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Chapter I

CURRENT TRENDS AND CHALLENGES IN THE WORLD ECONOMY

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A. Recent trends in the world economy

1. Global growth

The global economy weakened significantly towards the end of 2011 and further downside risks emerged in the first half of 2012. The growth rate of global output, which had already decelerated from 4.1 per cent in 2010 to 2.7 per cent in 2011, is expected to slow down even more in 2012 to below 2.5 per cent (table 1.1). Despite a very modest improvement in gross domestic product (GDP) growth in the United States and a more significant one in Japan, developed economies as a whole are likely to grow by only slightly more than 1 per cent in 2012, owing to the recession currently gripping the European Union (EU). This contrasts with a much stronger performance in developing and transition economies, where GDP growth should remain relatively high, at around 5 per cent and 4 per cent respectively.

Developed countries have not yet recovered from the financial crisis,[1] which has left in its wake a highly indebted private sector and a vulnerable financial system, with rising non-performing loans and limited access to inter-bank financing. Significant deleveraging was set in motion as banks sought to recapitalize and the private sector was unable or unwilling to take on new debts, strongly hampering domestic demand. Expansionary monetary policies, which included huge money creation in addition to very low policy interest rates, proved inadequate for reversing this situation. High levels of unemployment and wage stagnation or compression further hindered private consumption. On top of already weak private demand, fiscal tightening has been adopted in several developed countries with a view to reducing public debt and restoring the confidence of financial markets.

These problems have been particularly severe in the *European Union*, where economic activity is set to shrink in 2012: a fall in domestic consumption and investment since mid-2011 is only partly compensated by a rise in net exports. Recently, a number of policy initiatives have been undertaken to strengthen the banking system and reassure financial investors. Among these is a new fiscal architecture that includes a requirement for national budgets to be in balance or in surplus,[2] long-term refinancing operations by the European Central Bank (ECB), write-down of part of the Greek debt, reinforcement of the European Stability Mechanism and new rules for bank recapitalization. However, improvements in financial markets and confidence indicators in response to these measures were short-lived because the underlying causes of the crisis persist.

Within the EU, the euro zone faces some specific difficulties: it lacks a lender of last resort which could support governments as well as banks

Table 1.1

WORLD OUTPUT GROWTH, 2004–2012

(Annual percentage change)

Region/country	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012[a]*
World	**4.1**	**3.5**	**4.1**	**4.0**	**1.5**	**-2.3**	**4.1**	**2.7**	**2.3**
Developed countries	**3.0**	**2.4**	**2.8**	**2.6**	**0.0**	**-3.9**	**2.8**	**1.4**	**1.1**
of which:									
Japan	2.4	1.3	1.7	2.2	-1.0	-5.5	4.4	-0.7	2.2
United States	3.5	3.1	2.7	1.9	-0.4	-3.5	3.0	1.7	2.0
European Union (EU-27)	2.6	2.0	3.3	3.2	0.3	-4.4	2.1	1.5	-0.3
of which:									
Euro area	2.2	1.7	3.2	3.0	0.4	-4.4	2.0	1.5	-0.4
France	2.5	1.8	2.5	2.3	-0.1	-3.1	1.7	1.7	0.3
Germany	1.2	0.7	3.7	3.3	1.1	-5.1	3.7	3.0	0.9
Italy	1.7	0.9	2.2	1.7	-1.2	-5.5	1.8	0.4	-1.9
United Kingdom	3.0	2.1	2.6	3.5	-1.1	-4.4	2.1	0.7	-0.6
European Union (EU-12)[b]	5.6	4.8	6.5	6.0	4.1	-3.7	2.3	3.1	1.2
South-East Europe and CIS	**7.7**	**6.5**	**8.4**	**8.6**	**5.2**	**-6.5**	**4.2**	**4.5**	**4.3**
South-East Europe[c]	5.6	4.9	5.3	5.9	4.2	-3.7	0.7	1.1	0.2
CIS, incl. Georgia	7.9	6.7	8.7	8.9	5.3	-6.8	4.6	4.8	4.6
of which:									
Russian Federation	7.2	6.4	8.2	8.5	5.2	-7.8	4.0	4.3	4.7
Developing countries	**7.4**	**6.8**	**7.6**	**7.9**	**5.3**	**2.4**	**7.5**	**5.9**	**4.9**
Africa	7.9	5.4	6.1	6.0	4.8	0.9	4.5	2.5	4.1
North Africa, excl. Sudan	4.8	5.1	5.4	4.7	4.6	3.2	4.0	-1.1	3.9
Sub-Saharan Africa, excl. South Africa	12.8	5.8	6.9	7.2	5.6	0.6	5.8	4.8	4.9
South Africa	4.6	5.3	5.6	5.6	3.6	-1.7	2.8	3.1	2.7
Latin America and the Caribbean	5.8	4.6	5.6	5.6	4.0	-2.0	6.0	4.3	3.4
Caribbean	3.7	7.3	9.3	5.8	3.0	0.2	2.8	2.6	2.7
Central America, excl. Mexico	4.2	4.8	6.4	7.0	4.1	-0.2	4.0	4.9	4.5
Mexico	4.1	3.3	5.1	3.4	1.2	-6.3	5.8	3.9	4.0
South America	7.1	5.0	5.5	6.6	5.4	-0.2	6.5	4.5	3.1
of which:									
Brazil	5.7	3.2	4.0	6.1	5.2	-0.3	7.5	2.7	2.0
Asia	8.0	7.9	8.7	9.0	5.9	4.1	8.4	6.8	5.5
East Asia	8.3	8.6	10.0	11.1	7.0	5.9	9.4	7.6	6.3
of which:									
China	10.1	11.3	12.7	14.2	9.6	9.2	10.4	9.2	7.9
South Asia	7.5	8.2	8.5	8.9	5.8	5.5	7.3	6.0	5.2
of which:									
India	8.3	9.3	9.6	9.7	7.5	7.0	9.0	7.0	6.0
South-East Asia	6.5	5.8	6.2	7.0	4.0	1.3	8.0	4.5	4.9
West Asia	8.8	6.9	6.7	4.5	3.8	-1.1	6.5	6.9	3.7
Oceania	2.2	3.5	2.9	3.6	2.7	2.1	3.4	3.8	3.6

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): Update as of mid-2012;* ECLAC, 2012; *OECD,* 2012; IMF, *World Economic Outlook*, April 2012; Economist Intelligence Unit, *EIU CountryData* database; JP Morgan, *Global Data Watch*; 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.

if needed, and it has to manage trade imbalances and asymmetric trends in competitiveness within the zone while individual countries are unable to resort to nominal devaluations. Policy responses so far have been characterized by fiscal tightening, especially in countries with high external and fiscal deficits, in order to reassure financial investors of the solvency of their governments and banking systems. Both of these are closely related, as public bonds account for a significant share of banks' assets. In addition, governments have been seeking to reduce nominal wages and other costs in order to achieve a real devaluation within the monetary union (a process known as "internal devaluation"). These policies have taken a toll on economic growth and employment because they have aggravated the basic problem of insufficient demand. With faltering growth, fiscal revenues have been below expectations and the stress in the banking system has intensified in several countries. In addition, since "internal devaluation" has been undertaken simultaneously by several partners, and not all trading partners can become more competitive at the same time, ultimately none of them have been able to improve their competitiveness significantly. Given the disappointing results in terms of rebalancing competitiveness and reducing sovereign and banking risks, new initiatives have been approved, or are being debated, with the aim of supporting domestic demand. One such initiative is the announcement of a €120 billion "growth pact" at the Euro Summit on 28–29 June. There are also proposals for strengthening the mechanisms for supervision and recapitalization of the banking systems.

As a result of these developments, in 2012 almost all European countries will either experience decelerating growth (e.g. France, Germany and Sweden) or fall into recession (e.g. the Czech Republic, Hungary, Italy, the Netherlands, Spain and the United Kingdom). Meanwhile, Greece and Portugal are already in the throes of an economic depression. It is only in Iceland and Norway that GDP growth seems to be accelerating.

In the *United States,* GDP is forecast to grow at close to 2 per cent in 2012 – only slightly higher than in 2011. This growth is being driven almost exclusively by domestic demand; since exports and imports (by volume) are growing by similar amounts, the contribution of net exports to growth is virtually neutral. After recovering from the 2009 recession, domestic demand has lost momentum since late 2010 owing to high indebtedness of households, lower housing prices, sluggish real wages and persistently high unemployment rates. There were some improvements in household demand in the last quarter of 2011 and the first quarter of 2012, partly due to a reduction in the savings rate and a moderate increase in bank credit, but this trend was not maintained in the second quarter. The Government has managed to avoid full-scale fiscal tightening so far, although a fall in public spending has had a negative impact on overall growth since the third quarter of 2010. This could dramatically worsen if political considerations lead to deep fiscal cuts – the so-called "fiscal cliff" – in 2013.

Japan's GDP growth rate will probably exceed 2 per cent in 2012, based on relatively strong domestic demand. In particular, government expenditure on reconstruction following the natural disasters and nuclear accident in March 2011 will help boost GDP growth in 2012. The country's monetary policy remains very expansionary, with a policy rate close to zero and the extension of the asset-purchase programme. This policy, which aims at countering deflationary pressures by setting the inflation target at 1 per cent in 2012, has helped maintain low interest payments on the public debt. However, it has not stimulated bank credit to the private sector, which remains flat.

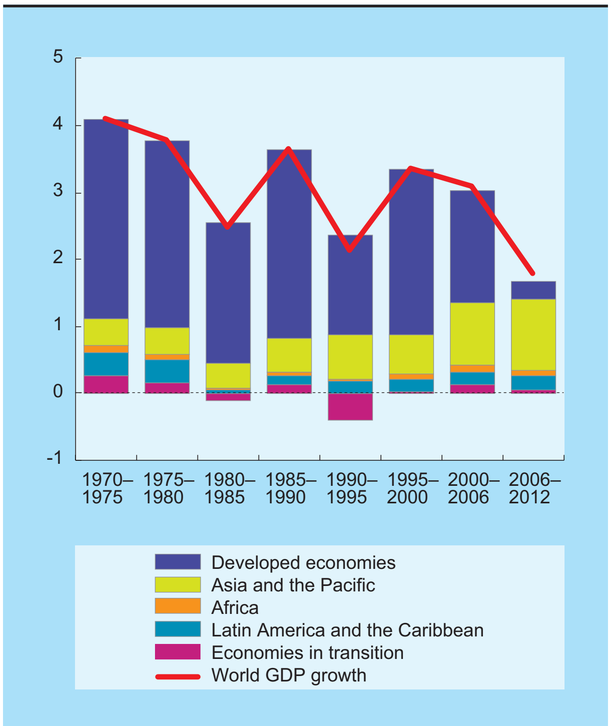
The crisis and its fallout have accelerated the trend towards a greater role of developing countries in the world economy. Between 2006 and 2012, 74 per cent of world GDP growth was generated in developing countries and only 22 per cent in developed countries. This is in sharp contrast to their respective contributions to global growth in previous decades: developed countries accounted for 75 per cent of global growth in the 1980s and 1990s, but this fell to a little over 50 per cent between 2000 and 2006 (chart 1.1).

GDP growth has been slowing down moderately in *Latin America and the Caribbean* to reach around 3.5 per cent in 2012 (table 1.1). Growth stems mainly from resilient domestic demand and other positive factors, including only a modest current-account deficit for the region as a whole averaging about 1.4 per cent of GDP in 2011, an equilibrated primary fiscal balance, falling public and external debts (except in the Caribbean countries) and solvent banking systems. In 2011 and the first half of 2012, employment grew consistently, particularly in formal occupations, real wages and credit to the private sector increased,

Chart 1.1

REGIONAL CONTRIBUTIONS TO WORLD GDP GROWTH, 1970–2012

(Per cent)



Source: UNCTAD secretariat calculations, based on table 1.1; *UNCTADstat*; UN/DESA, *National Accounts Main Aggregates* database; World Bank, *World Development Indicators*; and Maddison, 2008.

Note: Data are averages for the periods.

and the flow of remittances from the United States to several countries recovered. All these factors supported the expansion of private consumption. Regional gross fixed investment reached 23 per cent of GDP in 2011, exceeding its pre-crisis level. As a response to the worsening external environment, many countries have been adopting countercyclical fiscal policies by increasing public spending rather than lowering taxes. Indeed, some of them (including Brazil, Costa Rica, Chile, Colombia, Ecuador, El Salvador, Guatemala, Paraguay and Peru) have recently launched fiscal reforms aimed at increasing revenues to sustain government expenditure (ECLAC, 2012). Concerns about inflationary pressures that caused interest rates to rise in the first half of 2011 receded subsequently, which led to more accommodative monetary policies, particularly in the Bolivarian Republic of Venezuela, Brazil, Chile and Paraguay. Some countries, such as Argentina and Brazil, complemented such policies with credit schemes to promote the financing of productive activities. These measures aim to safeguard the policy space generated in recent years through higher public revenues and macroprudential financial policies (including the management of volatile external capital flows), and to use it for supporting growth and employment.

Growth rates increased in *Africa* because of the continuing dynamism in sub-Saharan African economies and a partial recovery in the Northern African countries whose economies had been strongly affected by internal conflicts in 2011. However, it will be difficult for the latter countries to return to their 2010 GDP levels before 2013 owing to a slow revival of their tourism revenues, high unemployment and the recession in Europe which is an important market for them. In South Africa, strong growth in public investment continued to support economic activities in early 2012. However, private investment, and to a lesser extent household consumption, have been showing signs of slowing down since early 2012. More generally, the weaker global environment is also taking its toll on several African economies, particularly those that are more dependent on developed-country markets. In addition, some mineral-exporting countries have witnessed a cooling off of external demand from some large emerging economies, though to a lesser extent. Nevertheless, the external and fiscal balances of many economies continue to be supported by relatively high prices of primary commodities. In addition, a few African countries have also benefited from the exploitation of mining, oil and gas deposits. In contrast to the bleak external conditions, domestic economic activities remain dynamic in many African economies. In sub-Saharan Africa, public spending and the services sector, particularly transport and telecommunications, continue to register robust growth. In parallel, investment in infrastructure and in natural resources has also been supporting domestic expenditure and growth.

Although it remains the fastest growing region, *Asia* is experiencing an economic slowdown, its GDP growth rate having fallen from 6.8 per cent to around 5.5 per cent in 2012. Several countries, including China, India and Turkey, have been negatively affected by weaker demand from developed countries and by the monetary tightening they applied in 2011 for curbing inflation and rising asset prices. Given the headwinds from the international economy, they have since relaxed monetary conditions and several countries have applied countercyclical measures. Regional growth has been driven mainly by high levels of investment and by the continuing expansion of household incomes and consumption, thereby reflecting a rebalancing of the sources of growth from external to domestic demand.

Within Asia, *East Asia* remains the fastest growing subregion, even though economic activity has moderated since mid-2011. In China, the recent easing of credit amidst a property market downturn, combined with a slightly more expansionary fiscal policy stance, is projected to maintain growth close to 8 per cent in 2012. Rising real wages will also support private domestic consumption. By contrast, Taiwan Province of China is forecast to experience a marked decline in annual GDP growth in 2012, owing to its strong exposure to developed economies and its smaller domestic market. In *South Asia*, India's recent slowdown also reflects decelerating private domestic demand, particularly investment, as a result of aggressive monetary tightening. In *South-East Asia*, some highly export-oriented economies registered low quarterly GDP growth in late 2011 and early 2012. On the other hand, populous economies of this subregion continue to experience robust domestic demand. For example, in Indonesia, which is one of the world's fastest growing economies, the unemployment rate declined further in early 2012. In Thailand, a large increase in fiscal spending is expected, which will support economic activity in the country, as the Government invests heavily in post-flood reconstruction activities. In *West Asia*, there are indications of a substantial slowing down of economic growth in 2012 owing partly to lower public spending in some of the countries compared with the exceptionally high levels of such spending in 2011. Moreover, conflict in the Syrian Arab Republic is strongly affecting its economy, and higher import bills in the oil-importing economies have been dragging down domestic demand. On the other hand, in the oil-exporting countries continuing high oil prices should allow them to resume strong public spending if necessary, and boost private consumption.

The *transition economies* have been maintaining a growth rate of over 4 per cent. This is entirely due to the dynamism of members of the Commonwealth of Independent States (CIS), given that the countries of South-Eastern European continue to suffer from the impact of economic recession in the EU. Growth in the CIS is based on strong domestic demand, spurred by gains from the terms of trade and/or workers' remittances. In the Russian Federation, private consumption and fixed investment supported growth despite near record capital outflows of over $84 billion in 2011 (Bank of Russia database). On the supply side, the recovery of agriculture has also played a significant role. In the central Asian CIS economies, growth continued to be strong as a result of relatively high commodity prices and increased public spending on infrastructure.

Summing up, most developing and transition economies have supported their GDP growth by encouraging domestic demand, and pursuing countercyclical policies, including the provision of fiscal stimulus and expansionary credit. They have also succeeded in preventing a significant rise in unemployment, and their incomes policies have enabled a continued growth of real wages. All this, together with public transfers in several countries, has promoted private consumption, and consequently, productive investment, even though in some countries this has not been sufficient to avoid a deceleration.

However, the developing and transition economies cannot avoid the impacts of economic troubles in the developed countries. This is already reflected in stagnating export volumes to those markets and a declining trend in commodity prices since the second quarter of 2011. Moreover, financial instability in developed countries is affecting financial flows to emerging market economies and adding to the inherent volatility of commodity prices. In several developing countries, excessive short-term capital inflows have had a negative impact on their exchange rates and competitiveness, prompting them to take measures to manage capital flows. Finally, the risk of a new major shock in global financial markets cannot be excluded, with its associated impacts on international trade volumes, asset and commodity prices, risk spreads, capital flows and exchange rates, all of which would affect developing and transition economies (Akyüz, 2012). These countries should continue to preserve their fiscal and financial room for manoeuvre, including by strengthening public revenues; capital and exchange rate management in order to avoid currency overvaluation and artificial credit booms; maintaining foreign currency reserves at an appropriate level for covering their precautionary needs; and enhancing regional monetary and financial cooperation.

2. International trade

Growth of world *merchandise trade* slowed down significantly to around 5.5 per cent in 2011, after a sharp rebound in 2010 when it grew by 14 per cent in volume (table 1.2). Moreover, available data for the first months of 2012 point to a further deceleration to around 3.5 per cent for the whole year (chart 1.2). These rates are well below the pre-crisis level of trade expansion of 8 per cent, on average, between 2003 and 2007.

The slowdown is largely the result of the weak performance of developed economies, which remain the major participants in world trade even though their aggregate share in total trade declined from 69 per cent in 1995 to 55 per cent in 2010 (UN/DESA, 2012a). Slow economic growth in these countries has dampened their imports, which grew by only 3.5 per cent (by volume) in 2011. Indeed, the recovery of trade flows from the slump of 2009 appeared to have ended by mid-2011, and the volume of imports has remained stagnant since then. Exports have performed slightly better, growing at 5.1 per cent in 2011 as a result of the rising, albeit recently decelerating, demand from the developing and transition economies. Among the developed countries, exports from the United States continued to grow at a faster rate than those from Japan, as the latter were affected by supply disruptions due to natural disasters in 2011. In the EU, intraregional trade, which accounts for a large proportion of member countries' trade has suffered as a result of the region's current economic recession. Viewed over a longer period, since 2006 the trade volume of this group of countries has almost stagnated: in the first months of 2012 compared with 2006, EU exports were only 8 per cent higher and imports were roughly at the same level (chart 1.2).

Faced with weak external demand from developed countries and heightened global uncertainties, export growth in developing countries and economies in transition also registered a deceleration in 2011, to 7 per cent and 6 per cent respectively. Sluggish demand from developed countries has primarily affected exporters of manufactures in developing countries, though increased South-South trade has partly counterbalanced this deceleration (UN/DESA, 2012a). However, the slowdown is expected to persist or even worsen in 2012 owing to the near-zero growth of imports expected in Europe, which is the largest trading partner for many developing countries. Some Asian developing countries will be the worst affected by the sluggish demand from developed countries because their exports – mostly manufactures – are highly dependent on developed-country markets. South Asia and West Asia have been the exceptions, as their exports actually accelerated in 2011, but this is somewhat misleading, as this increase was from low levels in 2010 when some large economies in these regions, such as India and Turkey, failed to bounce back above the levels they had registered in 2008. Overall, monthly data for late 2011 and early 2012 indicate a decelerating trend for exports from developing Asia, including South and West Asia: in April 2012, export levels for the whole region were only about 2 per cent higher year on year.

In the other developing regions as well as the transition economies, export volumes also slowed down significantly during the first half of 2011, but prospects seem better for 2012. Exports from Africa, Latin America and the transition economies increased well above the world average in the first months of 2012, on a year-on-year basis. This seems to reflect the higher resilience of demand for primary commodities, especially energy and food, owing to continued growth in many developing-country markets and also to the low elasticity of demand for these goods in developed countries. Imports grew significantly faster than exports in the commodity-exporting countries in these regions. These countries benefited from significant gains from the terms of trade in 2011, as the purchasing power of their exports increased well above what their volume growth would have allowed. The reverse occurred in most Asian countries, where the volume of imports grew slower than that of exports (table 1.2).

The year-on-year growth of *commercial services* (at current prices) also experienced a marked slowdown to 3 per cent for two consecutive quarters in late 2011 and early 2012, after having registered double-digit growth rates during the first three quarters of 2011 (UNCTAD/WTO, 2012). Travel and tourism services, which account for approximately a quarter of the trade in services, grew by 4.6 per cent in volume (measured by the number of arrivals), down from 6.4 per cent in 2010. Unlike overall economic activities, international tourism arrivals were particularly robust in Southern Europe, where they grew by 7.7 per cent. The prospects for tourism in 2012 also contrast with those for merchandise trade. Indeed,

Table 1.2

EXPORT AND IMPORT VOLUMES OF GOODS, SELECTED REGIONS AND COUNTRIES, 2008–2011

(Annual percentage change)

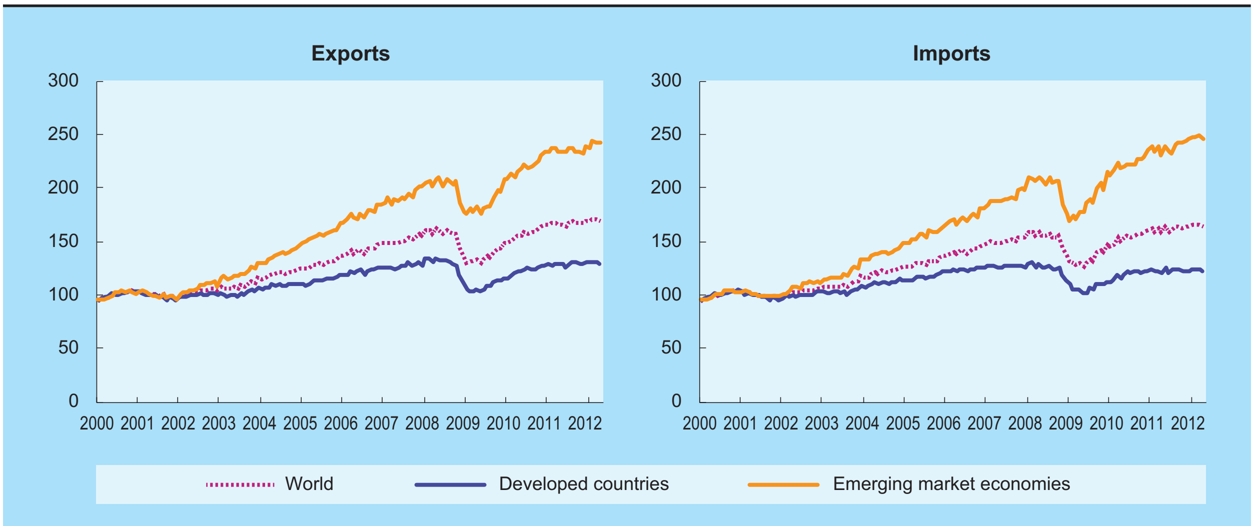
	Volume of exports				*Volume of imports*			
Region/country	*2008*	*2009*	*2010*	*2011*	*2008*	*2009*	*2010*	*2011*
World	**2.4**	**-13.1**	**13.9**	**5.9**	**2.5**	**-13.4**	**14.1**	**5.0**
Developed countries	**2.5**	**-15.2**	**13.2**	**5.1**	**-0.2**	**-14.5**	**11.0**	**3.5**
of which:								
Japan	2.3	-24.9	27.5	-0.4	-0.6	-12.4	10.1	1.9
United States	5.5	-14.9	15.3	7.2	-3.7	-16.4	14.8	3.8
European Union	2.4	-14.3	12.0	6.0	0.8	-14.2	10.0	3.2
Transition economies	**-0.2**	**-14.4**	**11.5**	**6.0**	**15.5**	**-28.6**	**15.5**	**17.0**
of which:								
CIS	-2.6	-11.4	13.3	2.3	22.0	-32.5	18.2	19.1
Developing countries	**3.2**	**-9.7**	**15.4**	**7.0**	**6.6**	**-9.9**	**19.2**	**6.2**
Africa	-3.1	-9.7	8.7	-5.1	10.6	-3.9	7.1	3.9
Sub-Saharan Africa	-4.1	-8.0	10.2	2.9	3.2	-4.4	8.8	7.0
Latin America and the Caribbean	-0.3	-11.0	10.3	3.4	8.5	-17.9	23.3	7.1
East Asia	7.3	-10.6	23.8	9.9	0.4	-5.3	25.0	7.5
of which:								
China	10.6	-13.9	29.0	12.8	2.3	-1.8	30.8	10.6
South Asia	6.8	-6.0	6.0	9.1	20.9	-5.6	13.9	4.1
of which:								
India	16.8	-6.6	5.9	13.7	29.7	-0.8	13.8	5.3
South-East Asia	1.6	-10.9	18.8	4.5	8.0	-16.3	21.9	6.1
West Asia	4.4	-1.1	2.6	12.7	12.5	-11.5	5.4	3.8

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

Chart 1.2

WORLD TRADE BY VOLUME, JANUARY 2000–APRIL 2012

(Index numbers, 2000 = 100)



Source: UNCTAD secretariat calculations, based on the CPB Netherlands Bureau of Economic Policy Analysis, *World Trade* database.
Note: Emerging market economies excludes Central and Eastern Europe.

in the first four months of 2012, tourism grew by 5.4 per cent year on year, mainly due to accelerating tourist activities in North America, North-East Asia and Western Europe (World Tourism Organization, 2012). Thus growth of international tourism is likely to remain stable in 2012, if not slightly higher than in 2011.

Transport services, the second largest category of commercial services, also decelerated in 2011. World seaborne trade grew by about 4 per cent in 2011 compared with 7 per cent in 2010, according to preliminary estimates. Growth was mainly due to a robust increase in container and dry bulk trade, which took the total volume of goods loaded worldwide to 8.7 billion tons (UNCTAD, 2012a). By contrast, oil trade, which accounts for about one third of total seaborne trade, expanded by less than 1 per cent. The share of developing countries in world seaborne trade has also been on the rise, reflecting their growing contribution to world gross product and merchandise trade (UN/DESA, 2012a). In 2011, 57 per cent of total world seaborne trade (by volume) was delivered in developing countries while 60 per cent of this trade originated from them. Geographically, Asia maintained its lead position in seaborne trade, with its share of goods unloaded amounting to 56 per cent, and the share of goods loaded reaching 39 per cent. In addition, the surge in China's demand for imported industrial commodities since 2000 has heightened its need to diversify the sources of supply, including from distant locations such as Brazil, South Africa and the United States. The estimated average distance of global iron ore trade, for instance, increased by about 15 per cent between 1998 and 2011, and is expected to increase further as new mines in the Arctic and West Africa are exploited (UNCTAD, 2012a).

Trends in the *terms of trade* show increasing divergences across different groups of developing countries over the past few years. Since 2002, developing countries that have a high share of oil and mineral and mining products in their total merchandise exports have gained the most from higher commodity prices compared with those of manufactures (chart 1.3A). Given that most of these countries are transition economies or are located in Africa, Latin America or West Asia, they have contributed to these regions experiencing the greatest improvements in their terms of trade (chart 1.3B). In those countries where fuel exports account for the largest share of their total exports, the terms of trade more than doubled between 2002 and 2011. By contrast, developing countries that have a large share of manufactures in their total exports, many of which are located in East or South-East Asia, experienced deteriorating terms of trade. This is partly due to the rising prices of their commodity imports, but also to the declining prices of manufactures exported by these countries relative to manufactures exported by developed countries. These divergent trends continued in 2011 as the prices of developing countries' exports of oil and mineral and mining products reached record high levels, while exporters of manufactures and net food importers experienced further deterioration in their terms of trade. Nevertheless, these trends are showing a pause or a moderate reversal in 2012, as many commodity prices have been falling since mid-2011 and might, on average, lead to levels slightly lower than those in 2011, as discussed in next section.

Turning to country-specific evidence, among the countries that have a dominant share of minerals and mining products in their exports, exporters of copper and/or gold (e.g. Chile, Peru and South Africa) have been seeing a very strong improvement in their terms of trade since 2004 (except for 2009). For these countries, the positive effect of the surge in international prices of copper and gold exceeded the combined negative effects of rising oil prices and adverse movements in the prices of manufactures.

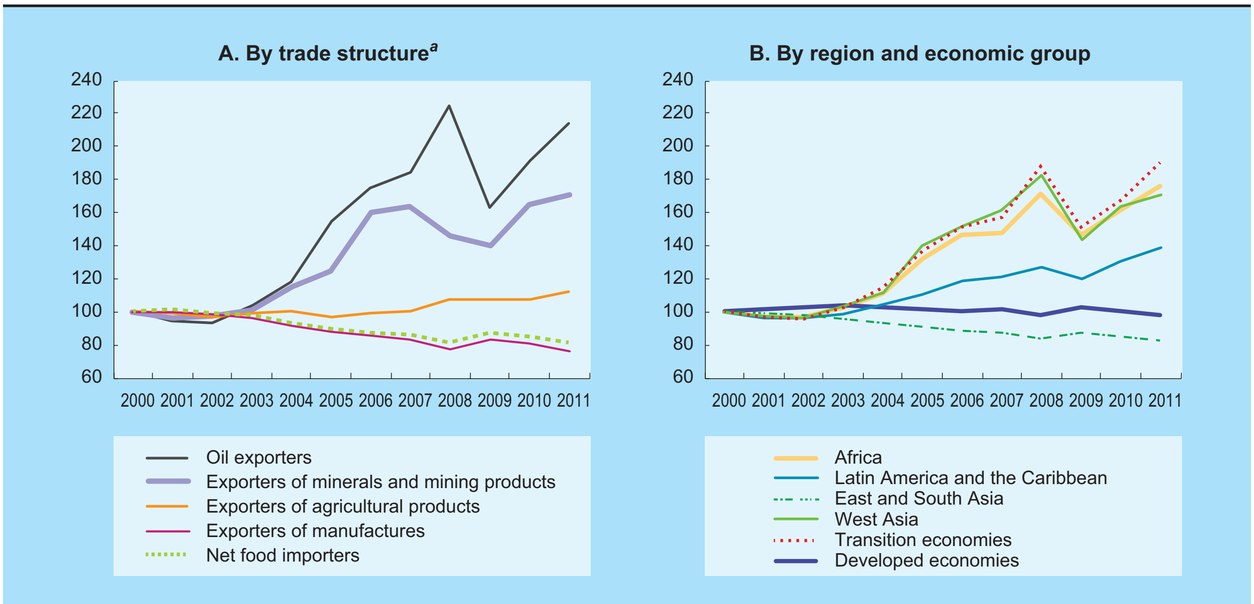
Terms-of-trade developments have varied widely among economies where agricultural commodities have dominated their total merchandise exports, owing to a combination of three factors: differences in price movements of specific agricultural products; differences in the share of other primary commodities in total exports across countries; and differences in the share of oil in their imports. Two countries in the group of agricultural commodity exporters that witnessed increases in their terms of trade, Argentina and Uruguay, benefited from higher prices of soybeans, beef and some cereals. In Argentina, this trend has been strengthened by exports of oil (until 2010) and mining products, although the impact of higher prices of these product categories has been dampened by increases in the prices of imported manufactures.

On the other hand, some fuel-importing developing countries whose merchandise exports are dominated by manufactures, such as India and the Republic of Korea, have seen deteriorating terms

Chart 1.3

NET BARTER TERMS OF TRADE, 2000–2011

(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 Data refer to developing and transition economies.

of trade. This has been largely due to their heavy dependence on fuel and mineral imports, and sometimes to the relative decline in the prices of their exports of manufactures.

The combined effect of the lower prices of exports of labour-intensive manufactures and higher prices of commodity imports has been less pronounced in countries that have become exporters of manufactures but remain sensitive to fluctuations in the prices of specific primary commodities. This is the case, in particular, for some countries in Latin America (e.g. Brazil, Colombia and Mexico) and East Asia (e.g. Indonesia), as well as South Africa. In many of them, price movements in the different product categories neutralized each other in their impact on the terms of trade. In Mexico, the Russian Federation and Saudi Arabia, where fuels account for a sizeable share of total merchandise exports, the positive contribution of higher fuel prices largely compensated for the negative impact of the falling prices of manufacturing exports and/or rising prices of food imports on the terms of trade.

These examples illustrate the diversity of the impact of recent international price movements on the terms of trade of developing countries. The variations in the global pattern of demand and their impact on individual countries have led to a redistribution of income, not only between developing and developed countries, but also, increasingly, among different groups of developing countries.

3. *Commodity markets*

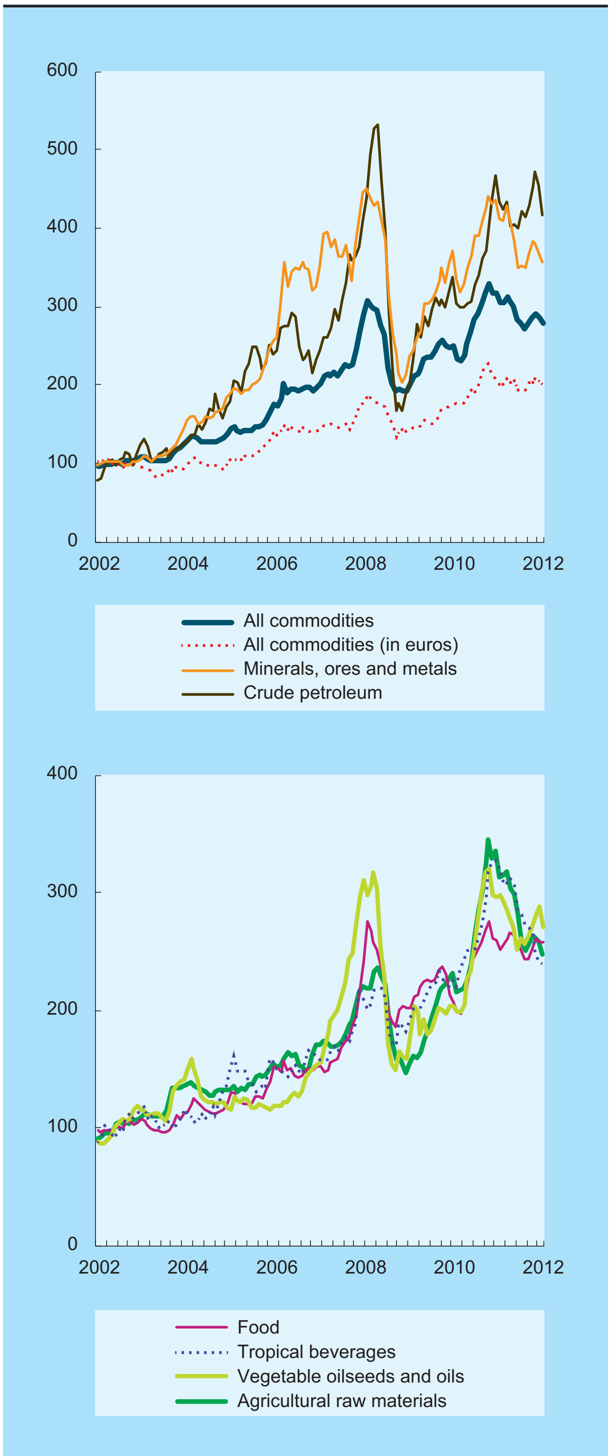
(a) *Recent trends in commodity prices*

Commodity prices have remained high and volatile in 2011 and the first half of 2012 (chart 1.4). However, they have been exhibiting a declining trend after peaking during the first months of 2011, oil being an exception to this general trend. The prices of commodities briefly rebounded at the turn of the year only to drop again in the second quarter of 2012.

Chart 1.4

MONTHLY COMMODITY PRICE INDICES BY COMMODITY GROUP, JAN. 2002–MAY 2012

(Index numbers, 2002 = 100)



Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics Online* database.

Note: Crude petroleum price is the average of Dubai/Brent/Texas, equally weighted. Index numbers are based on prices in current dollars, unless otherwise specified.

The magnitude of the price declines in the first half of 2012 by commodity compared to their last peaks is shown in table 1.3.[3] The last column of this table also shows that in 2011-2012 commodity prices were generally much higher than the average levels of the commodity price boom of 2003-2008. Recent price developments have been marked by the slowdown in global demand. Moreover, news about the evolution of the world economy and tensions in the euro zone had an impact on the activities of financial investors whose position-taking in commodity derivatives markets continues to affect price developments.[4]

The evolution of commodity prices varies depending on the type of commodity and the different factors affecting each particular market. For example, with regard to oil, price increases in early 2012 were partly related to geopolitical tensions in West Asia. The subsequent increase in oil production contributed to a decline in oil prices in the second quarter of 2012. In the case of agricultural commodities, weather conditions have played an important role; for instance, the price of soybeans rose during the first half of 2012 due to reduced harvests associated with dry weather conditions in South America and more recently in the United States. Positive expectations regarding corn crop yields based on a record planting season were reversed towards mid-2012 owing to a severe drought in the United States. As a result, prices of corn and soybeans reached record levels by July 2012. Similarly, the price of wheat has been affected recently by unfavourable weather in the Black Sea area. The rapid increase in food prices has raised fears of the possibility of a renewal of the global food crisis of 2008. However, so far inventories of the most important commodities for food security, rice and wheat, are not as dramatically low as they were at that time.

The fact that price movements continue to be heavily influenced by the strong presence of financial investors in commodity markets is reflected in an almost 40-fold increase in commodity assets under management between 2001 and 2011. Indeed, the price reductions in 2011 and 2012 have been accompanied by a large decline in positions taken by financial investors. The year 2011 was the weakest for commodity investment flows since 2002, and also the most volatile (Mohammadian-Molina, 2012). After briefly rebounding in early 2012, commodity investments turned negative in the second quarter. According to Barclays Capital (2012a), investors

Table 1.3

WORLD PRIMARY COMMODITY PRICES, 2006–2012

(Percentage change over previous year, unless otherwise indicated)

Commodity groups	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012[a]*	*Change from last peak[b]*	*2011–2012 versus 2003–2008[c]*
All commodities[d]	**30.2**	**13.0**	**24.0**	**-16.9**	**18.2**	**17.4**	**-6.5**	**-15.2**	**70.8**
All commodities (in SDRs)[d]	**30.5**	**8.6**	**19.5**	**-14.5**	**19.5**	**13.5**	**-4.2**	**-13.5**	**64.1**
All food	**16.3**	**13.3**	**39.2**	**-8.5**	**7.4**	**17.8**	**-3.6**	**-9.5**	**77.9**
Food and tropical beverages	**17.8**	**8.6**	**40.4**	**-5.4**	**5.6**	**16.5**	**-3.6**	**-8.6**	**77.7**
Tropical beverages	6.7	10.4	20.2	1.9	17.5	26.8	-17.1	-26.9	97.5
Coffee	7.1	12.5	15.4	-6.9	27.3	42.9	-18.5	-31.8	124.7
Cocoa	3.5	22.6	32.2	11.9	8.5	-4.9	-22.1	-33.4	52.4
Tea	11.7	-12.3	27.2	16.5	-1.0	11.4	-1.7	-7.4	55.1
Food	19.0	8.5	42.5	-6.0	4.4	15.4	-2.1	-6.7	75.8
Sugar	49.4	-31.7	26.9	41.8	17.3	22.2	-11.3	-29.7	144.1
Beef	-2.4	1.9	2.6	-1.2	27.5	20.0	4.7	-3.8	62.8
Maize	24.4	38.2	34.0	-24.4	13.2	50.1	-5.0	-13.8	106.3
Wheat	26.6	34.3	27.5	-31.4	3.3	35.1	-12.1	-23.1	48.3
Rice	5.5	9.5	110.7	-15.8	-11.5	5.9	3.7	-0.7	61.8
Bananas	18.5	-0.9	24.6	0.7	3.7	10.8	5.0	-17.0	61.5
Vegetable oilseeds and oils	**5.0**	**52.9**	**31.9**	**-28.4**	**22.7**	**27.2**	**-3.7**	**-15.4**	**78.9**
Soybeans	-2.2	43.0	36.1	-16.6	3.1	20.2	-0.1	-0.3	60.5
Agricultural raw materials	**13.3**	**12.0**	**20.5**	**-17.5**	**38.3**	**28.1**	**-15.9**	**-28.4**	**89.1**
Hides and skins	5.1	4.5	-11.3	-30.0	60.5	14.0	-2.5	-4.6	20.2
Cotton	5.9	10.2	12.8	-12.2	65.3	47.5	-36.2	-61.5	120.9
Tobacco	6.4	11.6	8.3	18.0	1.8	3.8	-2.1	-5.3	47.9
Rubber	40.6	9.5	16.9	-27.0	90.3	32.0	-20.7	-37.2	154.0
Tropical logs	-4.7	19.5	39.3	-20.6	1.8	13.8	-4.2	-10.7	32.4
Minerals, ores and metals	**60.3**	**12.8**	**6.2**	**-30.3**	**33.7**	**12.7**	**-7.7**	**-19.3**	**53.7**
Aluminium	35.4	2.7	-2.5	-35.3	30.5	10.4	-11.8	-24.9	8.3
Phosphate rock	5.3	60.5	387.2	-64.8	1.1	50.3	2.8	-13.6	92.3
Iron ore	..	77.4	26.8	-48.7	82.4	15.0	-15.4	-27.0	37.9
Tin	18.9	65.6	27.3	-26.7	50.4	28.0	-14.8	-37.3	139.4
Copper	82.7	5.9	-2.3	-26.3	47.0	17.1	-6.8	-19.7	78.1
Nickel	64.5	53.5	-43.3	-30.6	48.9	5.0	-18.0	-39.8	7.7
Lead	32.0	100.2	-19.0	-17.7	25.0	11.8	-13.9	-27.3	65.8
Zinc	137.0	-1.0	-42.2	-11.7	30.5	1.5	-8.8	-21.7	10.0
Gold	35.9	15.3	25.1	11.6	26.1	27.8	5.9	-10.5	182.5
Crude petroleum[e]	**20.4**	**10.7**	**36.4**	**-36.3**	**28.0**	**31.4**	**6.9**	**-11.6**	**80.5**
Memo item:									
Manufactures[f]	**3.4**	**7.5**	**4.9**	**-5.6**	**1.9**	**8.4**	**..**	**..**	**..**

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 unless otherwise specified.

a Percentage change between the average for the period January to May 2012 and the average for 2011.
b Percentage change between May 2012 and the last monthly peak.
c Percentage change between the 2003–2008 average and the 2011–2012 average.
d Excluding crude petroleum.
e Average of Brent, Dubai and West Texas Intermediate, equally weighted.
f Unit value of exports of manufactured goods of developed countries.

withdrew $8.2 billion from commodity investments in May 2012 in what was described as "something approaching a stampede ... evoking memories of 2008".[5] Overall, total commodity assets under management were down $28 billion from an all-time high of about $450 billion reached in April 2011 (Barclays Capital, 2012b). A recent illustration of the influence of financial investors on commodity markets is the rally in the oil markets following the agreement reached in the euro zone in late June 2012 on bank recapitalization, when the price of Brent oil rose 7 per cent in one day – an increase that could hardly be justified by fundamental supply and demand changes. The sharp increases in corn and soybean prices at the end of June 2012 would also appear to be partly related to the reaction of financial investors to the news of hot weather affecting harvests.[6]

These short-term price developments have revived the debate about long-term commodity price trends. The commodity price boom that started in the early 2000s and continued at least until 2011 – with the exception of the crisis-related break of 2008-2009 – is viewed as a new super-cycle (i.e. a trend rise in real prices of a broad range of commodities that lasts for one to two decades and is driven by urbanization and industrialization in at least one major economy). A high and growing intensity of the use of metals (i.e. the volume of metals consumed per unit of output) is often taken as an indicator of a commodity super-cycle (*TDR 2005:* 46–51).[7] However, the recent turnaround of the upward trend in commodity prices in the context of slower global economic growth may be an indication that the current commodity super-cycle is coming to an end.

Some of the factors contributing to the upward phase of the current commodity super-cycle have not disappeared, especially rapid and resilient economic growth in several major developing countries and their continuous need for investment in infrastructure and construction. In particular, China's robust demand for commodities has been a strong factor influencing the super-cycle. However, there are increasing concerns that it may be fading. There is disagreement as to whether China's high rate of fixed investment will be maintained with the same intensity of commodity demand growth per unit of output growth. There is a possibility that the expected slowdown in China's infrastructure and real estate sectors will mark an end to the commodity super-cycle (Credit Suisse, 2012). More generally, it is widely expected that the continued sluggish growth performance of the major developed countries will cause the post-crisis slowdown in China's export growth to remain subdued for quite some time. It is uncertain whether China's investment boom in infrastructure and commercial real estate, much of it due to the Government's post-crisis stimulus package (Cai, Wang and Zhang, 2010), can continue to compensate for the associated decline in aggregate demand growth indefinitely.[8] Strong domestic private and public consumption may sustain high growth rates, although that growth may involve less intensive use of certain types of commodity inputs. This would mean that China's contribution to the favourable conditions in global non-food commodity markets, and especially in base metals markets, may decline. In addition, some investment projects initiated during the years of rising prices may now begin to generate an increase in commodity supplies, which will ease the pressure on commodity prices.

As a result, it is rather uncertain whether the combination of sustained demand growth and constraints on supply expansion on which the commodity super-cycle has been based – and whose price effects have been amplified by financial speculators on commodity markets – will last much longer. As such, this would affect, in particular, base metals and perhaps also energy. Although continuing growth in East and South Asia and in other regions of the developing world is likely to prevent a significant fall in the demand for primary commodities, it is unlikely that future commodity price developments will show a stable upward trend. Therefore, commodity producing countries should not take rising commodity prices for granted and become complacent about policies towards diversification and industrialization.

(b) Distributional implications of commodity price developments

Regardless of what the future evolution of commodity prices might be, the persistence of high and volatile prices in recent years raises a number of issues relating to inequality and distributional aspects. Commodity price movements create winners and losers between and within countries. At the country level, rising prices of certain commodities led to higher export earnings and growth rates in the countries that produced and exported those commodities in the 2000s. However, the impact on domestic inequality in those exporting countries is unclear: on the one hand, rising commodity prices improves their fiscal space enabling them to apply redistributive policies; but on the other hand it is likely that only a small number of private owners of natural resources are the main beneficiaries. By contrast, commodity-importing developing countries have been burdened with rising import bills, particularly for food and fuel. This may limit their capacity to import capital goods and inputs, which are essential for their development.[9]

In addition, this tends to impose a much heavier burden on most household budgets in developing countries than in developed countries. In the poorest countries, food can account for up to 80 per cent of household expenditure. Thus rising food prices may cause the poorest households not only to reduce their nutrient intake, but also to cut down on other basic expenditures, such as on health care or education. They may also be forced to sell assets that provide them with the means for improving both their current and future income, thereby plunging them into a poverty trap and exacerbating income inequality that will be difficult to reverse.[10]

According to World Bank estimates, the international food price spike of 2007-2008 kept or pushed 105 million people below the poverty line, and the 2010-2011 spike similarly affected 48.6 million people (World Bank, 2012). In 2011 and the first half of 2012, the most dramatic situations in this regard were the famines in the Horn of Africa and the Sahel region of West Africa. While drought was the main cause of these emergency situations, the alarming hunger problem is compounded by the high food prices in international markets and worsened by conflicts. Yet many of the concerned countries cannot afford the necessary additional social expenditure to tackle hunger and malnutrition unless they reduce spending for other purposes, including urgent infrastructure investments. This dilemma suggests the need for additional external assistance to overcome this distribution problem in the poorer countries.

Indeed, in response to the global food crisis, G-8 leaders meeting at the summit in L'Aquila in 2009 pledged to increase aid to agriculture and committed to respect country-owned plans, with priority given to public investment to benefit smallholder farmers. However, only 22 per cent of the $22 billion pledged over three years had been actually spent in the first two years. The prospects for aid to agriculture, and for development aid more generally, are grim in the context of current fiscal austerity programmes in developed countries. Moreover, the announcement of the New Alliance for Food Security and Nutrition at the G-8 summit in May 2012 offers much lower investment pledges and gives greater emphasis to private agribusiness investment. Public and private investment may be complementary, but the goals of agribusiness, which focus on profits, do not necessarily correspond with the interests of smallholder farmers in improving income and food security, and neither do they necessarily help reduce poverty (AfricaFocus, 2012).[11]

The effects of commodity price developments on growth have often been accompanied by adverse distributional impacts. Even in commodity-producing developing countries where higher commodity prices boosted growth performance, the resulting gains did not spread sufficiently to benefit the overall population. One reason is that the ownership of natural resources is typically less equally distributed than that of other assets. Commodity production and their trade are dominated by large transnational corporations (TNCs) and trading companies.[12] In this context, it is often the large TNCs – and financial investors – that capture most of the gains from the commodity price increases, and few go to the commodity producers and workers in this sector, or even to the governments of the producing countries.[13]

As a result of high food prices and global food security concerns, there has been a rush by foreign investors for large-scale land acquisitions (or leases) in developing countries in the past few years, with potentially negative effects on land distribution and food security. Different actors, such as sovereign wealth funds, investment and pension funds, food corporations and large agricultural producers and landowners, have shown an increasing interest in acquiring or leasing land. This land rush is motivated mainly by widespread expectations of robust demand for food crops on account of population growth, strong growth in emerging markets and continuing increases in demand for biofuels, in addition to seeking higher returns and diversification of investment. Some governments in food-importing countries have also been investing in land abroad with the main goal of assuring their national food security.

A comprehensive assessment of the scale of these operations is complicated by the fact that many of these deals are rather opaque. Nevertheless, available evidence suggests that there has been a very large and rapid increase in these land investment deals, particularly since the 2007-2008 food crisis, and that they are set to continue. For example, according to Oxfam (2011), as many as 227 million hectares of land have been sold or leased in developing countries since 2001. Other estimates are lower, such as that of the International Land Coalition which suggests a figure of approximately 80 million hectares since 2000 (HLPE, 2011).[14] These deals, many of which are in Africa, often take place against payment of very low fees.

The trend in large-scale land acquisitions – commonly dubbed "land grabs" – can offer opportunities for developing countries, but it also poses significant challenges. On the one hand, in theory, they could provide a push to investment in agriculture after many decades of underinvestment, potentially leading to improvements in technology and infrastructure as well as promoting job creation. On the other hand, concerns have been raised about the challenges and risks they pose, particularly for small farmers and food security in developing countries. There are indications that most of the gains from this investment in land are captured by the investors and are not fairly distributed among the population in the host developing countries. It is hard to see how alleged benefits, for example in terms of employment generation or improved food security, would materialize, as most of this investment relates to crops for export which involve highly mechanized farming. In addition, since land rights are weak in many developing countries, poor smallholder farmers are very vulnerable to the increasing pressures and competition for land. In particular, they risk being displaced from their lands without receiving appropriate compensation, if any. Therefore this investment generally leads to rising concentration of land in a few hands.[15]

There have been a number of initiatives to address these issues and guarantee that land investments respect land rights and do not harm smallholder production – which constitutes a large share of agriculture in many developing countries – or food security. In May 2012, the United Nations Committee on World Food Security adopted *Voluntary Guidelines on the Responsible Governance of Tenure of Land, Fisheries and Forests in the Context of National Food Security*. In addition, UNCTAD, together with the FAO, the International Fund for Agricultural Development (IFAD) and the World Bank, has been participating in the development of the *Principles for Responsible Agricultural Investment that Respects Rights, Livelihoods and Resources*.[16] These are examples of some initial steps that are being taken to provide governments in developing countries with an appropriate framework for ensuring that land investments are made to be truly conducive to inclusive development.

Proactive policies are also needed in order to prevent rising inequality that may result from the current high prices of mineral and fuel commodities. Indeed, there are several distributional challenges associated with the extractive industries in terms of income inequality, regional asymmetries and intergenerational distribution. As they are capital-intensive, they create relatively little direct employment. Moreover, mineral and fuel production are generally geographically concentrated and the infrastructure developed for exporting their production is usually of little use for other economic activities or for the physical integration of the country. In the absence of effective policies aimed at developing upstream and downstream productive linkages, there tends to be only modest indirect employment and income generated in the producing country. Furthermore, as these are non-renewable resources, their exploitation will not benefit future generations unless a significant share of the income generated is invested within the country.

The challenge for making resource-based activities a source of inclusive growth is therefore to pursue policies that enable all segments of the population to share the benefits derived from resource earnings. To achieve this goal, it is necessary to address the issue of the distribution of the revenues from extractive industries between TNCs, which control a large proportion of export activities in this sector, and the governments in the producing countries. Resource exploitation generates rents (i.e. the difference between the sales value and the cost of exploitation of the resources, including normal profits) which, if effectively used, can serve as a basis for structural change and increased fixed capital formation. This in turn would lead to the creation of employment opportunities. Sources of government revenues from the primary commodity sector may be royalties, taxation, joint ventures, or full public ownership of the operating firms (see also chapter V of this *Report*). In this context, and quite independently of short-term price developments, there is a fundamental need to achieve the right balance between the profitability of private investment, on the one hand, and government appropriation of a fair share of the rents accruing from the higher prices in the extractive industries on the other. Governments should avoid engaging in a "race to the bottom" in fiscal rules and environmental regulations in order to attract foreign direct investment.

Evidence indicates large variations in the distribution of the rents from extractive activities across countries and sectors, which reflect differences in the role of State-owned enterprises (SOEs) and fiscal regimes. In countries where SOEs play a major role in the extractive industries, the share of the rents captured by the governments is much higher than in countries where these companies have been privatized and where the fiscal treatment is relatively liberal (*TDR 2010*, chap. V).

A fair sharing of resource rents between the State and investors (foreign or domestic) may be best assured by country-specific agreements with room for occasional renegotiation. Otherwise, they may include flexibility to adapt to changing market conditions. Both developed and developing countries, as well as some transition economies, have recently modified their fiscal regimes governing rent sharing with a view to benefiting more from windfall profits.[17] These policies are normally easier to apply for producing countries when commodity prices rise or are at historically high levels. Since TNCs cannot claim credit for the windfall gains, there is no economic or ethical reason for allowing them to appropriate those gains. As pointed out by the United Kingdom's Chancellor of the Exchequer, George Osborne, in justifying the Government's unilateral changing of the North Sea oil tax regime by imposing a supplementary charge on oil and gas production, "The oil companies are making unexpected profits on oil prices that are far higher than those they based their investment decisions on".[18]

By modifying their fiscal regimes to ensure more equitable rent sharing, governments can take advantage of favourable commodity price developments to achieve sustained and inclusive growth. In the long run, this goal is best achieved through policies that foster economic diversification and industrialization. The increase in government revenues can reduce income inequality and prevent deindustrialization through public investment and transfer payments that target those segments of the population that do not directly benefit from resource revenues. Policies should also aim at promoting industrial production, by encouraging exporting firms to add value locally and create a network of domestic suppliers, maintaining a competitive exchange rate and pursuing a monetary policy that stimulates private investment. Commodity-producing countries can also establish revenue stabilization funds, which could not only contribute to macroeconomic stability and intergenerational equity, but also minimize real exchange rate appreciation.

B. Economic challenges for the world economy and policy responses

1. *The difficult path towards strong and balanced growth*

Until the first half of 2009, governments of all the major economies responded to the economic and financial crisis by providing strong stimulus packages. The mix of policy tools varied from country to country. On the financial and monetary side, policies included the bailout of large financial institutions, the reduction of policy interest rates to historically low levels and the massive provision of liquidity in response to the freezing up of interbank credit. Some central banks interpreted their mandates broadly, providing direct support to their governments or to non-financial private agents. Many countries also relied on "automatic stabilizers" for increasing public expenditure and reducing tax collection. As all these policies were applied simultaneously in different countries, all the countries benefited from each other's stimulus measures, and the fall in GDP and international trade, albeit sharp, was relatively short-lived, especially in developing countries. This provided strong evidence of the power of economic synergies, and gave new impetus to forums for international economic cooperation such as the Group of 20 (G-20).

Leaders at the G-20 Summit in Pittsburgh in September 2009 reached a formal agreement to cooperate with a view to ensuring strong, sustainable and balanced global growth and to strengthening domestic and international financial systems. However, instead of continuing to provide general stimulus measures in order to sustain a global recovery that was still fragile, they agreed that strategies would vary across countries: those with external deficits would support private savings and undertake fiscal consolidation, while surplus countries would strengthen domestic sources of growth. It was considered that, in principle this would be consistent with a benign rebalancing whereby stronger domestic demand in surplus countries would allow deficit countries to increase their exports. In actual fact, rebalancing has been only partial and is associated with weaker global growth. The main reason is that the policy shift towards higher public savings in developed countries with deficits took place before growth in private sector demand had a chance to recover. In addition, the stimulus packages provided by developed countries with surpluses have been meagre. At the G-20 summit in Toronto in June 2010, the developing and emerging country members with surpluses were encouraged to provide direct support to spur their domestic demand and imports, including through currency appreciation, whereas the developed-country members with surpluses were supposed to reach that goal by focusing on structural reforms that support increased domestic demand. As discussed below, such reforms cannot deliver rapid results, and, considering the nature of some of the suggested reforms, they are unlikely to boost demand.

The asymmetry in the policy approaches of the developed and developing countries is reflected in the different contributions to global rebalancing by Germany and China – the two major surplus countries in absolute terms. Germany's external surplus has shrunk only moderately since the crisis erupted, both in current prices and as a percentage of GDP (from 7.5 per cent in 2007 to an estimated 5.5 per cent in 2012). In addition, its net exports contributed to a significant share of Germany's overall growth in 2010 and 2011, while private consumption remained subdued. By contrast, China's current-account surplus declined from its peak of 10 per cent of GDP in 2007 to below 3 per cent in 2011 and 2012, and the contribution of its net exports to growth has been negligible since 2010. A fundamental rebalancing of the Chinese economy is under way, with an increasing reliance on domestic demand to spur growth (Lemoine and Ünal, 2012). However, internal rebalancing efforts remain unfinished, as private consumption has still to take on a greater role relative to investment. Rapid wage increases are supporting this internal goal while also promoting further external rebalancing.

In most developing and transition economies, the contribution of net exports to growth seems to have fallen dramatically since the start of the crisis. It was close to zero during the period 2010–2012 in developing Asia and Africa, and turned negative in Latin America and in the transition economies. By contrast, it rose significantly in the EU, where the volume of exports increased significantly more than that of imports. However, the contribution of net exports in the EU only partially compensated for the negative impact of falling domestic demand (chart 1.5).

In addition to changes in the volume of trade, price developments also had a significant impact on global imbalances. The reduction of such imbalances in 2009 had much to do with the fall in surpluses of the oil-exporting developing and transition economies, mirrored by lower deficits in the United States and Europe (excluding Germany). Due to the renewed oil price increase since mid-2009 and the sustained reduction of surpluses in China and Japan, the fuel-exporting countries were responsible in large part for the increasing global imbalances in 2010 and 2011 (chart 1.6). To some extent, rising oil prices have been dragging down global growth. This is because rising oil prices immediately affect aggregate spending in fuel-importing countries, while increased spending in fuel-exporting countries normally occurs only after a time lag. For some oil exporters, it is reasonable to maintain a certain level of surplus in the current account, as they cannot increase their imports beyond certain levels without incurring superfluous expenditure financed by a non-renewable resource, to the detriment of future generations.

Concerns about global imbalances have eased somewhat in the past year, owing to significant corrections in some major surplus countries (e.g. China and Japan) and in the largest deficit country (the United States), but related problems remain. While the euro zone as a whole is fairly balanced vis-à-vis the rest of the world, the persistent imbalances within the zone pose considerable risks (box 1.1). Additional risks stem from significant tensions related to international capital flows and exchange rates.

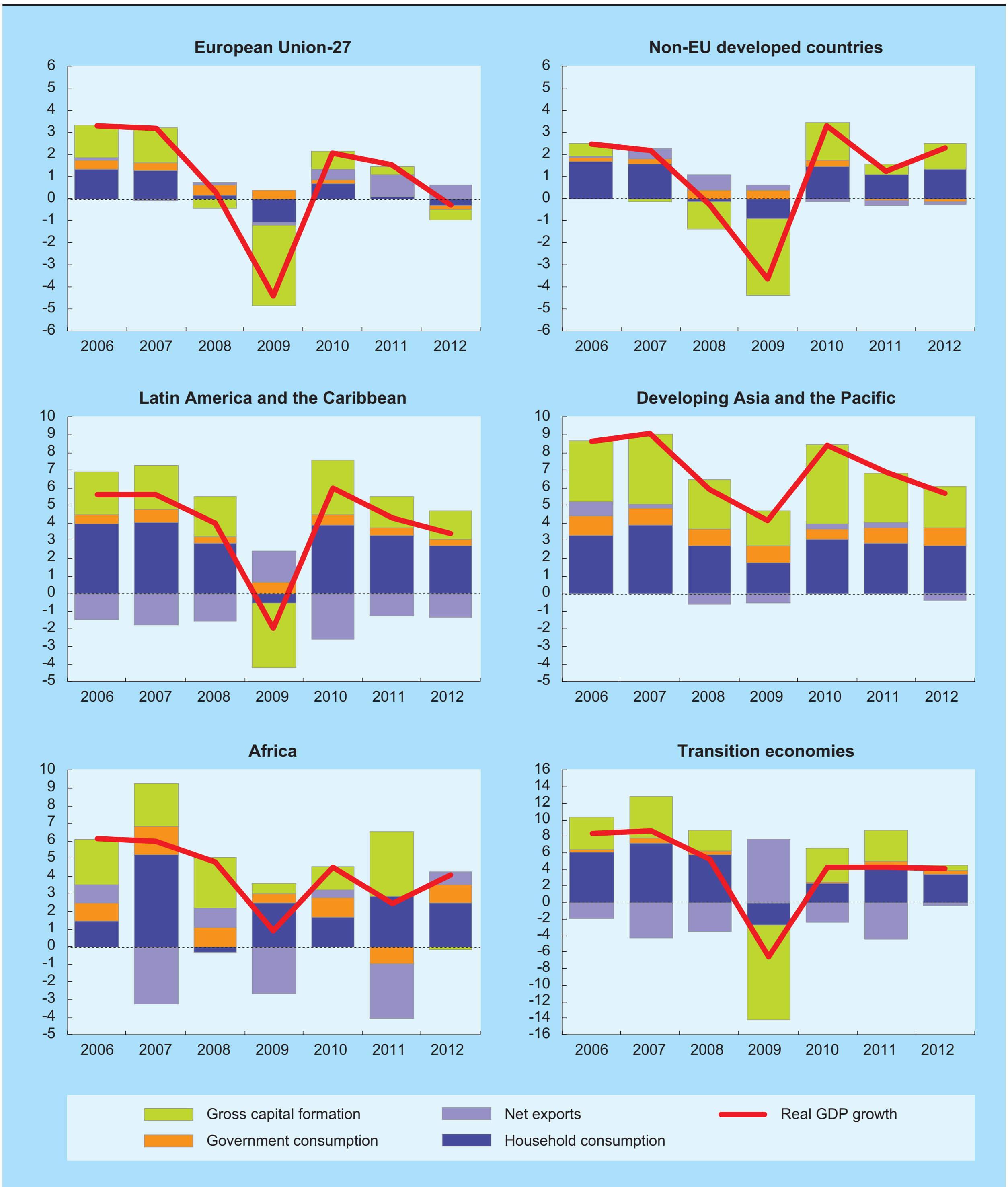
International capital flows have experienced wide gyrations, increasing sharply in the run-up to the financial and economic crisis and falling significantly (although with some exceptions) thereafter. International operations of banks reporting to the Bank for International Settlements (BIS) have involved mainly developed countries, as reflected in the distribution of their assets: 73 per cent of international bank claims were against debtors in developed economies in the first quarter of 2012, and this figure rises to 80 per cent if offshore centres are not taken into account.[19] However, changes in banks' assets in other regions, even if smaller in absolute terms, may have a strong macroeconomic impact in these countries given their fledgling financial and foreign exchange markets. Between the first quarter of 2002 and the first quarter of 2008, total international claims increased by 226 per cent to $28 trillion – a historical high. This rate was much higher for the new EU members[20] (630 per cent) and the transition economies (865 per cent); it was also extremely high for Greece, Ireland, Italy, Portugal and Spain (at almost 400 per cent). Between the first quarter of 2008 and that of 2012, international claims shrank globally by 16 per cent, with the strongest reductions in the developed and the transition economies (falling by 22 and 18 per cent respectively). Among the developed countries, the most severely hit were the European countries, particularly Greece, Ireland, Italy, Portugal and Spain, where international banks' assets halved. Even though part of this diminution was due to exchange rate movements,[21] sizeable credit reversals have been one of the major factors contributing to the fragility of their banking systems.

This contrasts with the continued increase in capital flows to developing countries, where the value of banks' assets had been increasing and registered a further 25 per cent rise between the first quarter of 2008 and the first quarter of 2012. In particular, in Latin America they increased by an average of 30 per cent for the whole region and by 55 per cent in Brazil. In developing Asia as a whole, they increased by an average of 21 per cent, and by as much as 80 per cent in China. A number of these countries face problems of a different kind, resulting from excessive capital inflows tending to exert appreciation pressures on

Chart 1.5

REAL GDP GROWTH AND CONTRIBUTIONS OF NET EXPORTS AND DOMESTIC DEMAND, SELECTED COUNTRY GROUPS, 2006–2012

(Per cent)



Source: UNCTAD secretariat calculations, based on table 1.1; UN/DESA, *National Accounts Main Aggregates* database; European Commission, *Annual macro-economic database* (*EC-AMECO*); ECLAC, *CEPALSTAT*; Economist Intelligence Unit (EIU) database; IMF, *World Economic Outlook*; and national sources.

Note: Data for 2011 are preliminary estimates and those for 2012 are forecasts.

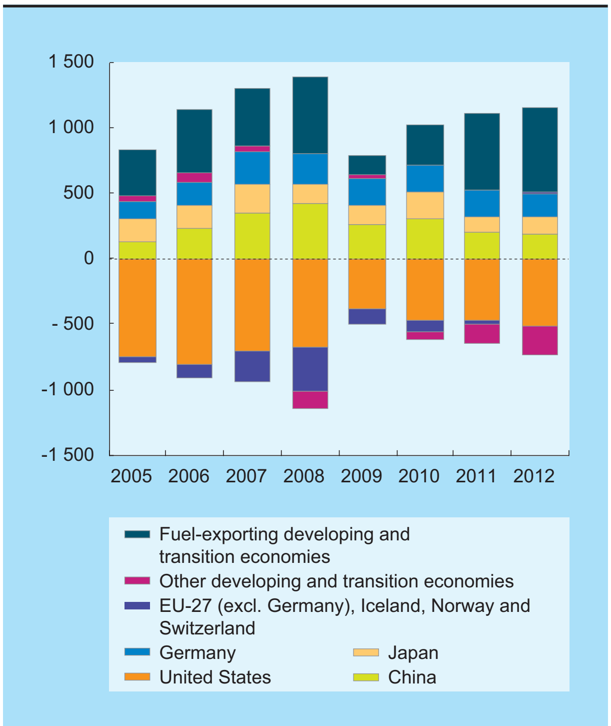
their currencies. Some of these countries (most notably Brazil) contend that loose monetary policies adopted by the central banks of developed economies have had negative impacts on their macroeconomic stability and competitiveness. This implies a kind of "currency war", with developed countries seeking to recover some of their competitiveness at the expense of a number of more dynamic developing countries.

Tensions over exchange rates were exacerbated in the first half of 2011 due to tightening monetary policies in several emerging market economies. Those policies were aimed at curbing inflationary pressures stemming mainly from rising international prices of food and energy. Higher interest rates dampened domestic demand, and, as they attracted short-term capital, they also tended to put pressure on currency appreciation. This appreciation may have contributed to lowering inflation rates, but at a high cost to economic growth. As international growth decelerated and prices of commodities receded, policy goals shifted once more, from price stability to supporting growth. To this end, several countries, including Brazil, China, India and Turkey, cut their policy interest rates in 2011 and 2012, while Mexico maintained its rate at a historical low of 4.5 per cent. In addition to interest rate cuts or reduced reserve requirements, some countries have also adopted credit policies designed to support domestic demand more directly and effectively, especially investment. Development banks and other State-owned financial institutions have been playing an important role in this regard.

Chart 1.6

CURRENT-ACCOUNT BALANCES, SELECTED COUNTRIES AND COUNTRY GROUPS, 2005–2012

(Billions of current dollars)



Source: UNCTAD secretariat calculations, based on UN/DESA, 2012b; IMF, *World Economic Outlook* (WEO) and *Balance of Payments Statistics* databases; and Economist Intelligence Unit (EIU) database.
Note: Data for 2012 are forecast.

With lower interest rates and perhaps also greater risk aversion among financial investors owing to financial tensions in the euro zone, portfolio flows to developing countries receded somewhat in the first months of 2012. However, the negative impacts on developing and transition economies of repeated massive capital inflows followed by "sudden stops" showed the importance of adopting active capital management policies as part of macroprudential regulation. The G-20 agreement on capital flows of October 2011 explicitly acknowledges the need for the flexible use of capital-account management measures in containing the risks that may routinely arise in liberalized and integrated global financial markets. It suggests that the development and deepening of local capital and bond markets and the adoption of appropriate regulations and prudential practices will eventually enable developing countries to better absorb and handle volatile capital flows. But as the examples of Japan and Switzerland show, even countries with well-developed financial systems may have to intervene in foreign exchange markets in order to prevent undesired exchange rate movements and significant mispricing due to short-term capital movements. Against this background, the intention to "move towards more market-determined exchange rate systems, enhancing exchange rate flexibility to reflect underlying economic fundamentals" (G-20, 2011) seems to overlook the fact that capital movements have a much stronger influence on exchange rates than trade or current-account balances, and there is no reason to believe that they will reflect "economic fundamentals". Public intervention is needed to manage these capital flows and guide real exchange rates to sustainable levels. It seems, for instance, that the

Box 1.1

TRADE IMBALANCES AND THE EURO ZONE CRISIS

Serious intraregional divergences in competitiveness and the related build-up of regional imbalances have been the root cause of the crisis in the euro zone. Members of the currency union committed to a common low inflation rate, at "below but close to 2 percent". Members cannot stray for too long from their joint commitment to that common inflation rate without eventually undermining the union. Since wages are the most important determinant of prices, national wage trends, corrected for productivity growth (i.e. unit labour costs), must remain aligned to hold the European currency union together (Flassbeck, 2007).

In the event, lasting wage restraint in the largest member country, Germany, led to inflation differentials and had the following effects: in Germany, it caused a protracted stagnation of consumption and rising income inequality; for the union as a whole, trade imbalances built up as the low-inflation countries gained in competitiveness vis-à-vis those with high wage-price inflation. In a fiscal union, such trade imbalances can last for a long time if the surplus members finance the deficit members through fiscal transfers. In Europe's currency union, private debt flows provided the financial counterpart to rising trade imbalances, as banks in surplus countries, unable to expand business in their home markets, lent to willing borrowers and spenders in the deficit countries instead (Bibow, 2007 and 2012).

The private lending flows upon which unbalanced European growth had come to depend stopped abruptly when lenders harboured doubts about the solvency of their borrowers. The global crisis merely acted as the trigger that turned home-grown housing booms and bubbles into busts across Europe. The ending of the private debt bonanzas then resulted in a sequence of debt crises, as the original household debt overhangs turned into banking crises, which eventually morphed into sovereign debt crises. In treating the symptom of sovereign debt crises by prescribing ever higher doses of austerity, the European authorities are upping the ante: with draconian retrenchment pushing debtor countries into debt deflation, contagion across a deeply interconnected regional economy that lacks a solid fiscal backstop risks choking regional growth, with debt sustainability becoming a threat for the currency union as a whole.

Flaws in the original design of the currency union are partly to blame: demand management was not envisaged, and proactive macroeconomic policies have been generally frowned upon. Moreover, no proper policy coordination is taking place. By restricting fiscal transfers, but failing to forestall intra-area imbalances that would make such transfers indispensable, the currency union has manoeuvred itself into the current impasse. At present, by putting the burden of rebalancing disproportionately on the shoulders of deficit countries, the European authorities increase the cost of rebalancing (De Grauwe, 2012). The latter could be achieved more effectively, and at a lower cost, if surplus countries within the region agreed to an upward adjustment of their wages and prices.

The institutional measures agreed so far are inadequate, because they do not have growth recovery as their main goal. While the announcement of a €120 billion package for investment projects is a step in the right direction, it seems insufficient. Measures include the establishment of the European Financial Stability Facility and the European Stability Mechanism as the main crisis management tools ("firewall"), along with various initiatives undertaken to improve economic governance in the EU and thereby prevent future crises (ECB, 2012). In essence, all new initiatives continue to follow the old blueprint. Measures are mainly focused on strengthening the so-called Stability and Growth Pact and aligning policies with the latest version of the EU's long-standing structural reform agenda – the Europe 2020 strategy. Europe continues to ignore the vital issues of domestic demand management and proper policy coordination for internal balance.

gradual appreciation of the renminbi in real terms, which was allowed by the People's Bank of China,[22] was preferable to a combination of capital-account opening and a floating exchange rate. The latter probably would have generated financial instability and an abrupt currency appreciation, thereby posing a serious risk not only to Chinese growth but also to the global economy.

2. The scope for monetary and fiscal policies

The debate on the role and impact of various macroeconomic policies in the present crisis is shaped by differing views on the main problems to be addressed at any given point in time, the availability of policy tools (e.g. "fiscal space" or "monetary space"), and the results that can be expected from their use.

The first question relates to the diagnosis of the causes of the global crisis and the main economic problems that need to be overcome to surmount them. One diagnosis focuses on fiscal problems – high deficits and debt-to-GDP ratios, mainly in the developed countries. Based on this, "fiscal consolidation" is proposed as the remedy. According to this view, fiscal austerity will reassure financial investors of the solvency of sovereign debtors and thereby keep interest rates in check and restore credit supply, which in turn will lead to economic recovery. There are variations around this main position. The most optimistic observers cited the "green shoots" of 2010 as proof that the global economy was strong enough to allow retiring public stimulus without adverse consequences, since the private sector had already resumed spending on a sustainable basis (IMF, 2011). The most pessimistic argue that fiscal tightening would not restart growth, but it would buy time (i.e. prevent a financial panic) for implementing the structural reforms needed for exiting from the crisis. Adopting an intermediate position, there are those who believe that fiscal austerity must be strong enough to be credible in terms of fiscal sustainability, but loose enough for minimizing its adverse impacts on growth (IMF, 2012a).

An alternative diagnosis of the cause of the global crisis points to private overindebtedness and not fiscal profligacy – even if one of its consequences was a deterioration in the fiscal situation of developed economies. A typical feature of financial crises is that they are followed by a long process of deleveraging, as both banks and debtors try to adjust their balance sheets (Koo, 2011). In the present instance, with private demand further constrained by high unemployment, stagnating or falling wages and negative wealth effects, it was overly optimistic to assume that the private sector had already "taken the baton" and that private spending would sustain recovery. Consequently, fiscal tightening is seen as counterproductive. By further depressing growth and fiscal revenues, it probably will not even achieve "fiscal consolidation" nor regain the confidence of financial markets.[23] Confidence, especially among financial markets, is normally restored only when the economy has recovered.

For all these reasons, monetary policy cannot restart growth. The problem is not that insufficient liquidity is constraining credit supply: central banks have provided huge amounts of money to the banks. For example, since September 2008 the Federal Reserve in the United States has injected more than $2 trillion into the banking system, trebling its total assets, and in Europe the European Central Bank (ECB) has doubled its assets to around 3 trillion euros. Despite this, bank credit to the private sector stagnated in Europe and decreased by 4 per cent in the United States between the third quarter of 2008 and the end of 2011. If banks are not increasing their lending to the private sector, it is not because they lack the funds; it is either because they do not want to lend (i.e. preferring instead to consolidate their balance sheets), or because the private sector is not demanding net credit (i.e. credit in addition to roll-over of maturing debts) as it does not intend to increase its consumption or investments. Once again, credit markets are showing a tendency to procyclicality. This does not mean that monetary policy is completely ineffective – a contractionary monetary stance could considerably worsen the present situation. On the other hand, the monetary authorities could be more effective if they focused less on the global amount of money issued and more on who should receive the money and how it should be used. Nonetheless, monetary policy has revealed its limitations, which is why fiscal policy remains an indispensable tool.

There are conceptual issues underlying this policy debate. The fundamental error of fiscal orthodoxy is to treat the public finances of a country as if they function just like the private finances of an individual household. As no household can permanently live beyond its means by spending more than it earns, it is assumed that the same principle must also apply to any responsible government. This analogy is seriously misleading as a guide to sound policy-making. An isolated household may well succeed in reducing its debt by cutting back on spending, given that its revenues are unaffected by its own retrenchment. It is, however, a fundamental principle of market economies that one household's spending is another household's income. Therefore, if one big player or many households together try to reduce their debt by simultaneously cutting their spending, they will end up reducing overall income, including their own.

It was the simultaneous cutting of expenditure by the private sector (both households and firms) throughout the world that caused a slump in global revenues and growth. The world is unlikely to recover from this slump unless individual agents' attempts to reduce spending are reversed. If the tide of spending cuts is not stemmed, it will end in a downward spiral of incomes and spending. However, an individual private agent cannot expect to change the course of events by acting countercyclically; it is only governments that can counterbalance the negative impact of private retrenchment on income.

This raises the question of fiscal space. *TDR 2011* made the case for assessing the role of fiscal policy from a macroeconomic and dynamic perspective. It argued for the need to take into account the impact of fiscal policy on total income and GDP growth, and consequently on the budgetary position itself. Fiscal space and the sustainability of public finances do not depend only on the public debt-to-GDP ratio and the size of the current budget deficit; growth and interest rates must be considered as well. Hence, by its impact on GDP and the interest rate level, macroeconomic policy is a major determinant of fiscal space in an economy.

Today, several European governments are facing rising interest rates on their sovereign debt, as their borrowings are viewed by financial markets as high-risk. This has been the reason invoked for pushing towards stronger fiscal tightening. For example, EU leaders have signed off on the "golden rule", requiring legislation (or even constitutional changes) which would ban structural fiscal deficits in excess of 0.5 per cent of GDP. In the United States, there are also strong pressures for possibly large and "automatic" cuts in government spending beginning in early 2013 if a political agreement on fiscal consolidation is not reached before then.

However, what generates the solvency risk in Euro-zone countries is not their high debt-to-GDP ratios, but rather their lack of sovereign control over their monetary policy. Several euro-zone countries have debt-to-GDP ratios well below those of the United States, Japan and the United Kingdom. The difference is that the latter countries not only have sovereign control over their monetary policies, but also their central banks can act as lenders of last resort both for banks and for their governments. In the euro zone, the solution will not come from more fiscal tightening and the dismantling of the welfare State, but rather from deeper fiscal and financial integration and a cooperative approach to economic rebalancing (Aglietta, 2012).

Some of the factors determining fiscal space (most notably different GDP growth rates) explain the divergent trends of public debt-to-GDP ratios in developed, developing and transition economies (chart 1.7). Those ratios remained stable in developed economies between 1995 and 2007, and have tended to decline in the developing countries since 2002 and in the transition economies since 1999. The crisis sharply increased that ratio in developed countries, but did not reverse the declining trend in the other groups of countries, despite the sizeable fiscal stimulus packages many of them introduced. In part, this was due to the costs of the financial bailouts mainly in the developed countries. But it was also because the developing and transition economies generally returned to robust GDP growth much more rapidly, which also boosted their fiscal revenues. Indeed, developing countries generally made good use of their fiscal space, with some of them implementing sizeable fiscal stimulus packages. Several developing countries that chose proactive macroeconomic policies in response to the global crisis have fared rather well (Takats, 2012). Their stimulus programmes, which have been focusing more on boosting public spending rather than on tax cuts, have proved very effective in quickly restoring growth. As a result, their public finances have generally remained healthy and their fiscal space has also recovered.[24]

It is not only changes in the amount of public spending and taxes that can provide the needed economic stimulus, but also their composition. The aim is to improve the multiplicative impact of a given level of expenditure, or reduce the contractionary effect of taxation on private expenditure. As discussed in *TDR 2011*, what matters for stimulating the economy is not the size of the fiscal deficit or surplus per se, but rather the impact on the distribution of income of specific public revenues and expenditures. In particular, it is necessary to consider the extent to which fiscal operations generate new aggregate demand, not only directly but also indirectly through the multiplicative effect of the new demand. Indeed, a recent study by the International Monetary Fund finds that fiscal multipliers may be quite large during recessions, when "the traditional crowding-out argument is less applicable" (IMF, 2012b: 34). It also finds that increased spending provides more stimulus than cutting taxes, departing from some of its previous views (IMF, 2010). However, rather than recommending the use of those high fiscal multipliers for reversing recessionary pressures, the IMF recommends a more gradual approach to fiscal tightening. Nevertheless, it is important to note that the harm done by procyclical policies is now more widely recognized, as is also the possibility for improving economic performance through countercyclical fiscal policies.

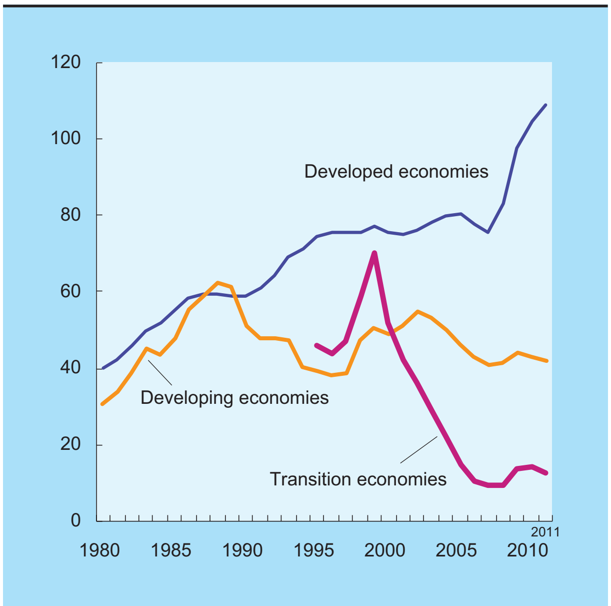
Hence, much of the effectiveness of monetary and fiscal policies depends on their distributional effects, as they can enhance the purchasing power of agents with high propensities to consume and/or invest. This is particularly important when the main problem in an economy is the lack of demand. It is also possible to seek the same result by implementing income and employment policies that aim at increasing the share of low- and middle-income groups in primary income distribution. An incomes policy that creates expectations of a progressive rise in workers' incomes – with real wages (in the case of wage earners) growing at a similar rate as productivity – may be of critical importance in reviving growth of consumption.

In conclusion, in the context of high unemployment, ongoing deleveraging and downward pressures on real wages, an exit from recession in crisis-hit countries cannot be left to market forces alone. Public policies should aim to restore demand, instead of further depressing it with fiscal retrenchment. In order to revive aggregate demand, growth and employment, governments need to combine several instruments which may be more easily available than is frequently

Chart 1.7

PUBLIC DEBT-TO-GDP RATIO, 1980–2011

(Per cent)



Source: UNCTAD secretariat calculations, based on IMF, *Historical Public Debt Database*, *World Economic Outlook*, April 2012, and *Country Reports 2012 for Article IV consultations*.

believed. As argued in previous *TDRs* and further discussed in chapter VI of this *Report*, incomes and labour market policies are legitimate tools that may be combined with fiscal and monetary instruments in efforts to achieve inclusive and sustainable growth.

3. *Structural reforms are not a substitute for supportive macroeconomic policies*

Broadly defined, structural policies are designed to establish or reshape the structure of institutions and the functioning of markets. Measures may concern both the role of government in (particular) markets and the interaction of market participants. Development and the corresponding structural transformation of economies over time require appropriate structural policies to best support and enhance economic performance in terms of efficiency, stability and growth. Reassessing the scope and form of structural policies thus constitutes a continuous challenge for governments of all countries.

As such, structural policies may cover a wide range of areas, including markets (de)regulation, education, health care, pension, tax and welfare systems, infrastructure and the public administration itself. For instance, since the global crisis of 2008-2009, financial reform has been a common priority of structural policies in many countries in their attempts to restore stability and redefine the economic role of their respective financial sectors as well as initiatives for international cooperation in this area.

There have been quite a few national and global initiatives for financial regulatory reform. However, re-regulation remains fragmented, and full implementation is unlikely for many years to come. At the global level, the "Basel III" accord (developed by the Basel Committee on Banking Supervision (BCBS) and endorsed at the G-20 Seoul Summit in November 2010) and the establishment of the Financial Stability Board (FSB, formerly the Financial Stability Forum) are among the main initiatives undertaken in the area of global financial regulation and supervision prompted by the financial crisis. The former provides international regulatory standards for transnational banks (BCBS, 2010a and b), while the latter is a conduit of information and a coordination platform for national financial authorities and international standard setting bodies charged with assessing vulnerabilities in the financial system and identifying and overseeing actions needed to address them. The Basel III requirements will be phased in gradually, with full implementation expected to be completed only by January 2019 (BCBS, 2012). Complementing the IMF's (enlarged) financial surveillance functions, the FSB is part of the new post-crisis focus on containing systemic risks through macroprudential regulation. However, macroprudential principles are undermined by pressures that favour free international capital movements, even though these have proved to be a major source of financial instability in many developing and transition economies.

Important unresolved issues relate to the threat that financial institutions and activities may once again succeed in avoiding supervision, in particular through shadow banking and offshore centres. Further, the handling of the "too-big-to-fail" banks may require cooperation between national fiscal authorities and the sharing of financial resources. However, this issue is proving to be particularly challenging even within the EU despite its long record of deep regional integration.[25]

Much remains to be done for restructuring national and global financial systems in order to reduce the systemic risks associated with their insufficient regulation and perverse incentive systems. Equally important is the need to reorient their activities towards supporting the real economy, in particular to finance productive investment, employment generation and growth (*TDR 2011*, chap. IV). However, the focus of structural reforms has been changing over the past few years, especially in developed economies, in the direction of reform packages reminiscent of those implemented in response to an earlier financial crisis, that in Latin America in the 1980s.

Most governments of developed countries as well as the international financial institutions assume that there is very little room for manoeuvre for stimulating the economy through macroeconomic policies. There is a perception that further scope for more supportive monetary policies may be limited by the already very low policy interest rates. On the fiscal side, governments fear that a new stimulus might signal a departure from the goal of fiscal consolidation. The focus is therefore increasingly on structural reforms, which are intended to boost competitiveness and revive growth.

Accordingly, several developed countries have initiated a broad range of reforms such as reducing labour protection, shifting wage bargaining to the firm level, implementing privatization plans, liberalizing the energy and retail sectors, and cutting public employment and social expenditure. Announced privatizations have been particularly extensive in Central and Eastern European economies and in Portugal, Ireland and Greece. Other developed economies also plan to sell portions of their State-owned assets. Some tax and welfare reforms are likely to have adverse impacts on the revenues of low- and middle-income households, and consequently on inequality. For example, Greece, Ireland, Portugal and Spain have limited unemployment benefits in terms of access and amounts. In addition, several OECD countries have introduced pension reforms, raising the retirement age and/or reducing the level of pensions, and tax reforms that broaden the tax base and increase indirect taxes but reduce direct personal or corporate taxes (OECD, 2012b). On the other hand, some measures appear to aim at tempering the effects of the social crisis, such as increased resources provided for worker training and the extension of unemployment benefits.

A particular focus seems to be on labour market reform. Liberalizing what some consider to be excessively rigid labour markets is based on the general belief that more flexible markets are more efficient. Reforms that seek to lower the costs of labour and facilitate dismissal of workers are assumed to provide greater incentives to hire workers and improve overall competitiveness, which in turn will boost growth and increase employment opportunities. Chapter VI of this *Report* discusses the rationale for labour institutions and rules, and shows that so-called "rigidities" exist for good reason and do not harm growth. Furthermore, microeconomic reasoning concerning the labour market ignores the macroeconomic dimension of that market and of wage determination. Since labour income is a strong determinant of aggregate demand (especially in developed countries), extensive cuts in that remuneration subdue economic activity and therefore the demand for labour. Unlike other goods and services, lowering the price of labour also lowers its demand.

A case may be made for a policy that seeks to find a way out of the crisis through the expansion of net exports. Falling wages create scope for lowering prices, thereby improving price competitiveness, provided that changes in exchange rates do not offset inflation differentials. This seems to be the policy promoted by the European Commission and the ECB.[26] However, cutting wages in several countries of the same region at the same time is counterproductive when domestic and regional demands are quantitatively greater than exports to the rest of the world, as is the case for many crisis-hit countries in Europe.

Quite apart from the debate about the long-term effects of structural reforms, concerns are also being raised about their timeliness and their suitability for addressing the current problems. As the main problem in the present crisis is the lack of demand (Krugman, 2012), reforms aimed at improving the supply side of the economy are not the most appropriate, especially if they further weaken aggregate demand. For instance, introducing more flexibility in labour markets and increasing the participation rate (a specific goal of several governments) when there is no increase in the demand for labour will only exacerbate the unemployment situation and further depress wages and domestic demand, which is precisely the opposite of what is needed. Even institutions that strongly support such a programme of structural reforms warn that they may be "detrimental in bad times" (OECD, 2012b: 20), and that austerity effects can be too severe in the current context of low private sector demand and persistent unemployment (IMF, 2012d). Furthermore, large privatization programmes implemented under pressure and in the midst of an economic depression will probably generate much lower revenues for governments than initially expected.

So far, economic reforms in a number of OECD countries have not been associated with a revival of economic growth. Indeed, countries that were among the most energetic in introducing these kinds of policies are failing to achieve the expected GDP growth, job creation and fiscal consolidation (OECD, 2012). This does not mean that the reforms themselves are the main cause of the current recession; it is more likely that the economic and financial crisis has been considered a justification for implementing structural reforms that were sought for other reasons, independently of the crisis context.[27]

In contrast, the structural reforms being adopted by developing countries have tended to create or reinforce social safety nets and to expand the economic role of the State. In several developing countries, welfare reforms have moved in a different direction to those in developed countries – sometimes in a kind of "counter-reform" of previous market-oriented principles. In Latin America, many countries have embarked on a major overhaul of their pension schemes, turning back the private-sector-oriented reforms of the 1980s and the 1990s, and reintroducing State involvement. For example, Chile has increased its universal coverage of non-contributory benefits paid for by the Government; Argentina has returned to the public pay-as-you-go pensions system; and related reforms are being introduced in Colombia, Mexico, Peru and Uruguay (Arza, 2012; Kritzer, 2008; Rofman, Fajnzylber and Herrera, 2010; ISSA, 2010). These structural "counter-reforms" aim to redress the perceived failures of the private pension-fund revolution of the 1980s and 1990s, which included a sharp reduction in coverage, gender inequalities, high administration and marketing costs, and low payments to beneficiaries. In some countries they also enable the government to use pension revenues or accumulated funds for public investment purposes.

In India, the Government adopted a $5 billion plan to provide free medical care to the poorest 50 per cent of the population in 2012.[28] This was coupled with a ruling that only generic drugs (and not branded ones) were to be used, which will not only improve access to health care but also give a boost to the domestic pharmaceutical industry. In South Africa, ongoing health-care reforms seek to establish some form of national insurance and improve the quality and coverage of the country's health services.

At the Los Cabos summit of the G-20 in June 2012, a number of developing economies committed to strengthening or expanding social safety nets and poverty reduction programmes. In Indonesia, for instance, Government actions have focused on family-based social assistance, community empowerment, economic opportunities for low-income households and the provision of basic needs to low-income people at an affordable price. In Argentina, the main income transfer programme, the Universal Child Allowance, which targets vulnerable children up to 18 years of age, has achieved an 85 per cent coverage rate and was extended to pregnant women in 2011. In Brazil, several schemes aimed at eradicating extreme poverty and improving opportunities for vulnerable populations were launched or strengthened. These include the Brazil Free from Extreme Poverty initiative which comprises three main pillars: (i) increasing per capita income in poor households; (ii) expanding access to public services and social welfare; and (iii) extending employment and wage-earning opportunities. Mexico has introduced measures aimed at promoting the attractiveness of formal employment for workers.

In several developing countries, structural reforms include expanding the role of public policies for supporting investment and structural change. Such measures are frequently aligned with stimulus objectives targeting both the supply and the demand side. For example, Brazil recently reduced the reserve requirements for bank lending to the automobile industry and lowered interest rates for consumer loans aimed at supporting car manufacturers and car buyers alike. This targeted measure accompanied more broad-based public investments in infrastructure on a massive scale, including transport and energy projects that can create jobs in the short-term while boosting productive capacity for the long-term. Several other governments of large developing countries have also extended their involvement in infrastructure development to support domestic economic activities and boost job creation. In Indonesia, for instance, a significant share of public expenditure targets the information and communications technology (ICT) sector, while in Argentina and Mexico it focuses more on the energy sector. South Africa's public sector investment, which is directed principally to developing transport, electricity and water infrastructures, was 7.1 per cent of GDP in 2011, and is expected to remain above 7 per cent of GDP over the next three years at least. In parallel, the Government has strengthened its public works programmes, which guarantee work opportunities for the vulnerable and disadvantaged. Meanwhile, in Saudi Arabia, the Government's facilitation of access to credit by small and medium-sized enterprises is expected to stimulate job creation (G-20, 2012).

Most of these measures have a countercyclical purpose, as they aim to safeguard employment and support economic activity in troubled times. However, some of them are not just temporary measures that will be reversed when the international environment becomes more favourable. One important structural reform is reforming the State itself (constructing or restoring the "developmental State"), which is also the tool for implementing industrial policies and making other structural reforms. Extending social security, unemployment benefits and pension coverage also has a countercyclical component through its immediate effect on demand, but there is no reason to dismantle these social advances once growth resumes, although some associated transfers will normally decline with economic recovery and improvements in the labour market.

In conclusion, structural reforms cannot be the main tool to exit from an economic depression; that task should be left largely to supportive macroeconomic policies. These reforms should be carefully gauged against a country's long-term social objectives and development strategy. They should aim, in particular, at correcting the main dysfunctioning areas that led to the global crisis, many of which are related to global and domestic financial systems. Other factors leading to the crisis are income inequality and its determinants, which are discussed in some detail in this *Report*. Structural reforms should aim to reduce inequality, rather than amplifying it as has frequently happened in the past.

Notes

1 By the end of 2011, only 15 out of 35 developed economies registered GDP levels that were higher than their respective pre-crisis peaks reached between 2007 and 2008.

2 On 2 March 2012, 25 EU members signed the Treaty on Stability, Coordination and Governance which includes a fiscal compact establishing that the structural fiscal deficit must not exceed 0.5 per cent of GDP to be incorporated into national legislation.

3 These commodity price peaks generally occurred between January and April 2011, except for rice, tobacco, tropical logs and gold, which peaked in August-September 2011. The last peak for phosphate rock was in January 2012, while for oil, bananas and beef prices peaked in March 2012.

4 For a detailed discussion on the role of information and the influence of commodity investors on prices, see *TDR 2011*, chap. V.

5 Cited by *Reuters*, Barclays says $8.2 bln pulled from commodities in May, 25 June 2012.

6 See, for instance, Kemp (2012); Danske Research (2012); *Reuters*, Oil posts fourth biggest daily gain on record, 29 July 2012; and *Reuters*, Corn eases after rally, soy turns up ahead of USDA report, 10 July 2012.

7 Looking at the period 1865–2010, Erten and Ocampo (2012) identify four super-cycles. They also show that the average price of all non-oil commodity categories has significantly declined from one price cycle to the next.

8 Maintaining the post-crisis investment drive would risk creating overcapacity and non-performing loans. As noted by Akyüz (2012), China's commercial real estate sector risks heading towards a bust, and local governments appear to be facing difficulties in servicing their debt.

9 For example, the net import bill for cereals of the low-income food-deficit countries is expected to reach a record high in 2011/2012 – even higher than that of the 2008 food crisis (FAO, 2012).

10 The Food and Agriculture Organization of the United Nations (FAO, 2011) offers a detailed analysis on how food price volatility makes both smallholder farmers and poor consumers increasingly vulnerable to poverty. The International Labour Office (ILO, 2011) examines the employment and distributional impacts of increasing food prices in developing countries, and concludes that there is significant evidence of a negative poverty effect associated with higher food prices.

11 For a more detailed assessment of the progress on aid to agriculture since the L'Aquila summit, see Action Aid, 2012, and the *Guardian*, Rich nations risk breaking their pledges on farming aid, says anti-poverty group, 10 July 2011. The FAO has also highlighted the funding gap for the Sahel and Horn of Africa emergency plans. Regarding overall aid for development, the OECD (2012a) reports that aid to developing countries by major donors fell by nearly 3 per cent in 2011, after a long trend of annual increases.

12 For detailed discussions on the roles of TNCs in agriculture and in the extractive industries, see UNCTAD, 2009 and 2007 respectively.

13 According to PricewaterhouseCoopers (PWC, 2012), the world's 40 biggest mining companies posted record profits in 2011 due to high commodity prices.

14 For evidence on the global land rush, see also IIED, 2012.

15 For a discussion on how land deals have failed to provide benefits to the poor, see OXFAM, 2011.

16 The guidelines include such aspects as promoting equal rights for women in securing access to land, creating transparent record-keeping systems that are accessible to the rural poor, and help with recognizing and protecting informal and customary rights to land (Graziano da Silva, 2012). The guidelines are available at: http://www.fao.org/fileadmin/templates/cfs/Docs1112/VG/VG_Final_EN_May_2012.pdf. The principles for responsible agricultural investment refer to respecting land and resource rights, ensuring food security, transparency, good governance and a proper enabling environment, consultation and participation, responsible agro-enterprise investing, and social and environmental sustainability (UNCTAD, 2010).

17 For examples of countries that have been reviewing their mining regimes recently, see Leon, 2012; Ernst &Young, 2012; *The Economist,* 2012a; and Australian Mining, 2012.

18 See 2011 Budget statement by the Chancellor of the Exchequer at: http://www.hm-treasury.gov.uk/2011budget_speech.htm.

19 See BIS database at: http://www.bis.org/statistics/index.htm.

20 These are the 12 countries that acceded to the EU after 2004.

21 BIS statistics on international claims are stated in dollars, although some claims may be denominated in other currencies (e.g. in euros, particularly within Europe). Consequently, the appreciation of the dollar vis-à-vis the euro following the crisis tends to accentuate the reduction of banks' claims measured in dollar terms.

22 In real terms, the renmimbi appreciated since 2005 by 20 per cent vis-à-vis the dollar, and by about 30 per cent on the basis of real effective exchange rate.

23 Pleasing the markets has proved to be a difficult task, since "markets appear somewhat schizophrenic – they ask for fiscal consolidation but react badly when consolidation leads to lower growth" (IMF, 2012a: xiv).

24 In general, the trends in low-income developing countries are less positive (IMF, 2012b; UNCTAD, 2012b). The aggregate picture masks the fact that 20 countries remain at high risk of, or are already in, debt distress (IMF, 2012c).

25 The FSB has issued recommendations on strengthening oversight and regulation of shadow banks (FSB, 2011a), and has also developed a framework to address the systemic and moral hazard risks associated with financial institutions that are judged "too big to fail" (FSB, 2011b; see also BCBS, 2011). The FSB and BCBS have identified an initial group of 29 global systemically important financial institutions (G-SIFIs), which will eventually be required to have additional loss absorption capacity.

26 According to Mario Draghi, President of the ECB, "Reforms in these areas are particularly important for countries that have suffered significant losses in cost competitiveness and need to stimulate productivity and improve trade performance" (Introductory statement to the press conference, Barcelona, 3 May 2012; see also Barroso, 2012).

27 As noted by *The Economist* (2012b), "It's tempting to chalk economic failure up to profligacy, or insufficient adherence to a set of commonly accepted economic principles. Some leaders seem anxious to misdiagnose crises, intentionally or unintentionally, in order to seize the opportunity to foist preferred policies on vulnerable economies." The OECD (2012b: 25) also observed, "Overall, the crisis seems to have acted as a catalyst for structural reforms. Compared with the pre-crisis period, responsiveness rates have increased on average to *Going for Growth* recommendations for enhancing both labour productivity and labour utilization. For the latter, this partly reflects recent extensive labour market reforms undertaken in the context of the euro area debt crisis."

28 See *Financial Times*, India to give free medicine to millions, 6 July 2012.

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