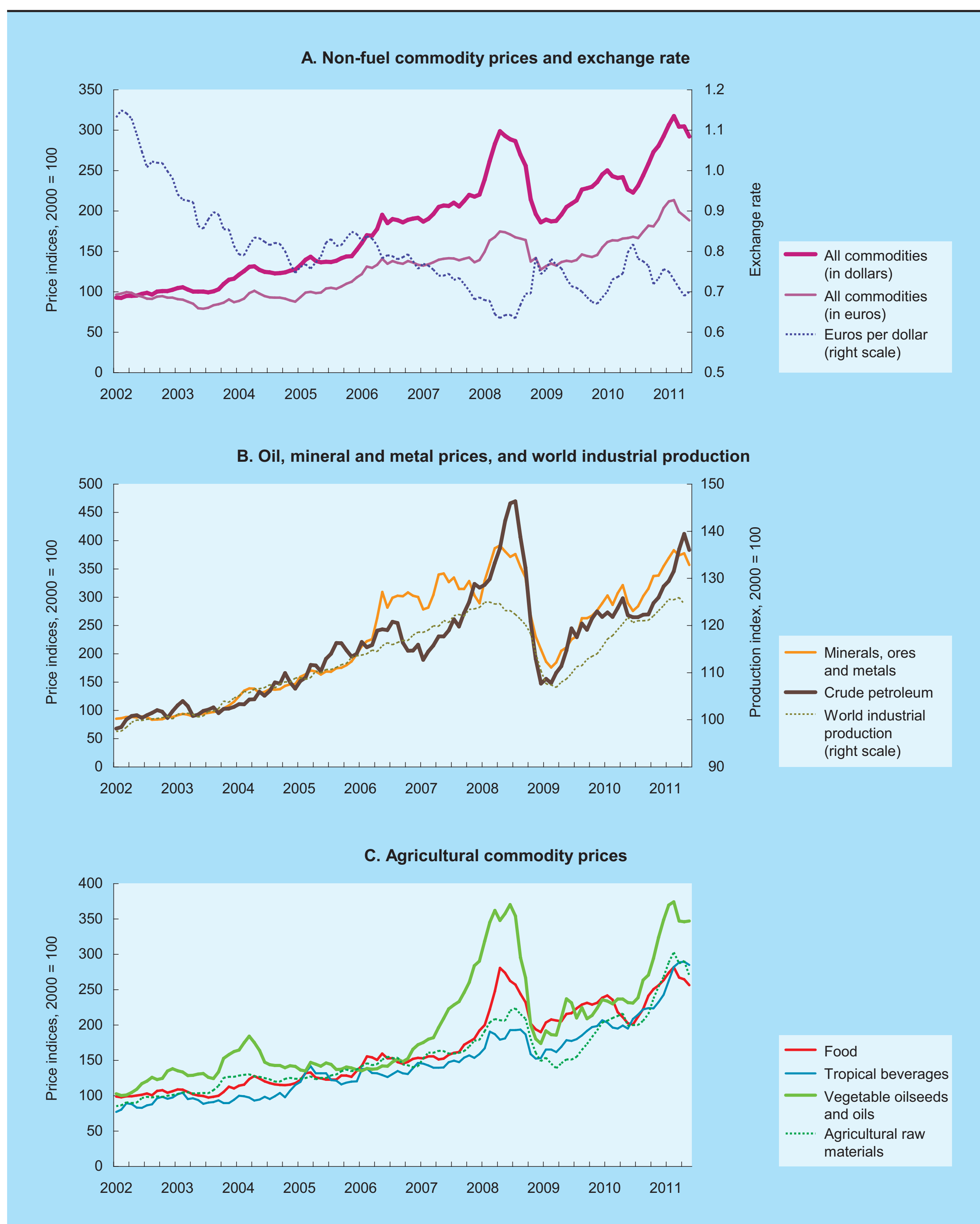
3. Recent developments in commodity markets

Commodity price developments have traditionally been discussed in terms of changes in fundamental supply and demand relationships. However, there is increasing support for the view that recent commodity price movements have also been influenced by the growing participation of financial investors in commodity trading. It is difficult to quantify the relative price impact of fundamental versus financial factors. This is not only because of a lack of comprehensive and disaggregated data on the participation of financial investors, but also because the various types of information that drive price formation, which may stem from either fundamental factors or financial markets, are likely to influence each other. For example, it may well be that a major supply shock signals a tightening supply-demand balance and imminent price increases, which in turn will attract financial investors searching for yield, and thus amplify the price hike. But price changes on financial markets or signals from algorithms may also prompt financial investors to adjust their commodity portfolios, which may be misinterpreted by producers and consumers as signalling fundamental changes. This may cause them to adjust their activities in line with market fundamentals and reinforce price movements. Chapter V of this *Report* provides a detailed analysis of the role of information in this context. This section focuses on price developments, as well as on shifts in fundamental supply-demand balances.

Uncertainty and instability have been the major distinguishing features of commodity markets in 2010 and the first half of 2011. This is reflected in greater volatility of commodity prices than in the past, similar to the period of the commodity boom prior to the eruption of the global financial and economic crisis in 2008. The increase in commodity price volatility over the past decade can be illustrated by comparing the standard deviation of the monthly commodity price data in chart 1.4 between 2002–2005 and 2006–2011 for different commodity groups. Between these two periods, this simple measure of volatility multiplied by a factor of 3.8 for food commodities and vegetable oilseeds and oils, by 2.7 for agricultural raw materials and tropical beverages, and by 1.6 for minerals and metals and crude petroleum.[1]

Chart 1.4

MONTHLY EVOLUTION OF COMMODITY PRICES, EXCHANGE RATE AND WORLD INDUSTRIAL PRODUCTION, JANUARY 2002–MAY 2011



Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics Online*; World Bank, *Commodity Prices* (Pink Sheet) database; *UNCTADstat*; and CPB Netherlands Bureau of Economic Policy Analysis, *World Trade* database.

Note: Price indices are in current values and world industrial production is in constant values.

After declining in the second quarter of 2010, commodity prices generally surged until early 2011. Price increases were associated with three broad tendencies: (i) rising demand that reflected the recovery in the world economy, and, in particular, robust growth in developing countries; (ii) supply shocks; and (iii) the increased financialization of commodity markets. However, their relative impact on price changes is difficult to quantify, and in any case is beyond the scope of this section. The price indices for all commodity groups peaked in February-March 2011 at levels close to those reached in 2008, except for tropical beverages and agricultural raw materials which were considerably higher. Although commodity prices generally declined over the second quarter of 2011, they have remained at relatively high levels. This reversal of the upward trend, particularly in the case of energy commodities and minerals and metals, seems partly due to the slowdown in world industrial production growth (chart 1.4B). However, the sharp downward correction in early May 2011, in particular, could also be attributable more to position changes by financial investors than to actual changes in physical fundamentals. These position changes resulted from a variety of factors, including the announced phasing out of quantitative easing in the United States and sovereign debt problems in Europe, with a resulting rebound of the dollar exchange rate; uncertainties about the evolution of the Chinese economy following several rounds of monetary policy tightening; and technical factors such as the increase in margin requirements in the futures exchanges for some commodities. As commodity prices are denominated in dollars, the instability of the dollar exchange rate plays an important role in measuring the volatility of commodity prices. The movements in the index for non-fuel commodities are much smoother when measured in euros than when measured in dollars (chart 1.4A).

The upward price trend may have peaked, as prices started falling in the second quarter of 2011. However, at the time of writing in mid-2011 it was still too early to assess if this is just a temporary correction in the rising trend or a more long-lasting reversal. Indeed, between May and early July 2011, prices have been experiencing sharp and frequent gyrations, even on a daily basis. These are largely due to changing moods and nervousness among market participants, partly because of uncertainty about the direction of financial market developments. In the particular case of oil, as discussed below, policy decisions of the Organization of the Petroleum Exporting Countries (OPEC) and, especially, the International Energy Agency (IEA), which took market participants by surprise, have also played a role.

The greater presence of financial investors, who treat commodities as an additional asset class, has had a major impact on commodity price movements (discussed in chapter V of this *Report*). Parallel to the price increases, financial investments in commodities registered new record highs in early 2011. Similarly, the downward price correction in May 2011 was associated with a massive retreat of commodity investors from the market.[2] Abundant liquidity in the financial markets may also have contributed to the increased financialization of commodity markets, boosted by the second round of monetary easing by the United States Federal Reserve launched in the third quarter of 2010. To the extent that this additional liquidity has not translated into increased credit for productive investment, but instead has been used by financial investors searching for maximum yield, it may have contributed to the rise in commodity prices (Koo, 2011).

Regarding the evolution of physical supply and demand conditions in international commodity markets, rising demand for commodities in rapidly growing emerging markets, notably in China, has played a key role over the past few years. This is linked to the highly commodity-intensive processes of industrialization and urbanization in these countries, as well as to the higher protein content of the dietary changes resulting from rising household incomes (*TDR 2005*). At the same time, supply constraints have resulted in supply growth lagging behind the rapid demand growth.

These common macroeconomic and financial shocks have been major determinants of the recent developments in commodity prices, especially as measured by aggregate price indices. Depending on the specific commodity and period under consideration, these common shocks have been reinforced or dampened by commodity-specific supply and demand shocks, and together, they have determined the evolution of prices of individual commodities (table 1.3). The remainder of this section discusses these commodity-specific supply and demand developments in some detail.

In the *crude oil* market, prices were fluctuating within a $70–$80 band during the first three quarters

Table 1.3

WORLD PRIMARY COMMODITY PRICES, 2005–2011

(Percentage change over previous year, unless otherwise indicated)

Commodity groups	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*[a]	*2009–2011*[b]
All commodities[c]	**11.6**	**30.2**	**13.0**	**24.0**	**-16.9**	**17.7**	**21.8**	**62.1**
All food	**6.3**	**16.3**	**13.3**	**39.2**	**-8.5**	**7.4**	**20.7**	**39.6**
Food and tropical beverages	**8.8**	**17.8**	**8.6**	**40.4**	**-5.4**	**5.6**	**18.5**	**33.9**
Tropical beverages	25.5	6.7	10.4	20.2	1.9	17.5	32.1	71.5
Coffee	43.8	7.1	12.5	15.4	-6.9	27.3	49.0	104.5
Cocoa	-0.7	3.5	22.6	32.2	11.9	8.5	3.6	25.1
Tea	9.1	11.7	-12.3	27.2	16.5	-1.0	9.5	28.4
Food	7.2	19.0	8.5	42.5	-6.0	4.4	17.1	30.5
Sugar	37.9	49.4	-31.7	26.9	41.8	17.3	23.7	101.2
Beef	4.1	-2.4	1.9	2.6	-1.2	27.5	22.4	68.3
Maize	-12.0	24.4	38.2	34.0	-24.4	13.2	52.8	74.5
Wheat	-1.4	26.6	34.3	27.5	-31.4	3.3	44.5	42.3
Rice	17.1	5.5	9.5	110.7	-15.8	-11.5	-1.2	-17.6
Bananas	9.9	18.5	-0.9	24.6	0.7	3.7	13.3	13.5
Vegetable oilseeds and oils	**-9.5**	**5.0**	**52.9**	**31.9**	**-28.4**	**22.7**	**36.4**	**89.8**
Soybeans	-10.4	-2.2	43.0	36.1	-16.6	3.1	24.8	42.5
Agricultural raw materials	**3.2**	**13.3**	**12.0**	**20.5**	**-17.5**	**34.0**	**31.5**	**97.1**
Hides and skins	-2.1	5.1	4.5	-11.3	-30.0	60.5	14.5	142.3
Cotton	-11.6	5.9	10.2	12.8	-12.2	65.3	93.7	266.4
Tobacco	1.8	6.4	11.6	8.3	18.1	-23.3	-75.7	-80.5
Rubber	16.7	40.6	9.5	16.9	-27.0	90.3	54.1	285.7
Tropical logs	0.3	-4.7	19.5	39.3	-20.6	1.8	8.8	9.2
Minerals, ores and metals	**26.2**	**60.3**	**12.8**	**6.2**	**-30.3**	**33.7**	**20.2**	**104.2**
Aluminium	10.6	35.4	2.7	-2.5	-35.3	30.5	17.4	87.7
Phosphate rock	2.5	5.3	60.5	387.2	-64.8	1.1	36.6	-13.1
Iron ore	..	..	77.4	26.8	-48.7	82.4	22.3	152.3
Tin	-13.2	18.9	65.6	27.3	-26.7	50.4	47.9	173.9
Copper	28.4	82.7	5.9	-2.3	-26.3	47.0	25.7	183.6
Nickel	6.6	64.5	53.5	-43.3	-30.6	48.9	20.4	150.8
Lead	10.2	32.0	100.2	-19.0	-17.7	25.0	20.8	124.3
Zinc	31.9	137.0	-1.0	-42.2	-11.7	30.5	8.5	99.9
Gold	8.7	35.9	15.3	25.1	11.6	26.1	16.3	57.1
Crude petroleum[d]	**41.3**	**20.4**	**10.7**	**36.4**	**-36.3**	**28.0**	**32.4**	**136.7**
Memo item:								
Manufactures[e]	**2.5**	**3.4**	**7.5**	**4.9**	**-5.6**	**1.1**	**..**	**..**

Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics Online*; and United Nations Statistics Division (UNSD), *Monthly Bulletin of Statistics*, various issues.

Note: In current dollars.

a Percentage change between the average of January to May 2011 and the average for 2010.

b Percentage change between the average of January to May 2011 and the average of January to March for 2009 (period of trough in commodity prices due to the global financial crisis).

c Excluding crude petroleum.

d Average of Brent, Dubai and West Texas Intermediate, equally weighted.

e Unit value of exports of manufactured goods of developed countries.

of 2010. They then surged in the last quarter of the year, to reach a monthly average of $116.3 in April 2011 (UNCTADstat). Global oil demand rose by 3.2 per cent in 2010, after having declined by 0.8 per cent and 1.3 per cent in 2008 and 2009 respectively. Oil demand in OECD countries increased by a meagre 1.1 per cent, while that of non-OECD countries grew by 5.5 per cent, with Chinese oil demand growing at 12.3 per cent in 2010.[3] Therefore, non-OECD countries were responsible for over 80 per cent of the increase in oil demand. At the same time, oil supply increased by only 2.1 per cent in 2010 (IEA, 2011a). One of the main reasons for oil production growth lagging behind that of demand, and for the surging oil prices in late 2010 and the first months of 2011, is the tensions in West Asia and North Africa. These affected oil production, reducing global oil supply and providing an incentive for financial investors to bet on rising oil prices.

Oil production in the Libyan Arab Jamahiriya, which accounts for about two per cent of global production, with 1.6 million barrels per day, virtually stopped. Although Saudi Arabia stepped in and increased its production, this does not seem to have completely made up for the shortage of supply. This is mainly due to the difference in the quality of crude oil produced in the Libyan Arab Jamahiriya and that of the spare capacity oil in Saudi Arabia. By May 2011, amidst growing worldwide concerns that high oil prices were posing a major threat to the global economic recovery, the IEA observed a dent in oil demand, particularly in developed countries (IEA, 2011b). In this context of high prices, there were repeated calls for OPEC to increase production quotas. However, at its meeting on 8 June 2011 OPEC failed to reach an agreement to change the production quotas. While prices increased following the OPEC meeting, Saudi Arabia, which has by far the largest spare capacity among the OPEC members, announced that it would unilaterally increase production beyond the quota. Furthermore, two weeks later the IEA surprised the market with a release of emergency stocks, an extraordinary measure that had been taken only twice before.[4]

The prices of *food commodities* also surged during the second half of 2010 and early 2011, mainly due to weather-related events which affected harvests, thereby signalling an imminent deterioration in supply-demand balances. Markets for grains, excluding rice, generally remained tight by mid-2011. The immediate trigger of the sharp increase in wheat prices was droughts and related fires in the Russian Federation and Ukraine, compounded by export bans in these countries. Global demand for maize has been rising fast, because of increased use as animal feed and also because its use for biofuel production expanded, especially as the profitability of biofuel production increases with rising oil prices. Data from the United States Department of Agriculture (USDA) show that in 2010/11 about 40 per cent of maize harvested in the United States went to biofuel production, up from 20 per cent in 2006/07. This would explain why growth in global demand for maize has exceeded that of production: while global demand growth was 3.6 per cent in 2010/11, production growth was only 0.9 per cent. As a result, there has been a significant depletion of maize inventories.[5]

In this context, prices have varied recently in line with changing expectations of harvests for 2011/12, again closely related to evolving weather conditions. In May 2011, delays in the planting season in the United States due to heavy rains and floods, together with dry weather in Europe which threatened cereal harvests, led to tighter supply-demand balances. Climatic conditions have also been affecting agricultural production in China. However, by early July 2011, those pressures appeared to have eased as a result of the lifting of grain export restrictions in the Russian Federation and Ukraine, as well as better-than-expected data from the USDA regarding stocks and plantings.

Even though in February 2011 the UNCTAD index for food prices surpassed the alarming levels of the food crisis of 2007-2008, a number of factors limited their impact on food security, which was therefore less critical than it had been previously. First, the price of rice, which is a major staple food and strongly affects food security, has remained relatively low in comparison with the levels reached in 2008. Second, grain inventories had been built up in 2009, which initially provided some buffer against the pressure to increase prices, although vulnerabilities had become more evident in this respect by mid-2011. Third, a number of countries in Africa also had good grain harvests in 2010. And finally, apart from some exceptions like the Russian Federation and Ukraine, most countries refrained from imposing export restrictions which had exacerbated the food crisis of 2007-2008. Nevertheless, the rise in food prices in 2010-2011

could have a serious impact on food security, made worse by the threat of famine in East Africa. Overall, the World Bank has estimated that the increase in food prices between June and December 2010 drove 44 million people into extreme poverty (Ivanic, Martin and Zaman, 2011). Furthermore, the food import bill of the low-income, food-deficit countries is expected to increase by 27 per cent in 2011 (FAO, 2011). Therefore, high food prices remain a worrying threat to food security in poor countries, and many of the structural causes that were behind the crisis in 2008 still need to be adequately addressed (see also *TDR 2008*, chapter II). In 2008 it was generally agreed that to tackle this problem, increased official development assistance would be needed to boost investment in agriculture in developing countries.

Climatic conditions have also been a major factor influencing market developments relating to other agricultural commodities. The price of sugar hit a 30-year high in early 2011. The supply-demand balance in world sugar markets had been expected to tighten strongly due to concerns about supply shortages in major producing countries, high consumption growth and low inventories, but these expectations were reversed by the anticipation of more favourable harvests. In the *tropical beverages* group, reduced harvests of coffee in major producing countries, notably Colombia and Viet Nam, combined with buoyant consumption, particularly in emerging markets, led to sharply tightening supply-demand balances and resulted in very low inventory levels. As in the case of sugar, cocoa prices were in a boom and bust situation in 2010-2011: following a steep rise up to February 2011 as a result of political tensions and a related export ban in the major producing country, Côte d'Ivoire, they declined sharply once these tensions were resolved and an increased supply became available.

Prices of *agricultural raw materials* also soared in 2010. Strong demand, especially from China, together with poor harvests in countries like China and Pakistan, led to lower levels of cotton inventories[6] and contributed to record price hikes in February 2011. Falling prices in the second quarter of 2011 are partly due to slowing demand as a reaction to the higher prices. Similarly, record highs in natural rubber prices in early 2011 were a result of strong demand for tyres for vehicle production in emerging markets and of higher oil prices, which made synthetic rubber more expensive. Moreover, supplies were tight due to unfavourable weather conditions in South-East Asia, the major natural rubber producing region, which accounts for more than 70 per cent of global supply. However, in the second quarter of 2011, some easing of the supply situation, along with monetary tightening in China and the impact of the earthquake in Japan on automobile production, contributed to a decline in rubber prices.

In the markets for *metals and minerals*, prices rose steeply in the second half of 2010, and peaked in February-March 2011. Movements in metal and mineral prices tend to be highly correlated with changes in industrial production. Thus the price increase in 2010 was linked to global economic activity. In the case of copper, the tightness in the market is also due to supply shortfalls. The fall in prices since March 2011 appears to be partly associated with slower growth in global industrial production. Regarding nickel, recent price declines are also related to an increase in supplies. Moreover, it appears that the recent evolution of prices in mineral and metal markets has been influenced by unrecorded warehousing by financial institutions as well as by inventory dynamics in China, particularly for copper. However, these trends are hard to track owing to lack of information (see chapter V). It could well be that the lower growth in Chinese imports reflects a drawing down of inventories which had been previously built up, and would not necessarily be signalling reduced use of the metal. Consequently, as stocks should eventually be refilled, there are growing expectations of Chinese import demand picking up later in the year.

The prices of *precious metals*, particularly gold and silver, have been benefiting from uncertainties about the global economy. Demand for these metals has increased because investors have turned to them as a safe haven. In fact, it has been widely acknowledged that the soaring prices of silver were evidence of a speculative bubble which burst in early May 2011. And the increase in margins for silver futures contracts was considered one of the major triggers of the retreat of commodity investors at that time.

To a certain extent, rising commodity prices were the result of an acceleration of the global economic recovery in 2010, but they may in turn contribute to its slowdown in 2011. This is partly because high prices act like a tax on consumers and reduce purchasing power at a time when household

incomes are already being adversely affected by high unemployment, slowly rising (or stagnating) wages and the debt deleveraging process, particularly in developed countries. Most importantly, the recovery may stall if high commodity prices lead to monetary policy tightening worldwide. A reaction to high commodity prices, which are primarily the result of external factors (mostly related to supply shocks or to conditions in the financial markets), through monetary policy measures that reduce domestic demand does not seem to be the most appropriate solution.

Given the prevailing uncertainties and high level of instability in commodity markets, and in the world economy in general, commodity prices are set to remain highly volatile in the short term, particularly if financial investors continue to exert a significant influence on these markets. Demand for commodities will depend on the pace of the recovery, which in turn will be shaped by economic policies.

In the longer term, demand for commodities in emerging developing countries is expected to remain robust in view of their lower per capita commodity consumption in comparison with developed countries. At the same time, supply of energy commodities, as well as minerals and metals, is likely to increase as a result of stepped up investments in exploration and extraction driven by high commodity prices. Indeed, worldwide, spending on non-ferrous exploration increased by 45 per cent in 2010 to reach the second highest amount on record (Metals Economics Group, 2011). However, given the existing supply constraints in the extractive industries, related for example to more costly extraction in remote areas or to the lack of skilled workers in the sector, it is not certain that the expected additional supply will be sufficient to meet higher demand. In the agricultural sector, OECD-FAO (2011) expects prices to remain on a higher plateau in 2011–2020 compared with the previous decade. This is because higher costs could dampen yield growth and limit production, while demand is likely to increase rapidly due to growing population and rising incomes in large emerging developing countries, and to the increasing non-food use of grains for feedstock and biofuels. The latter are expected to be driven by high oil prices and policy mandates on the use of biofuels.

An additional issue to consider is how the earthquake, tsunami and subsequent nuclear problems in Japan in March 2011 have affected commodity markets. In particular, rethinking of the role of nuclear energy in the energy mix may affect the markets of other energy commodities, creating additional price pressures in the oil market.

B. Incomes policies and the challenges ahead

Over the past year, the instruments available to policymakers for supporting economic recovery seem to have been limited, especially in developed economies. On the one hand, there was little scope for monetary policy to provide additional stimulus, as interest rates were already at historic lows. The only possible monetary stimulus seemed to be quantitative easing, which several central banks were reluctant to implement, and which, given the ongoing deleveraging process, proved to be of little help in reviving credit to boost domestic demand. On the other hand, higher public-debt-to-GDP ratios have convinced many governments that they should shift to fiscal tightening.

However, there is much larger space for macroeconomic policies, especially for proactive fiscal policies, than is perceived by policymakers (as discussed in chapter III). Moreover, there are other policy tools that have been largely overlooked, but which could play a strategic role in dealing with the present challenges, such as incomes policies.

1. *The role of wages in economic growth*

In the period of intensified globalization from the early 1980s until the global crisis, the share of national income accruing to labour declined in most developed and developing countries. If real wage growth fails to keep pace with productivity growth, there is a lasting and insurmountable constraint on the expansion of domestic demand and employment creation (*TDR 2010*, chapter V). To offset insufficient domestic demand, one kind of national response has been an overreliance on external demand. Another kind of response has taken the form of compensatory stimulation of domestic demand through credit easing and increasing asset prices. However, neither of these responses offers sustainable outcomes. These are important lessons to be learned from the global crisis. Over and above the risks inherent in premature fiscal consolidation, there is a heightened threat that deflationary policies may accentuate downward pressures on labour incomes as a result of the slump in the labour market. Such policies ignore the vital role of consumer spending in contributing to a sustainable global recovery.

From the perspective of a single country, strengthening the international competitiveness of producers may seem to justify relative wage compression. However, the simultaneous pursuit of export-led growth strategies by many countries has systemic implications: a race to the bottom with regard to wages will produce no winners and will only cause deflationary pressures. With widespread weakness in consumer demand, fixed investment will not increase either, despite lower labour costs. Global deflationary tendencies and the drag on global demand resulting from wage compression in many developed countries would need to be countered by some form of policy-engineered higher spending somewhere in the world economy. In the pre-crisis era, widespread resort to export-led growth strategies was made possible mainly by fast-growing imports in the United States, leading to increasing external deficits and financial fragility in that economy. Subsequent crises, with private sector deleveraging and increasing public debt, clearly showed the deficiencies of this approach. Rethinking fiscal policy and avoiding premature consolidation is one issue; halting and reversing unsustainable distributional trends is another.

Trends in income distribution since the 1980s confirm that inequalities within many developed economies have increased as globalization has accelerated (European Commission, 2007; IMF, 2007a and b; OECD, 2008). In particular, wage shares have declined slowly but steadily over the past 30 years, with short reversals during periods of recession (particularly in 2008-2009), when profits tend to fall more than wages. After such episodes, however, the declining trend has resumed (chart 1.5A). This trend is creating hazardous headwinds in the current recovery. As wages have decoupled from productivity growth, wage-earners can no longer afford to purchase the growing output, and the resultant stagnating domestic demand is causing further downward pressure on prices and wages, thus threatening a deflationary spiral.

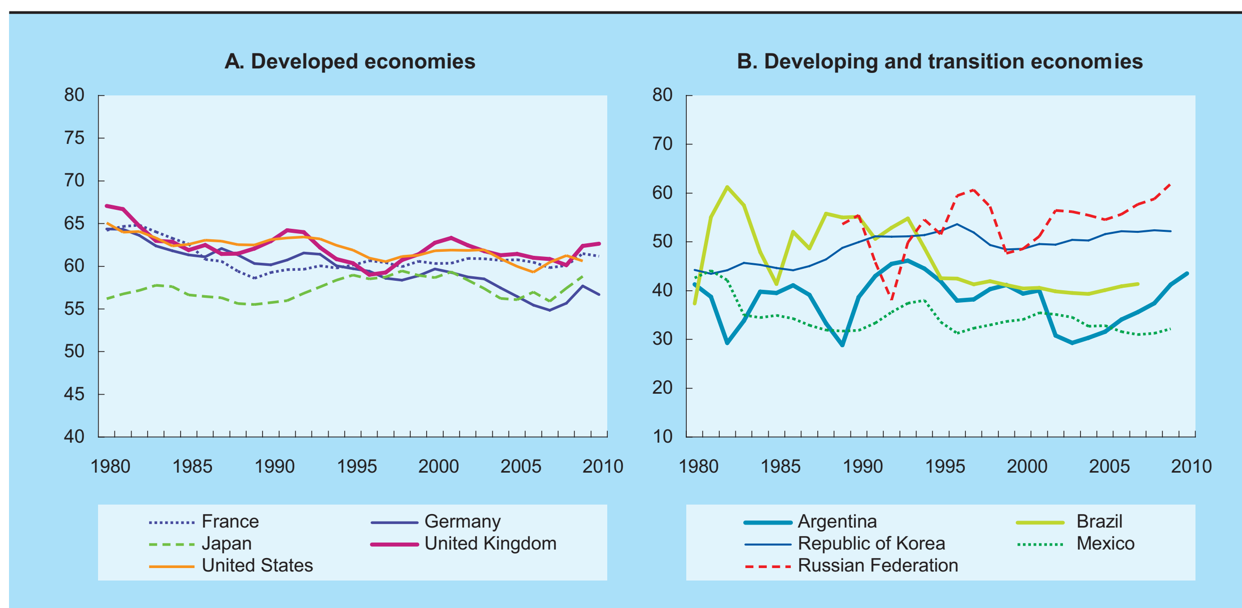
In most developing and transition economies, the share of wages has behaved differently. That share is generally between 35 and 50 per cent of GDP[7] – compared with approximately 60 per cent of GDP in developed economies – and it tends to oscillate significantly, owing mainly to sudden changes in real wages. In many of these economies, the share of wages in national income tended to fall between the 1980s and early 2000s, but has started to recover since the mid-2000s, though it has not yet reached the levels of the 1990s (chart 1.5B). The positive evolution of wages and the role played by incomes policies, particularly transfer programmes to the poor, may be the main factors behind the present “two speed recovery”.

In developed countries, real wages grew on average at less than 1 per cent per annum before the crisis, which is below the rate of productivity gains; they then declined during the crisis, and tended to recover very slowly in 2010. Arguably, the early move to a more contractionary fiscal policy and the relatively high levels of idle capacity and unemployment imply that the pressures for higher wages could remain subdued, thereby reducing the chances of a wage-led recovery. In contrast, since the early 2000s, in all developing regions and in the CIS, real wages have been growing, in some instances quite rapidly (table 1.4). In some countries, this may represent a recovery from the steep reductions in the 1990s or early 2000s, and in others it is more than a mere recovery, as wages follow the same path as productivity gains. Even during the difficult years of 2008 and 2009, real wages did not fall in most developing countries, as had generally been the case in previous crises. This suggests that to some extent recovery in

Chart 1.5

SHARE OF WAGES IN NATIONAL INCOME, SELECTED ECONOMIES, 1980–2010

(Per cent)



Source: UNCTAD secretariat calculations, based on OECD, *Main Economic Indicators* database; and Lindenboim, Kennedy and Graña, 2011.

developing countries was driven by an increase in domestic demand, and that real wage growth has been an integral part of the economic revival.

Examining the evolution of total wage income, which depends on employment and real wages, is essential for understanding the risks of wage deflation. A fall in real wages, rather than leading to an increase in the demand for labour, will affect demand by inducing a fall in consumption (Keynes, 1936). Generally, there is a very close relationship between the rate of change of total wage income and that of final consumer spending. In this respect, Japan's "lost decades" provide a stark warning of the growing challenge at the global level today. Failure to halt downward pressures on prices and domestic demand left the Japanese economy excessively dependent on exports, resulting in persistent deflation and stagnation for two decades. As wage-earners' real income stopped growing, so did private consumption (chart 1.6). Germany seems to be going the way of Japan owing to deliberate wage compression since the mid-1990s, with vastly destabilizing consequences in the euro area. In the United States, even though consumption was mainly driven by a credit and property boom until the inevitable bursting of the bubble, there is also a strong relationship between the wage bill and private consumption. Wage compression in that country was magnified by regressive tax policies and a strong tendency for households in the upper 1 per cent of the income distribution to appropriate more and more of the total income (Piketty and Saez, 2007).

At the current juncture, in view of the unemployment legacies of the crisis, downward pressures on wages in developed economies risk strangling any incipient recovery of private consumption, which is the necessary basis for a sustainable and balanced recovery. The widely shared agenda of structural reform that aims at improving labour market flexibility would only reinforce the bargaining power of employers in labour markets in developed economies.

In contrast, the rise of the wage bill after periods of decline in several developing and transition economies in the 1980s and 1990s boosted private consumption. For instance, the decline in wages in

Table 1.4

REAL WAGE GROWTH, SELECTED REGIONS AND ECONOMIES, 2001–2010

(Annual change, in per cent)

	2001–2005	*2006*	*2007*	*2008*	*2009*	*2010[a]*
Developed economies	**0.5**	**0.9**	**0.8**	**-0.5**	**0.6**	**0.1**
Germany	-0.9	0.0	1.1	1.2	-0.5	1.7
Japan	-0.4	1.6	-1.0	-1.1	-2.9	1.4
United Kingdom	2.8	2.6	3.9	-1.5	-2.2	-1.8
Unites States	-0.3	-0.1	0.5	0.1	2.8	-0.7
Developing and transition economies						
Africa	**1.3**	**2.8**	**1.4**	**0.5**	**2.4**	**..**
South Africa	0.3	5.1	0.2	2.3	3.2	5.2
Asia	**7.8**	**7.6**	**7.2**	**7.1**	**8.0**	**..**
China	12.6	12.9	13.1	11.7	12.8	..
India	2.6	0.4	-0.6	8.3	..	..
Republic of Korea	4.4	3.4	-1.8	-1.5	-3.3	1.2
Latin America and the Caribbean	**0.4**	**4.2**	**3.3**	**1.9**	**2.2**	**2.5**
Brazil	-2.6	3.5	1.5	2.1	1.3	2.4
Chile	1.6	1.9	2.8	-0.2	4.8	2.1
Mexico	0.9	1.4	1.0	2.2	0.8	-0.6
Eastern Europe and Central Asia	**15.1**	**13.4**	**17.0**	**10.6**	**-2.2**	**..**
Russian Federation	15.1	13.3	17.3	11.5	-3.5	2.6

Source: UNCTAD secretariat calculations, based on ILO, 2011; *EC-AMECO* database; ECLAC, 2010; Economist Intelligence Unit; and national sources.

a Preliminary.

the Republic of Korea and the Russian Federation after the crises of the late 1990s was followed by a significant upturn, which was not reversed by the Great Recession. Similarly, in Mexico wages recovered to some extent, but the economic influence of the United States may explain the negative rate of growth of the wage bill during the latest crisis.

The rise in real wages and the wage bill in developing countries, in addition to the real appreciation of exchange rates, indicate that the recovery in those countries depends increasingly on the expansion of domestic markets rather than on exports to developed countries. Nevertheless, developed countries remain important export destinations, and subdued growth in those countries, combined with upward pressures on developing countries' currencies, risks reigniting or reinforcing pressures for relative wage compression in developing countries as well. So far, this has not occurred, but the slowdown in global industrial production in the second quarter of 2011 increases that risk. Indeed, a macroeconomic policy mix in developed economies featuring fiscal austerity, tighter monetary policies and wage compression could create new global vulnerabilities, which may also affect developing countries. The global recovery would be ill-served by merely shifting fragility from the North to the South instead of directly addressing the fragilities at their source.

2. *Incomes policy and inflation control*

Growth-friendly macroeconomic policies, of which a proactive incomes policy is a key element, can also help to contain inflation, since investment and productivity growth create the capacities needed to meet the desired steady expansion of domestic demand. An incomes policy based on clear rules for determining wage income in a growing economy can greatly facilitate policymakers' task, and support capital formation and sustainable development. Such

Chart 1.6

TOTAL WAGE BILL AND PRIVATE CONSUMPTION AT CONSTANT PRICES, SELECTED COUNTRIES, 1996–2010

(Annual percentage changes)

Source: UNCTAD secretariat calculations, based on IMF, *World Economic Outlook* database; and *International Financial Statistics* database; and Lindenboim, Kennedy and Graña, 2011.

a policy, which aims at achieving wage growth in line with productivity growth (plus an inflation target), paves the way for a steady expansion of domestic demand as a basis for expanding investment while containing cost-push risks to price stability.

Wages are the most important determinant of the overall cost of production in a modern, vertically integrated market economy. An incomes policy is therefore also an instrument of inflation control. Wage growth based on the above-mentioned principle would contribute to keeping inflation within the government's target by preventing an overshooting of unit labour costs and maintaining a steady increase in demand. While incomes policy could focus on inflation control, monetary policy could concentrate on securing low-cost finance for investment in real productive capacity, which would create new employment opportunities. In several countries where real wages and the wage share fell due to prolonged economic stagnation and deteriorating labour conditions – as in Latin America and Africa in the 1980s and 1990s – real wages could be allowed to rise faster than productivity for some time in order to restore the desired income distribution pattern. Such a change in income distribution would probably need negotiations among the social partners and the government in order to avoid a wage-price spiral, and it is likely to be facilitated by economic recovery and subsequent improvements in the labour market.

By achieving a rate of wage growth that corresponds approximately to the rate of productivity growth, augmented by a target rate of inflation, it would be possible to control inflation expectations. The problem in the euro area is that these macroeconomic considerations have not been taken into account in some of the member countries (as discussed in chapter VI).

In view of the slow recovery in developed countries (as indicated in chart 1.1), the risk of demand inflation in these countries is minimal. The United States and Europe are experiencing enormous labour market slack, despite the fact that real wages are barely growing. Weak employment growth and stagnant wages, resulting in slow growth of disposable income, are hindering a sustainable domestic-demand-led recovery and are increasing the risk of an excessive reliance on exports for growth. In certain peripheral euro-area countries in particular, debt deflation is an additional acute threat. Fears that the increase in the monetary base in major economies will lead to an acceleration of inflation fail to take into account the context of deflationary forces in which these developments have been occurring. These forces include the ongoing deleveraging processes under way in the still weak financial systems and households of the respective developed economies.[8]

In this context, increases in food and energy prices may cause higher headline inflation in the short run. However, this should not pose a threat of sustained inflation, because the increase in the overall price level is only temporary, and a "second round" of price increases triggered by a wage-price spiral that could make the inflation hike permanent is highly improbable. Furthermore, anti-inflationary policies involving monetary tightening would also be ineffective, to the extent to which the increase in food and energy prices did not result mainly from higher demand for these goods, but rather from the speculative activities of financial investors (see chapter V). Even if restrictive monetary policies could trigger a severe world recession, causing commodity prices to plunge, as they did in the second half of 2008, the remedy would be worse than the illness.

In spite of that, the European Central Bank (ECB) has continued to take its cue from headline inflation, embarking on monetary tightening in April 2011. The Italian central bank governor and recently appointed head of the ECB, Mario Draghi, warned, as early as November 2010, that a "clear and present danger" of overheating justified a "greater need to proceed with monetary policy normalisation" to prevent inflation from being imported from emerging market economies (cited in Wiesmann, 2011). However, faster wage growth in China does not pose any imminent threat of global inflation;[9] rather, it is an important element in rebalancing the Chinese economy towards increasing private consumption. And rebalancing the Chinese economy not only pre-empts the deflationary threat potentially posed by an unravelling of China's fast-track catching up; it also contributes positively to the rebalancing of global demand. Indeed, rising wages amount to a real appreciation of the yuan. Moreover, inflation in China is being driven by rising prices of food, energy and industrial raw materials. However, more generally, rising headline inflation in developing economies is less an issue of overheating than a reflection of the fact that food and energy prices have a much greater weight in the consumer price indices of poorer

countries than of developed countries (*TDR 2008*, and chapter V of this *Report*).

More serious concerns arise from asset price inflation, strong credit growth and the widening of current-account deficits observed in some developing countries (e.g. Brazil, India, South Africa and Turkey, among the G-20 members). In the case of Brazil, the central bank raised the interest rate, which was already high in real terms, and the fiscal stance was also tightened. The Russian central bank took similar action. In both cases, it seems that core inflation beyond food and energy prices had also increased. However, that does not necessarily mean that contractionary monetary policy should be the instrument of choice to curb the rise in domestic prices. Price management and supply-side policies that increase the provision of goods and services, along with social pacts that link the rise of real wages to a rise in productivity, might be used to contain cost pressures when an economy still has spare capacity.

3. The European crisis and the need for proactive incomes policies

The lack of proactive and coordinated incomes policies is one of the main causes of present tensions in Europe, particularly within the euro area. Since the launching of the Economic and Monetary Union (EMU), serious imbalances have been building up as a result of diverging national wage trends. In a monetary union, national wage trends are the main determinant of the real exchange rate among its member economies. To avoid dislocations in intraregional competitiveness positions, national wage trends need to follow an implicit norm that is the sum of national productivity growth and the agreed union-wide inflation rate (defined by the ECB as "below but close to 2 per cent"). Countries in the periphery that are experiencing severe public-debt crises today departed from this norm somewhat in the upward direction, whereas Germany, the economy with the largest trade surplus within the euro area, also missed that implicit norm, but in a downward direction. As a result, over time Germany experienced cumulative competitiveness gains vis-à-vis its European partners, especially vis-à-vis the countries in the periphery (*TDRs 2006* and *2010*; Flassbeck, 2007; Bibow, 2006). If inflation rates differ among countries with their own national currencies, they always have the possibility to compensate for inflation differentials by means of exchange rate adjustments. However, this solution is not possible within the EMU, which makes the resolution of the crisis even more difficult than that of comparable crises in a number of emerging market economies over the past 30 years.

Widening current-account imbalances inside the euro area occurred partly as a result of lending flows, which in some cases caused property bubbles. The bursting of those bubbles resulted in private debt overhangs that first triggered banking crises and eventually turned into today's sovereign debt crises. As a result, banks in the surplus countries became heavily exposed to debtors in the deficit countries.

With the reappearance of severe debt market stress in a number of countries in the second quarter of 2011, most governments are convinced that fiscal austerity is needed for debt sustainability, and that wage compression and labour market reform will restore competitiveness. Reflecting a dogmatic rejection of government intervention, the euro-area authorities only reluctantly considered fiscal stimulus measures. Initially slow to act, they were then the first to call for an early exit from global stimulus, even before recovery had properly taken root. In the event, the euro area has proved the laggard in the global recovery and is now a hotspot of economic instability. Today's financial and economic instabilities arise from an unresolved debt crisis that has its origins in private debt, and which the euro area's policy-making mechanism seems ill-equipped to handle. The area's policy response remains single-mindedly focused on fiscal retrenchment and on "strengthening" the so-called Stability and Growth Pact that was established to govern and asymmetrically discipline member countries' fiscal policies.

Apart from a perceived lack of fiscal discipline, today's crisis in the euro area is widely seen as evidence of a lack of labour market flexibility. But neither fiscal profligacy nor insufficiently flexible labour markets can explain the crisis. Rather, the area's policy regime lacks suitable coordinating mechanisms that would assure stable domestic demand growth while preventing intraregional divergences and imbalances. In concrete terms, excessive wage increases in the economies now in crisis, on the one hand, and stagnating unit labour costs in Germany on the other, have allowed the accumulation of

current-account surpluses in the latter at the expense of other countries in the area. By further weakening economic growth, the policies proposed by the euro-area authorities may not succeed in improving debt sustainability either (see chapter III).

Austerity measures in the deficit countries may reduce intra-area current-account imbalances through income compression, but they may also worsen the underlying solvency problem through debt deflation (especially if emergency liquidity is provided at penalty rates). If the debtor countries receive sufficient official financing at reasonable rates (as decided by the European Council on 21 July 2011), they may avoid or postpone default, but this will not resolve the underlying problem of their lack of competitiveness and growth. Owing to erroneous regional policy responses, the crisis countries in the euro area are today labouring under extremely difficult conditions: their GDP growth is flat or even negative, while their market interest rates on public debt are prohibitively high. Seen globally, however, these local conditions are highly exceptional. While their budget deficits are generally high and their public debt ratios are rising, inflation remains low. Thus the current predicament in Europe should be resolved by promoting growth and reducing intraregional imbalances. The European experience holds important lessons for the rest of the world, in particular that austerity without regard for regional domestic demand growth may backfire badly. Well-coordinated monetary policies and debt management aimed at keeping borrowing costs in check regionwide is therefore of the utmost importance.

C. Progress towards global rebalancing, growth and development: an assessment of global cooperation

The latest global financial and economic crisis originated in the United States and Western Europe as excessive private debt led their tightly integrated financial systems to the verge of collapse. With the financial meltdown, which had the potential to cause another Great Depression of global dimensions, policymakers realized that dealing with the fallout would require urgent international coordination of economic policies.

At the peak of the global crisis there was a rare display of international solidarity, with coordinated monetary stimulus by major central banks leading the way. At the G-20 summit meetings in November 2008 in Washington and in April 2009 in London, Heads of State and Government committed to providing sizeable fiscal stimulus packages and emergency support programmes for restoring financial stability. The aggregate policy impact of these measures stopped the economic freefall and won global policymakers an important first round in battling the crisis. Today, the G-20 continues to be a leading forum for international economic cooperation. The Framework for Strong, Sustainable and Balanced Growth, launched at the G-20 summit meeting in Pittsburgh in September 2009, has also become the centrepiece of economic policy coordination among members. The framework commits G-20 members to "work together to assess how [their national] policies fit together, to evaluate whether they are collectively consistent with more sustainable and balanced growth, and to act as necessary to meet [our] common objectives" (G-20, 2009). A country-led, consultative "mutual assessment process" (MAP) was initiated to review members' actions for that purpose.

The success of these exercises critically hinges on a certain degree of commonality of policy views among members, which remains problematic. Since mid-2010, there has been a clear shift in the

general policy orientation. While the previous position was that fiscal stimulus should be maintained until recovery was assured, the Toronto Summit Declaration established fiscal consolidation as the new policy priority. Accordingly, developed countries announced their commitment to at least halve their fiscal deficits by 2013 and to stabilize or reduce their public-debt-to-GDP ratios by 2016 (G-20, 2010a). The subsequent Seoul Action Plan of November 2010 called for a common effort to safeguard the recovery and achieve strong, sustainable and balanced growth. A range of policies was identified as potentially contributing to reducing excessive imbalances, including a move towards ensuring that exchange rates are determined by "market fundamentals". In addition, members committed to implementing structural reforms "to reduce the reliance on external demand and focus more on domestic sources of growth in surplus countries while promoting higher national savings and enhancing export competitiveness in deficit countries" (G-20, 2011a).

In this context, it was agreed to monitor the implementation of countries' commitments and assess progress towards meeting their shared objectives. It was decided to enhance the MAP by means of "indicative guidelines" to serve as a "mechanism to facilitate timely identification of large imbalances that require preventive and corrective actions to be taken" (G-20, 2010b). Accordingly, it was agreed to establish a set of indicators, including public debt and fiscal deficits; private debt and savings rates; and current-account balances, "taking due consideration of exchange rate, fiscal, monetary and other policies" (G-20, 2011).

The definition of such indicators is neither obvious nor neutral: a lack of official data, different national methodologies, the choice of an appropriate reference period and the production of consistent country forecasts are some of the issues that need to be resolved. Looking at the components of the current account rather than just at the overall balance would add valuable insight to the analysis, especially as changes in the current-account balance can be driven by a variety of factors.[10] Moreover, there are different views as to how global imbalances could be reduced.

Much is at stake in finding a globally coordinated answer to this issue of global imbalances, but there are conflicting policy views. Disagreements pertain to how global imbalances contributed to the global crisis, which policy adjustments may be best suited for reducing excessive imbalances, and which countries should undertake most of those adjustments. One point of view is presented by the IMF, based on a distinction between developed and emerging G-20 economies on the one hand, and deficit and surplus countries on the other. It calls for stronger fiscal consolidation, mainly in the developed countries that have a deficit, and for emerging economies with a surplus to reorient their growth strategy from a reliance on external demand to a reliance on domestic demand. However, the developed surplus economies are not asked to do the same (i.e. to stimulate their domestic markets instead of continuously relying on net exports) (Lipsky, 2011).

On the other hand, a Feasible Policy Coordination Scenario for Global Rebalancing and Sustained Growth produced by the United Nations (UN/DESA, 2011) proposes a stronger role for fiscal policy in the short term (see also chapter III). It forecasts that a policy that postpones fiscal tightening in developed economies, and uses incentives to foster private investment, while also increasing government spending on improvements in infrastructure and on research and development for greater energy efficiency will be more favourable to GDP growth. Fiscal policy could either support or restrain household disposable incomes and spending in both current-account surplus and deficit countries. In this Feasible Policy Coordination Scenario, a general narrowing (or containment) of current-account imbalances to less than 4 per cent of GDP is achievable by 2015, or earlier, with only a moderate further depreciation of the dollar.

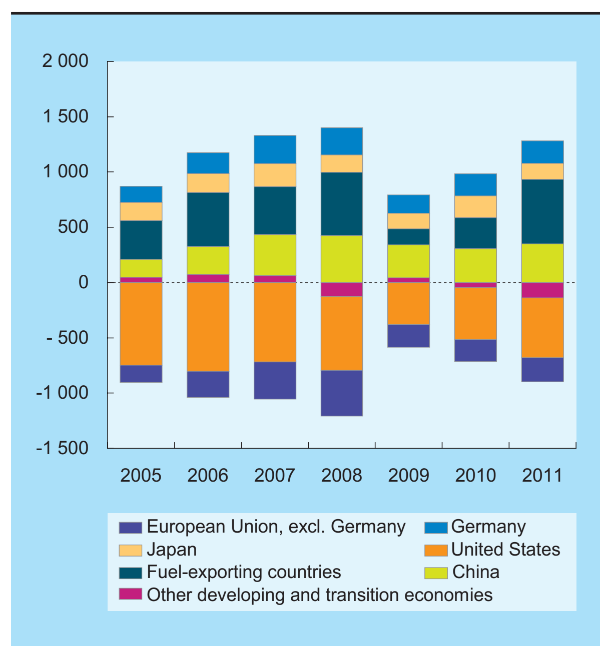
Examining the evolution of global current-account imbalances since the global crisis erupted raises doubts about the effectiveness of the existing initiatives. In current dollars terms, global current-account imbalances peaked in 2007–2008, shrank in 2009 – when the volume and value of global trade declined sharply – and are widening again in 2010–2011 as trade and GDP recover. Imports and exports (by volume) generally fall and rise in parallel in both deficit and surplus major economies. They fell and recovered at very similar paces in the EU, the United States and the developing economies as a group (see table 1.2). Among the surplus countries, only in China and Japan did the volume of exports fall more than that of imports in 2009, thereby contributing

to global rebalancing. Changes in prices played an even more important role: the decline in commodity prices (especially of oil) in 2009 helped reduce the deficit in the EU (excluding Germany) and the United States in 2009, and their recovery is contributing to a widening of these deficits in 2010 and 2011. An inflated oil import bill is today the largest contributor to the increase in the current-account deficit of the United States, as that country's non-oil merchandise trade balance has improved significantly. The counterpart to these developments is the reduction in 2009 of the current-account surplus of the major oil-exporting countries, and its subsequent renewed rise. In current dollars terms, or as a percentage of world GDP, global imbalances are still below their pre-crisis highs, but they are already approaching the levels of 2006 (chart 1.7).

Chart 1.7

CURRENT-ACCOUNT BALANCES, SELECTED COUNTRIES AND COUNTRY GROUPS, 2005–2011

(Billions of current dollars)



Source: UNCTAD secretariat calculations, based on UN/DESA, *National Accounts Main Aggregates* database, and *WESP 2011: Mid-year Update*; and IMF, *World Economic Outlook* database.
Note: Data for 2011 are forecast.

Current-account imbalances have been reduced if measured in terms of their share in each country's GDP. In 2010, the current-account deficit in countries such as the United States and Spain roughly halved from its pre-crisis levels (falling from 6 per cent to 3.2 per cent and from 10 per cent to 4.5 per cent, respectively); but it did not fall significantly in the United Kingdom. On the other hand, developed economies that had a surplus reduced that surplus rather moderately. In Germany, it remained at almost 6 per cent of GDP in 2010, mainly due to its trade surplus. In Japan, the surplus was around 3.5 per cent of the GDP, owing mainly to net income revenues, which, being a rather stable source of income, are likely to maintain this surplus in the foreseeable future. Among the developing countries with a current-account surplus, China's surplus has fallen sharply from its pre-crisis peak of over 10 per cent of GDP to around 5 per cent in 2010, and it is probably even lower in 2011. This is partly due to a decline in its trade surplus, but also to its continuing GDP growth, which is more rapid in current United States dollars than in constant yuan due to a real appreciation of its currency.

Current-account positions have been affected by the timing and characteristics of countries' recovery from the global crisis. A decomposition of growth into domestic demand and net exports shows that growth in Brazil, China, India and the Russian Federation has been largely driven by an increase in domestic demand. This suggests that these developing and transition economies are honouring their commitment to help reduce global imbalances. In other countries, such as Japan and members of the euro area, it is net exports that have been the major engine of growth. In the United States, net exports have played a near-neutral role in the recovery. While Germany and Japan have greatly benefited from brisk export growth to China, which outpaced their growth in imports, the increase in United States exports was balanced by a similar increase in its imports.

Exchange rates and interest rates are key variables that affect the sustainability of current-account imbalances. Exchange rates determine countries' international competitiveness, and adjustments in those rates may therefore serve to correct imbalances in competitiveness. Interest rates matter because of their influence on countries' net investment income, and also because of their role as drivers of capital flows, thereby indirectly affecting exchange rates and competitiveness. The question is whether global currency markets can be trusted to establish equilibrium in exchange rates on their own.

Since 2007, there has been a sizeable depreciation in the real effective exchange rate (REER) in two large current-account deficit countries, the United Kingdom and the United States (chart 1.8), which seems to be in line with rebalancing requirements.[11] The same holds for the marked rise in China's REER since 2005. In Germany, there has been a significant improvement in competitiveness in the context of the European crisis, which is inconsistent with the country's surplus position. The fact that the euro area's current account has been mostly balanced overall does not change this assessment; rather, it confirms the existence of serious intraregional imbalances. The increase in Germany's external competitiveness is inconsistent with the objective of achieving a global balance. Equally inconsistent with global requirements was the marked depreciation of Japan's REER in the pre-crisis period. The pronounced weakness of the yen during that period was due to its attractiveness as a carry-trade funding currency. Afterwards, the yen appreciated, as policy interest rates in all the major developed economies were cut to near zero in response to the global crisis, and the yen lost its role as the most important funding currency for carry trade (see chapter VI).

Brazil's REER moved sharply in the opposite direction to the Japanese yen, as carry-trade positions unwound at the peak of the crisis, but it has since resumed its sharp appreciation reflecting the Brazilian real's renewed attractiveness as a carry-trade target currency. As a result, Brazil's exports of manufactures have suffered a loss of competitiveness, and the country's trade balance has declined despite the ongoing commodity price boom, although it still remains in surplus. What has dramatically increased is its deficit in investment income, owing mainly to profit remittances by transnational corporations and, to a lesser extent, interest payments on debt. Similar exchange rate trends have been observed in other developing countries, a number of which have meanwhile drifted into sizeable current-account deficit positions – a new form of the "Dutch disease" – which may herald future instabilities of systemic significance (Bresser-Pereira, 2008). The currencies of Chile, India, Mexico, the Republic of Korea, the Russian Federation, South Africa and Turkey, for example, underwent a significant appreciation of their REER following the recovery from the crisis (chart 1.8).

Exchange rate movements that are persistently inconsistent with achieving balanced global competitiveness positions provide strong evidence for the need to coordinate global currency markets. National governments may intervene in currency markets in pursuit of national policy objectives, either to offset market failures and prevent exchange rate misalignment or to attain a competitive advantage. The point is that exchange rates are intrinsically a multilateral issue that requires multilateral management.

The Seoul Action Plan includes a commitment to "move toward more market-determined exchange rate systems, enhancing exchange rate flexibility to reflect underlying economic fundamentals, and refraining from competitive devaluation of currencies." It also states, "Advanced economies, including those with reserve currencies, will be vigilant against excess volatility and disorderly movements in exchange rates" (G-20, 2010b). If these commitments herald a move towards floating exchange rates and withdrawal of government intervention, the action plan will not succeed in achieving global stability. The evidence is overwhelming: left on their own, currency markets are a primary source of instability and systemic risk.[12]

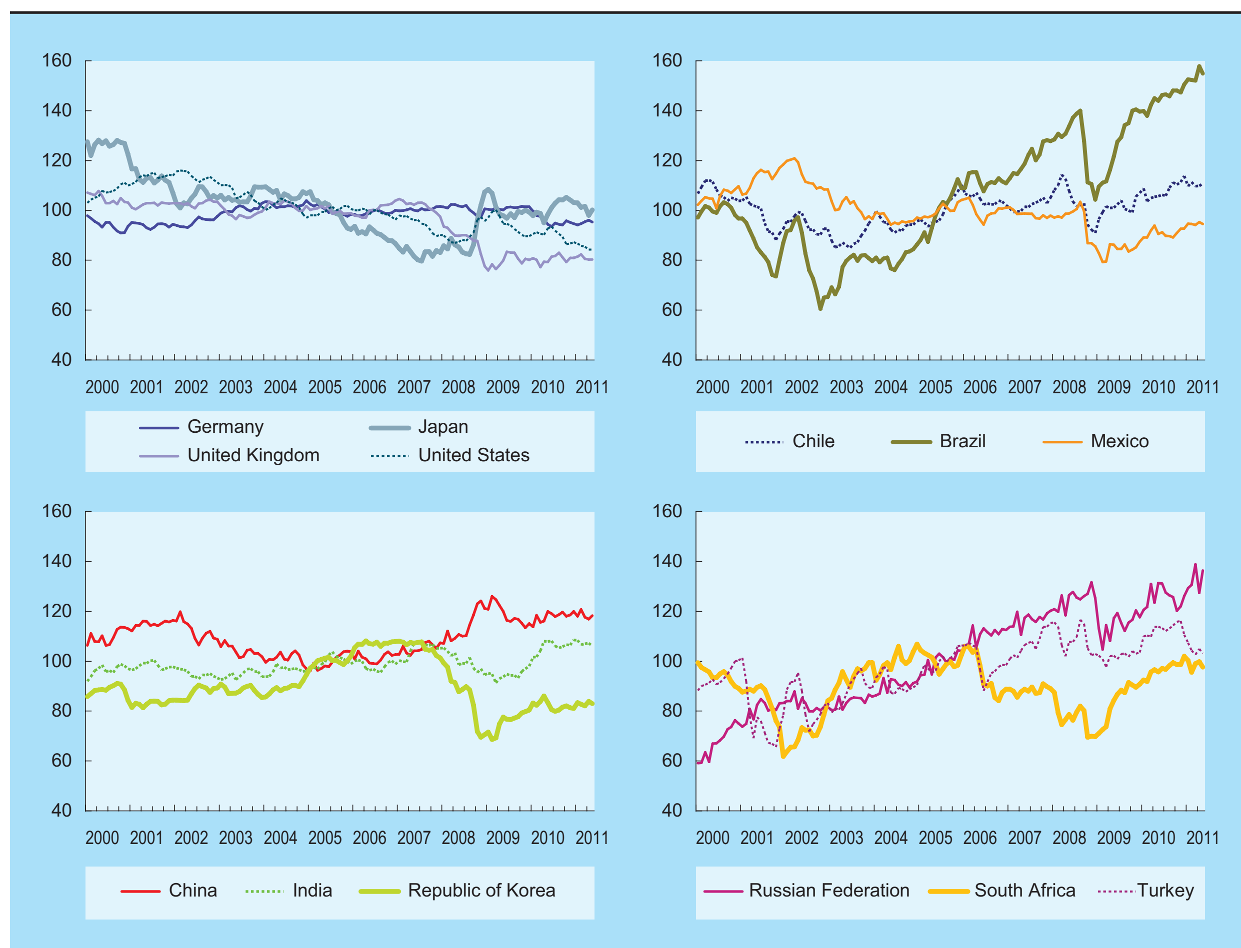
Globalization requires proper global economic governance. However, the existing system of global governance, especially the global monetary and financial system, has major shortcomings, as highlighted by the latest global crisis. This is why continued G-20 efforts to promote international economic cooperation are important. The crisis also highlighted serious flaws in the pre-crisis belief in liberalization and self-regulating markets. Liberalized financial markets have been encouraging excessive speculation (which amounts to gambling) and instability. And financial innovations have been serving their own industry rather than the greater social interest. Ignoring these flaws risks another, possibly even bigger, crisis. The new emphasis on adopting a macroprudential perspective and paying greater attention to cross-border spillovers is laudable, but questions remain as to whether the system's functional efficiency in contributing to growth and stability of the real economy will be assured. So far, policymakers have been merely tinkering with, rather than fundamentally changing, the global economic governance regime.

Globalization has created a fundamental tension between global economic integration and national economic policies aimed at effectively meeting the responsibilities of national governments (Rodrik, 2011). It has also shifted the balance of power in

Chart 1.8

REAL EFFECTIVE EXCHANGE RATE, SELECTED COUNTRIES, JANUARY 2000–MAY 2011

(Index numbers, 2005 = 100, CPI based)



Source: Bank for International Settlements, *Effective Exchange Rate Indices* database.

favour of large, globally active corporations and players, including financial institutions, and left employees more vulnerable to global forces compounded by often weakened (or even absent) national safety nets. In many developed as well as developing countries, the forces unleashed by globalization have produced significant shifts in income distribution resulting in a falling share of wage income and a rising share of profits. But the global crisis has clearly exposed the limitations of this model. Today, more than ever before, there is an urgent need for a shift in the policy paradigm, together with fundamental reform of the global system of governance. The Seoul Development Consensus states that "for prosperity to be sustained it must be shared." This laudable slogan is true not only between countries but also within them. *TDR 2010* proposed productivity-led growth of labour income as the basis for a successful development strategy that gives priority to employment creation and poverty reduction. This strategy is even more important today, when the world is in the midst of a fragile two-speed recovery.

Notes

1 Long-term comparisons show that recent price volatility is not unprecedented for individual commodities (Calvo-Gonzales, Shankar and Trezzi, 2010; Jacks, O'Rourke and Williamson, 2011). Volatility in the price of oil in 2008, while high, remained well below that of the early 1970s. Nevertheless, the speed and amplitude of price swings that can be observed for a broad range of commodities clearly distinguishes the recent price swings from earlier ones (Baffes and Haniotis, 2010). More specifically, the magnitude of the most recent price upswing was above historical averages for food and metals, while the magnitude of the price rebound for oil was similar to historical averages, but the rebound was more rapid.

2 See *Financial Times*, "Investors pull out of commodity bull run", 6 July 2011, which reports (based on Barclays Capital data), that the withdrawal of commodity investors in May-June 2011 was the largest since the global financial crisis in 2008, comparable to their withdrawal in the last quarter of that year. IMF (2011b) also notes that the corrections partly reflected the unwinding of an earlier build-up of non commercial derivative positions.

3 In 2010 China surpassed the United States as the world's largest energy consumer (BP, 2011).

4 On 23 June 2011, IEA member countries agreed to make 2 million barrels of oil per day available from emergency stocks over an initial period of 30 days (IEA press release, "IEA makes 60 million barrels of oil available to market to offset Libyan disruption", at: http://www.iea.org/press/pressdetail.asp?PRESS_REL_ID=418).

5 Calculations are based on data from the USDA *Production, Supply and Distribution online* database, as well as the USDA *Feed Grains Data: Yearbook Tables*.

6 However, the cotton stocks situation is not entirely clear. It seems that some unrecorded hoarding was taking place in parallel with the price increases.

7 This is partly due to a lower share of wage-earners in the total labour force in developing economies, especially in Africa and Asia (*TDR 2010*).

8 Borio and Disyatat (2009) assess the use of unconventional monetary policies during the crisis, and discuss the issue of excessive bank reserves as a source of inflation. Tang and Upper (2010) investigate non-financial private sector deleveraging in the aftermath of systemic banking crisis.

9 The pre-crisis debate on the relationship between globalization and inflation remains inconclusive (see, for instance, Ball, 2006; and Borio and Filardo, 2007).

10 The exercise appropriately focuses exclusively on multilateral, rather than on any particular bilateral, imbalances. In the present day and age, when there has been an enormous rise in global value chains, an interpretation of trade developments based on gross values of exports and imports is bound to give a distorted picture of bilateral trade imbalances (for example, see Xing and Detert, 2010). The Director-General of the World Trade Organization (WTO) recently suggested that "trade in value-added" would serve as a better measurement of world trade (WTO, 2011b; see also WTO, 2011c).

11 In the case of the United States, the sharp appreciation of the dollar at the peak of the global crisis, owing to a "dollar shortage", interrupted the adjustment (see *TDR 2010*). In the case of the United Kingdom, the country's aggressive fiscal austerity programme is taking place in relatively benign conditions, supported by an accommodative monetary policy and currency depreciation.

12 Chapter VI of this *Report* outlines a proposal for a multilateral system of managed exchange rates.

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