

## Chapter II

# International trade

### Trade flows

#### Merchandise trade: growth deceleration and potential revenue falls

World trade has started to decelerate sharply, weakening its role as a major engine of global economic growth in recent years. Growth in the volume of trade is estimated to have slowed to 4.4 per cent in 2008, nearly half of the average annual growth of 8.6 per cent during the period 2004-2007. This trend is expected to continue in 2009, with the volume of world exports anticipated to slow further to about 2 per cent on the heels of the global economic recession. In a more pessimistic scenario of a deeper and prolonged financial crisis, however, the recession will be more profound, causing world trade activity actually to decline by 3 per cent (see the pessimistic scenario outlined in chapter I), something which has not happened since the Second World War. During 2008, the signs of significantly weakening world trade were already visible in the Baltic Dry Index, a leading indicator of global trade activity measuring the demand for shipping capacity to transport commodities versus the supply of dry bulk carriers. In the six months between May and November 2008, the Index experienced an unprecedented continuous decline of 85 per cent. Because dry bulk primarily consists of materials that function as raw-material inputs into the production of intermediate or finished goods, such as concrete, electricity, steel and food, the Index can also be seen as an efficient indicator of future economic growth and production and is hence not signalling a promising outlook.

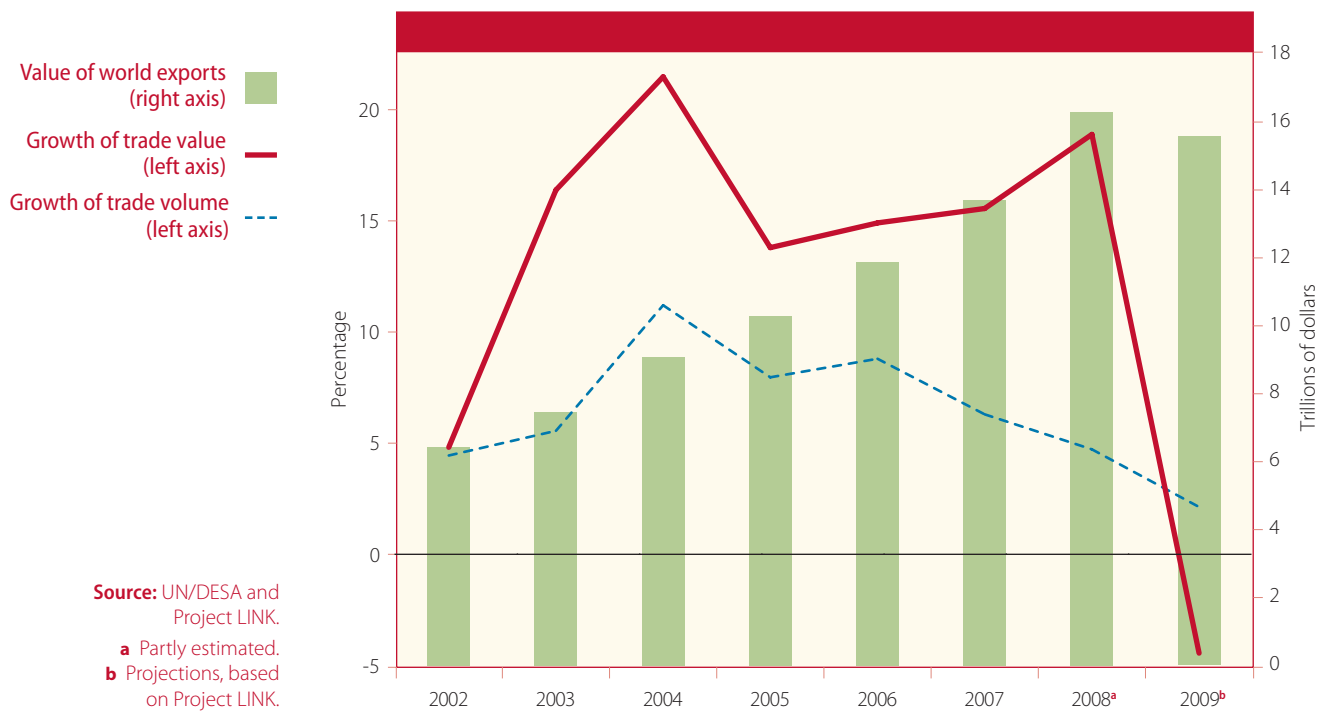
Meanwhile, the value of trade flows has increased significantly over 2008, but unlike a similar rise in 2004 which took place because of robust volume growth, this increase is largely due to extraordinary rises in the prices of oil and most commodities during the first half of the year. As noted in figure II.1, the declining trend of volume and the dramatic gyrations of the prices of most commodities in the second half of 2008 will lead to a fall in the value of global trade in the baseline estimate for 2009.

The costs of falling trade and commodity prices tend to be distributed unevenly across countries. In 2008, the clear winners were those who benefited from the sharp rise in oil and commodity prices. At an aggregate level, oil producers in North Africa, the Commonwealth of Independent States (CIS) and Western Asia doubled their rate of nominal export revenue growth in 2008, to 53 per cent, 48 per cent and 38 per cent, respectively. In addition, countries in sub-Saharan Africa (excluding Nigeria and South Africa) and the least developed countries (LDCs) as a group achieved remarkable rates of growth of export revenue following the primary commodity boom, averaging about 42 per cent in 2008. Latin America, which has a somewhat more diversified trade structure, saw the doubling of its rate of export revenue growth being offset by a more rapidly increasing import bill. Manufactured goods' exporters in East and South Asia were affected by the rise in commodity prices. In 2008, their import bills increased at almost twice the pace of 2007. In Europe, although import growth was less dramatic, it outpaced export growth (see tables II.1 and II.2).

World trade volume is growing at only half the pace of recent years

The value of trade has increased mainly on account of dramatic price increases

Figure II.1  
Growth of global trade, 2002-2009



Collapsing commodity prices have led to severe trade shocks in many parts of the world

The global imbalances have narrowed as a result of the recession in the developed countries

Fortunes reversed following the dramatic fall in the prices of oil and primary commodities in the second half of 2008, a trend which is likely to continue in 2009 as the global economy enters into recession. Countries in North Africa, the CIS and Western Asia that had gained from high commodity prices are expected to experience falling export revenues at rates ranging from between 4 and 19 per cent in 2009. Most alarming are the losses in export earnings in sub-Saharan African countries and among the LDCs, which are expected to fall by about 22 per cent on average on account of declining commodity prices. At the same time, these economies will see modest increases in their import bills in 2009, to the extent that their trade deficits are expected to widen.

The turnaround in the prospects for world trade will have an impact on the global imbalances. As emphasized in previous issues of the *World Economic Situation and Prospects*, the United States of America has, for the past decade, played a critical role as the world consumer of last resort. With the recession and the drop in consumer confidence in the United States, this is now changing and the trade deficit of the world's major economy has narrowed, mainly because of weakening domestic demand. As the United States accounts for about 12 per cent of other developed country exports on average, trade surpluses in Europe and Japan will be trimmed, and export growth in China and other developing countries will also be directly and indirectly affected by the recession in the United States. Income growth in the United States started to slow in 2007 (showing a negative growth rate in the fourth quarter) which, together with the cumulative dollar depreciation over recent years, resulted in shrinking import demand. Except for a small positive rate of growth in imports in the second quarter of 2007, weakening demand in the United States has been a main cause in the deceleration of global trade in 2007-2008. Consequently, export volume growth in developed Asia and Oceania fell from 7.6 per cent in 2006 to an average of 2.7 per cent during 2007-2008. Similarly, in Europe, export

Table II.1  
Value growth of exports and imports, 2002-2009

Annual percentage change									
	Flow	2002	2003	2004	2005	2006	2007	2008 <sup>a</sup>	2009 <sup>b</sup>
<b>World</b>	Exports	<b>4.8</b>	<b>16.4</b>	<b>21.5</b>	<b>13.8</b>	<b>14.9</b>	<b>15.6</b>	<b>18.9</b>	<b>-4.4</b>
<b>Developed economies</b>	Exports	3.6	15.1	18.5	8.3	11.9	14.4	13.9	-7.3
	Imports	3.0	16.0	19.3	11.8	13.2	13.6	14.7	-10.4
North America	Exports	-4.2	5.0	15.1	10.8	11.3	9.7	12.8	2.0
	Imports	1.5	7.9	16.4	13.9	10.5	5.9	11.4	-7.1
Asia and Oceania	Exports	3.1	13.1	20.2	7.0	9.3	11.2	15.4	4.3
	Imports	-0.3	15.6	19.8	15.9	11.2	11.0	24.7	-1.6
Europe	Exports	6.7	19.0	19.3	7.7	12.5	16.3	13.9	-11.7
	Imports	4.3	20.4	20.6	10.2	14.8	17.5	14.7	-12.9
<b>Economies in transition</b>									
South-eastern Europe	Exports	6.5	20.6	30.8	24.4	17.5	27.4	26.1	0.8
	Imports	20.2	19.1	21.9	17.4	15.2	30.7	24.5	3.5
Commonwealth of Independent States	Exports	6.3	26.8	36.7	36.9	28.1	25.0	47.9	-4.2
	Imports	10.3	27.1	30.0	28.0	32.4	40.4	38.2	13.4
<b>Developing countries</b>	Exports	7.2	18.2	26.1	21.9	18.4	16.3	23.2	-0.5
	Imports	5.0	16.4	27.9	17.4	16.9	17.5	25.3	5.7
<b>Africa</b>	Exports	3.4	23.4	29.3	37.1	18.6	20.1	38.3	-7.1
	Imports	3.4	20.3	26.3	22.5	19.5	25.5	29.1	6.6
North Africa	Exports	0.1	29.6	23.5	37.2	33.1	19.4	52.7	-5.4
	Imports	11.4	6.8	22.4	24.6	20.8	33.7	50.8	15.2
Sub-Saharan Africa (excluding Nigeria and South Africa)	Exports	15.1	14.9	28.0	36.8	20.7	21.2	42.1	-22.5
	Imports	4.6	19.6	26.7	19.3	12.0	18.7	18.2	2.8
<b>East and South Asia</b>	Exports	9.9	19.4	25.6	18.1	18.3	16.4	18.2	6.0
	Imports	8.7	19.5	28.1	16.9	16.5	14.4	24.8	8.1
East Asia	Exports	9.7	19.4	25.5	17.2	18.3	16.3	18.0	6.5
	Imports	8.8	19.2	27.4	15.5	15.8	14.8	24.1	7.5
South Asia	Exports	12.2	18.9	26.3	29.2	17.9	17.6	20.2	0.0
	Imports	7.5	22.6	35.3	30.6	22.3	10.8	31.0	13.6
<b>Western Asia</b>	Exports	5.0	22.5	31.0	33.1	19.1	17.3	37.7	-18.7
	Imports	7.2	17.4	36.5	15.2	14.7	28.1	23.2	-0.1
<b>Latin America and the Caribbean</b>	Exports	1.0	8.5	23.0	20.8	18.2	12.5	21.3	-2.5
	Imports	-7.0	3.4	22.0	18.7	19.4	19.0	26.8	0.2
<b>Memorandum item:</b> Least developed countries	Exports	9.5	16.0	35.8	35.6	23.2	25.6	42.8	-22.6
	Imports	3.5	18.8	25.5	14.7	14.9	18.2	22.3	6.4

Source: UN/DESA and Project LINK.

<sup>a</sup> Partly estimated.

<sup>b</sup> Forecasts, based in part on Project LINK.

volume growth slowed from 8.2 per cent in 2006 to 3.8 per cent per year on average in 2007-2008. This, in turn, suggests that the typically robust intraregional European trade is also experiencing negative feedbacks from export revenue to income, and from there to imports from other countries in the region. In the outlook, export growth of developed Asia and Oceania is likely to be negative and that of Europe to be flat, at best.

Table II.2  
Volume change of exports and imports, 2002-2009

Annual percentage change									
	Flow	2002	2003	2004	2005	2006	2007	2008 <sup>a</sup>	2009 <sup>b</sup>
<b>World</b>	Exports	<b>4.4</b>	<b>5.6</b>	<b>11.2</b>	<b>8.0</b>	<b>8.8</b>	<b>6.3</b>	<b>4.4</b>	<b>2.1</b>
<b>Developed economies</b>	Exports	2.2	2.5	8.9	5.6	7.5	4.5	3.1	0.0
	Imports	2.5	4.6	9.5	6.5	7.0	3.9	1.1	-1.1
North America	Exports	-2.4	0.5	9.0	6.3	5.5	4.8	4.6	1.3
	Imports	3.2	4.7	10.8	6.8	5.0	1.4	-4.1	-4.1
Asia and Oceania	Exports	6.6	8.1	12.1	5.5	7.6	6.8	-1.4	-4.0
	Imports	3.1	7.1	8.2	5.7	5.5	3.7	5.8	-5.5
Europe	Exports	3.1	2.1	8.2	5.4	8.2	3.9	3.6	0.4
	Imports	2.0	4.1	9.0	6.5	8.3	5.2	3.2	1.2
<b>Economies in transition</b>									
South-eastern Europe	Exports	5.2	7.5	17.6	18.1	8.9	13.7	9.2	6.6
	Imports	17.0	3.6	9.6	12.2	9.8	17.0	12.1	8.0
Commonwealth of Independent States	Exports	8.0	13.6	15.4	-0.2	6.4	8.6	4.7	4.4
	Imports	10.7	19.1	21.2	8.2	20.1	26.3	18.3	16.7
<b>Developing countries</b>	Exports	8.6	10.8	15.0	12.5	10.9	8.8	6.2	4.8
	Imports	7.4	10.3	16.3	11.7	12.0	9.8	9.8	6.3
<b>Africa</b>	Exports	4.7	10.0	9.0	17.9	0.2	10.1	10.6	3.6
	Imports	5.0	10.5	10.7	17.5	11.6	17.6	15.2	10.5
North Africa	Exports	1.2	16.0	1.1	12.0	16.5	10.4	14.3	6.6
	Imports	11.8	5.7	8.7	18.1	16.0	24.9	24.3	17.9
Sub-Saharan Africa (excluding Nigeria and South Africa)	Exports	11.0	2.7	10.5	13.8	4.7	8.1	6.1	4.9
	Imports	3.9	6.7	14.5	13.9	5.9	9.8	6.7	7.6
<b>East and South Asia</b>	Exports	12.0	13.0	17.8	14.0	13.6	10.5	7.4	5.2
	Imports	11.4	11.9	18.0	12.0	12.1	8.3	9.4	6.0
East Asia	Exports	12.0	13.5	18.5	14.2	13.8	10.7	7.4	5.3
	Imports	11.8	11.9	17.6	11.0	11.8	8.8	8.7	4.4
South Asia	Exports	11.8	6.0	9.2	11.5	10.7	7.8	7.1	3.9
	Imports	7.5	11.2	22.1	22.4	15.7	2.9	16.6	21.3
<b>Western Asia</b>	Exports	4.5	8.9	8.0	6.0	5.6	6.2	5.8	3.9
	Imports	7.3	7.7	23.5	8.8	9.8	15.6	9.8	8.5
<b>Latin America and the Caribbean</b>	Exports	1.7	4.4	11.3	8.9	7.3	1.9	-2.0	4.1
	Imports	-4.1	6.2	7.5	10.4	13.0	9.1	8.6	3.6
<b>Memorandum item:</b> Least developed countries	Exports	9.7	2.5	14.1	10.7	7.7	12.5	5.8	8.1
	Imports	3.1	7.3	13.9	8.9	9.1	9.7	9.9	10.5

Source: UN/DESA and Project LINK.

<sup>a</sup> Partly estimated.

<sup>b</sup> Forecasts, based in part on Project LINK.

**Weaker global trade will severely affect developing countries**

While the widening of the global imbalances during the past decade has been posing an increasing threat to global financial stability, the present trend of a recessionary unwinding could affect development prospects in the medium run. As noted in chapter I, the outlook of a global recession and falling commodity prices will have an adverse impact on growth and domestic resource mobilization in most developing countries. Net food and energy importers already suffered serious setbacks in early 2008 owing to the extraor-

dinary surges in prices of oil and food. The reversal in commodity prices in the second half of 2008 may be of little comfort to these countries, as the global recession will significantly weaken demand for their exports. Financing ensuing trade deficits will be increasingly difficult and costly in the context of great uncertainty in financial markets. In contrast, countries that had benefited from the commodity boom but did not invest in diversifying their economy in a timely fashion will be doubly hit as they will see both the prices and the volume of their exports decline.

### *Regional trends in trade*

As mentioned above, import demand in the United States has been weakening since 2007 and has fallen further in every quarter of 2008. Demand for imports of automobiles and car parts has been particularly affected. High oil prices and the slowdown in activity led to a drop in the volume of imports of fossil fuels. Export growth, in contrast, has strengthened over the past two years, driven by increased global demand for cheaper United States-made goods (in particular industrial inputs, computer-related commodities and consumer goods) after a prolonged period of dollar depreciation. Weakening demand worldwide and the rebound of the United States dollar (see chapter I) have reversed this trend, and United States exports have been falling since August 2008.

Trade growth in Western Europe has been affected by the United States slowdown. Growth of the total European export volume slowed from 3.9 to 3.6 per cent in the course of 2008. Export performance in the United Kingdom of Great Britain and Northern Ireland deviated from this trend, showing a recovery from the contraction in trade observed in 2007. European exports are expected to grow by a meagre 0.4 per cent in 2009, reflecting the global slowdown as well as the appreciation of the euro and the pound sterling against other major currencies from mid-2008. The weakening of global demand dominates prospects for import demand in Europe, which slowed from 5.2 per cent in 2007 to 3.2 per cent in 2008 and is expected to slow further, to 1.2 per cent in 2009.

The softening of import demand in the United States and elsewhere is also slowing export growth in developed Asia (Japan and Australia in particular). Falling oil prices are reversing the trend in preceding years of a rising import bill in Japan and have helped preserve the country's trade surplus, despite the poorer export performance. Australia managed to reduce its trade deficit, thanks to sharp increases in the negotiated price for its iron ore and coal exports, underpinning an increase in the country's total export revenues by more than 20 per cent in 2008. Canada's external sector is suffering from the weak United States economy, especially in the automobile industry, and, from mid-2008, also from the drop in oil prices and the appreciation of the Canadian dollar.

Among the new European Union (EU) member States, Estonia and Latvia have seen their imports decline in real terms as a consequence of the bursting housing and credit bubbles and their impact on private consumption and investment. In other new EU member countries, most notably Bulgaria and Romania, strong private consumption, continued foreign direct investment (FDI) inflows and continuing strong domestic investment have been driving import growth at a pace of about 12 per cent. Export performance of the new EU members has not been immediately hurt by the sluggishness in demand from major trading partners, possibly because many export contracts were component-based. The export contracts, on average, stretch over three quarters of the year, causing export growth to respond to slower foreign demand with a similar time lag. A significant deceleration of exports is therefore likely to be felt during the first half of 2009. During 2008, though, exports by the new EU members continued to expand at an annualized rate of 11 per cent in real terms.

Both imports and exports of the United States are declining

The rest of the developed world sees its income directly affected by sluggish United States trade growth

Export growth in new EU member States was strong in 2008, but it will be affected by the global slowdown with a time lag

Increases in production capacity of automotive plants in the Czech Republic and Slovakia in operation this year have helped to sustain a rapid growth of exports in 2008 despite declining sales of transport equipment in the EU, but prospects for 2009 will be less glowing.

The trade boom in South-eastern Europe may not last

In the economies of South-eastern Europe, buoyant private consumption, continuing FDI and, in some cases, heavy infrastructure spending resulted in strong import growth of about 8 per cent in 2008, amplified in nominal terms by higher food and energy prices. Exports of the region kept growing at a pace of about 9 per cent in 2008. It is expected, however, that the slower growth in the EU-15 may hold back further export expansion in the subregion.

Trade prospects in the CIS remain closely linked to oil and commodity prices

Growth of export revenues of the countries of the CIS was strong in 2008 and outpaced import value growth. The surge in oil and gas prices in the first half of 2008 helped boost trade surpluses in Azerbaijan, Kazakhstan and the Russian Federation, despite the rise in import demand based on growth in domestic consumption and investment. Growth in the volume of exports from the Russian Federation remained weak, and could decline significantly in the outlook. Imports of the Russian Federation increased by more than 20 per cent in 2008, but owing to the strong rise in hydrocarbon prices in the first six months of 2008, the economy was nonetheless able to increase its trade surplus. In some other parts of the CIS, however, import growth outpaced export growth in value terms, and trade deficits widened, especially in the smaller economies such as Armenia, Kyrgyzstan, the Republic of Moldova and Tajikistan. Ukraine suffered most from the rising costs of imported food, oil and gas. Its trade deficit surged during 2008 as import demand was further fuelled by strong domestic demand.

Trends in trade differ strongly between the oil and the non-oil exporters in Western Asia. In 2008, despite strong import growth, trade surpluses in the major oil-exporting countries of the Gulf Cooperation Council (GCC) and Iraq increased substantially from their already high levels of 2007. Saudi Arabia's trade surplus reached an estimated 65 per cent of gross domestic product (GDP) and that of Kuwait was no less than 72 per cent of GDP. In non-oil economies of the region such as Jordan, Lebanon and Turkey, in contrast, rising import costs outpaced increased export revenues, resulting in a further widening of trade and current-account deficits.

The fall in exports in Western Asia may cause worsening trade prospects in Europe

Until recently, import demand from oil exporters in Western Asia and from the fast-growing economies of East Asia had provided a buffer in Western Europe to the fallout in demand from the United States. This cushion is now deflating. East Asian economies are increasingly feeling the impact of the slowdown of developed economies in terms of a substantial deceleration in the demand for their exports. Export volume growth for the region as a whole is estimated to have weakened from an annual average of 13.7 per cent during 2001-2007 to about 8 per cent in 2008, and is likely to experience much weaker growth in the outlook for 2009. Nonetheless, China's trade balance has continued to widen in dollar terms during 2008, despite the appreciation of the renminbi that has taken place over the past three years. The Republic of Korea, the second largest exporter in the region, managed to sustain high rates of export growth until the third quarter of 2008. The economy's trade balance moved into deficit in 2008, however, as a consequence of strongly increasing import costs for energy and materials. Singapore and Taiwan Province of China suffered from considerably lower demand for information technology (IT) products, consistent with the weak demand in industrial countries.

Developing countries remain highly vulnerable to trade shocks

The developing countries most vulnerable to a global economic downturn and volatile commodity prices are primarily found in Africa and Latin America. The good performance of commodity exporters in Africa, owing to the rise in commodity prices in the first part of the year, is expected to give way to a much less favourable outcome, as

the demand and prices of their exports will decline further. A similar reversal of trends will also affect those African countries heavily reliant on agricultural exports and tourism. Oil exporters in the region will see significantly lower current-account surpluses in 2008 compared with previous years. Oil importers, in contrast, are expected to experience widening current-account deficits over 2008. South Africa is an exception to this trend, as its current-account deficit narrowed substantially in 2008 following the country's recovery from the electricity crisis that had stalled mining exports the year before. The outlook for 2009 will be much bleaker for both groups of economies, however, as export revenues are expected to collapse.

Meanwhile, the aggregate current-account balance of Latin America and the Caribbean is estimated to move into a small deficit in 2008, after registering a surplus of about 0.5 per cent of aggregate GDP in 2007. The declining trend is caused by a combination of the economic slowdown in the industrialized world, the drastic drop in commodity prices in the second half of 2008, which affected primary commodity exporters, and the erosion of competitiveness caused by strong currency appreciation in the region over the past few years (even though this trend has reversed in the second part of 2008). Going forward, the gains in competitive edge from the recent currency depreciation are likely to be more than offset by lower demand for exports because of the global slowdown and continued tight trade-credit constraints. Limited access to trade credit has already affected exports and production in Brazil. The recession in the United States will be felt most immediately in Mexico and Central America, which rely on United States markets for the lion's share of their exports. Countries in South America rely on a more diverse group of trading partners and will feel the consequences once demand for their exports slows in Europe and in Asia's emerging market economies.

### Trade in services: growth to slow with global downturn

World trade in services has expanded dramatically in recent decades. In 2007, it reached a total value of \$3.1 trillion, more than triple the size of 1990. This trend has been consistent with the worldwide trend of an increasing share of services in total output. During 1990-2007, the share increased from 65 to 72 per cent in developed countries and from 45 to 52 per cent in developing countries. Services today account for over 70 per cent of employment in developed countries and about 35 per cent in developing countries. In recent years, however, the fastest growth has taken place in merchandise trade, and it seems that this was a factor in the sustained growth of trade in services. Since the growth of merchandise trade has been particularly robust in the developing world, the share of services in total trade has decreased (see table II.3).

Business services, including information and communication technologies (ICT), as well as financial and insurance services, are on the rise, and in 2007 made up about one third of the services trade of developing countries. However, a prolonged financial crisis is likely to affect the trade and production of such services. Trade in financial services will be affected directly, but the effects will probably spill over into merchandise trade through tightening access to trade credit. Experts at a high-level World Trade Organization (WTO) meeting have suggested that the shortage of liquidity for financing trade credit worldwide amounts to \$25 billion as of November 2008.<sup>1</sup> This, on top of the contraction of demand, will constrain export opportunities, especially in developing countries.

Trade in financial and transportation services, which has become increasingly important in developing countries, is likely to weaken as the financial crisis unfolds

<sup>1</sup> See "Experts discuss problems of trade finance", World Trade Organization, WTO: 2008 News Items, 12 November 2008, available from [http://www.wto.org/english/news\\_e/news08\\_e/trade\\_finance\\_12nov08\\_e.htm](http://www.wto.org/english/news_e/news08_e/trade_finance_12nov08_e.htm) (accessed on 15 November 2008).

Table II.3  
Exports of services: share in total trade in goods and services, 2003-2007

Percentage					
	2003	2004	2005	2006	2007
<b>World</b>	<b>20.1</b>	<b>19.9</b>	<b>19.5</b>	<b>18.9</b>	<b>19.4</b>
<b>Developed economies</b>	22.5	22.7	22.7	22.2	22.8
<b>Economies in transition</b>	15.9	14.9	13.8	13.3	14.5
<b>Developing economies</b>	15.0	14.7	14.1	13.7	14.0
Africa	20.3	19.0	16.9	16.4	17.5
Latin America and the Caribbean	14.3	13.4	13.2	12.4	12.5
Asia	14.5	14.5	14.0	13.7	13.9
Oceania	35.4	34.2	33.7	30.4	28.5
<b>Memorandum items:</b>					
Least developed countries	15.9	14.7	12.4	12.5	11.6
Landlocked developing countries	17.3	15.9	14.6	13.0	13.4
Small island developing States	45.4	44.3	39.7	34.7	38.2

Source: UNCTAD GlobStat.

Most of the services trade of developing countries takes place in a limited number of countries, and its concentration has increased further over the past decade. Some 25 countries accounted for 86 per cent of total developing country services trade in 2007. Five of these alone accounted for 50 per cent of the total volume, up from 43 per cent in 2000 (table II.4). In less than two decades, China and India have become the largest developing country exporters of services, leaving behind other Asian countries that had dominated the services trade in the 1990s.

For developing countries in general, trade in services is particularly important in the areas of movement of natural persons supplying services (Mode 4 of the General Agreement on Trade in Services (GATS)) and outsourcing (included in Mode 1), but is also important in commercial presence (Mode 3), and is mostly carried out through FDI. Worldwide, the services sector accounts for the largest share of global FDI stocks and flows, while the share of manufacturing has continued to decline.<sup>2</sup> The services sector accounted for 62 per cent of estimated world inward FDI stock in 2006, up from 49 per cent in 1990. The share in the world total of FDI inflows to the services sectors in developing countries climbed from 35 per cent in 1990 to more than 50 per cent in 2007.

While trade, financial services and business activities continue to account for the lion's share of FDI in the sector, other services, including infrastructure, have begun to attract FDI since the 1990s. For example, the value of cross-border mergers and acquisitions (M&As) worldwide in electricity, gas and water rose from \$63 billion (about 6 per cent of total sales) in 2006 to \$130 billion (nearly 8 per cent of the total) in 2007.

In Africa, Western Asia, East and South Asia, and Latin America and the Caribbean, FDI inflows grew to nearly record levels in 2007, the finance sector being the largest FDI recipient, while activity in infrastructure services such as electricity, telecommunications and water was on the rise. In view of the current turmoil in financial markets, and considering the mixed results of privatized public services in the developing

FDI is a major vehicle for the expansion of trade in services in developing countries

FDI flows may weaken as the economic slowdown takes hold in developing countries

<sup>2</sup> See United Nations Conference on Trade and Development, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (United Nations publication, Sales No. E.08.II.D.23).



Table II.4  
Exports of services among developing economies, 1990, 2000 and 2007

Values in billions of dollars, share in per cent									
	1990			2000			2007		
	Value of exports	Share	Rank	Value of exports	Share	Rank	Value of exports	Share	Rank
<b>Developing economies</b>	<b>150.2</b>	<b>100.0</b>		<b>348.1</b>	<b>100.0</b>		<b>848.1</b>	<b>100.0</b>	
China, excluding Hong Kong SAR <sup>a</sup> , Macao SAR <sup>a</sup> and Taiwan Province of China	5.9	4.0	9	30.4	9.0	3	117.2	14.0	1
India	4.6	3.0	10	16.7	5.0	7	84.8	10.0	2
Hong Kong SAR <sup>a</sup>	18.1	12.0	1	40.4	12.0	1	82.7	10.0	3
Singapore	12.8	9.0	2	28.2	8.0	4	69.7	8.0	4
Korea, Republic of	9.6	6.0	3	30.5	9.0	2	63.2	7.0	5
Taiwan Province of China	7.0	5.0	6	20.0	6.0	5	30.6	4.0	6
Thailand	6.4	4.0	7	13.9	4.0	9	30.0	4.0	7
Turkey	8.0	5.0	5	19.5	6.0	6	28.7	3.0	8
Malaysia	3.9	3.0	11	13.9	4.0	8	27.6	3.0	9
Brazil	3.8	3.0	12	9.5	3.0	12	23.8	3.0	10
Egypt	6.0	4.0	8	9.8	3.0	11	20.0	2.0	11
Mexico	8.1	5.0	4	13.8	4.0	10	17.3	2.0	12
South Africa	3.4	2.0	13	5.0	1.0	14	13.5	2.0	13
Morocco	2.0	1.0	18	3.0	1.0	22	13.4	2.0	14
Macao SAR <sup>a</sup>	1.5	1.0	23	3.6	1.0	18	12.3	1.0	15
Indonesia	2.5	2.0	16	5.2	1.0	13	12.1	1.0	16
Lebanon	0.1	1.0	76	1.2	1.0	40	11.4	1.0	17
United Arab Emirates	1.1	2.0	32	2.2	1.0	25	10.7	1.0	18
Argentina	2.4	0.0	17	4.9	0.0	15	9.8	1.0	19
Iran, Islamic Republic of	0.4	1.0	48	1.4	1.0	37	9.3	1.0	20
Chile	1.8	1.0	19	4.1	1.0	17	8.8	1.0	21
Kuwait	1.3	2.0	26	1.8	1.0	32	8.6	1.0	22
Philippines	3.2	2.0	14	3.4	1.0	19	8.4	1.0	23
Saudi Arabia	3.0	0.0	15	4.8	1.0	16	7.7	1.0	24
Cuba	0.5	0.0	42	3.1	1.0	21	6.6	1.0	25

Source: UNCTAD GlobStat.

<sup>a</sup> Special Administrative Region of China.

world, these trends seem worrisome. Governments have often found themselves absorbing the costs of failures or shifting strategies of transnational corporations (TNCs) in basic services. Bailouts of large foreign financial corporations may give rise to an even heavier burden. Some countries in Latin America and the Caribbean adopted a number of policy measures related to FDI that range from reducing incentives to restricting or prohibiting such investment. As several factors have been influencing recent trends, the precise impact of the financial crisis on FDI flows is difficult to measure.<sup>3</sup>

Offshore services represent only a relatively small component of the world's outsourcing market. Offshore service activities mainly comprise IT services and IT-

<sup>3</sup> See United Nations Conference on Trade and Development, *World Investment Prospects Survey 2008-2010* (New York and Geneva: United Nations, September 2008).

enabled business services, as well as pharmaceutical and research and development (R&D) services. Developing countries have captured a sizeable and growing share of this market. The potential impact of the current financial and economic crisis on this incipient market remains uncertain, since offshore activity may either increase in pursuit of cost-saving strategies or fall as global demand recedes.

## World primary commodities and prices

### Non-oil commodities: dramatic price swings

Commodity price fluctuations in 2008 were caused by new factors

During 2008, the upward trend in commodity prices, which had put its stamp on commodity markets since the early 2000s, reached its peak and was followed by a dramatic fall. Long- and short-term factors had combined in an unprecedented manner to create a broad rise in commodity prices with characteristics unlike those of previous commodity price booms, such as the one in the early 1950s or those following the two oil-price shocks of the 1970s. These earlier booms resulted from supply bottlenecks and were broken by a rise in global inflation followed by monetary tightening. The most recent boom was different, however. Rather than experiencing a shock, supply was rising consistently in response to price increases, but apparently not as fast as the rise of demand fuelled by speculation in the futures markets. The expectations and exchange-rate volatility which triggered speculation, driving stocks down, also contributed to the surge in prices. Hence, rather than balancing supply and demand, rising prices fed speculation and further price increases. The tide was turned by a change of sentiment among financial investors in commodity markets.

Growing supply in some commodity markets is facing fading demand

From June 2008, commodity prices have generally been decreasing, as shown by the United Nations Conference on Trade and Development (UNCTAD) commodity price index, which lost 11.5 per cent in dollar terms between June and September 2008. This trend holds for all commodity groups, though specific commodities or commodity groups have been more affected than others (see table II.5). The change in trends can be partially explained by high price incentives and favourable weather conditions that are contributing to increased planting and harvesting of cereals, which may hit a new record in 2008. World production of wheat, maize and rice is expected to exceed demand and contribute to a partial replenishment of stocks. In addition, the recent appreciation of the United States dollar may also explain part of the price decline in nominal terms. While the replenishment of stocks and lower prices is a welcome turn of events for consumers, the sharp rise in price volatility during 2008 has hurt both consumers and producers.

Table II.5  
Commodity price indices in nominal terms, 2008

Base year 2000 = 100			
	Jan-08	Jun-08	Sep-08
<b>All non-oil commodities</b>	<b>239.4</b>	<b>289.8</b>	<b>256.4</b>
Food	200.0	262.6	232.3
Tropical beverages	167.1	192.8	186.7
Vegetable oilseeds and oils	318.8	370.5	266.9
Agricultural raw materials	196.6	228.6	212.7
Minerals, ores and metals	329.1	371.3	334.7

Source: UNCTAD Commodity Price Statistics.

Between 1997 and 2002, commodity prices followed a downward trend in both nominal and real dollar terms. The commodity price boom, which resulted in record prices in nominal dollar terms for several commodities, also allowed real prices to recover for some commodity groups. Nonetheless, most commodity prices, corrected for dollar inflation, remained well below previous peaks (see figure II.2 and table II.6).

Exceptional conditions caused the rise and fall of prices in world markets for basic grains, food and minerals. One of the unique features of the 2008 boom was the long and steady growth in commodity market trading, during which unused capacity was put into operation. Capacity utilization peaked in the production of most commodities belonging to the categories of basic grains, food and minerals, as new investments to increase sup-

Despite sharp rises, real prices of most commodities have remained below previous peaks

Figure II.2  
Monthly averages of free-market price indices of non-oil commodities,  
January 1997-September 2008

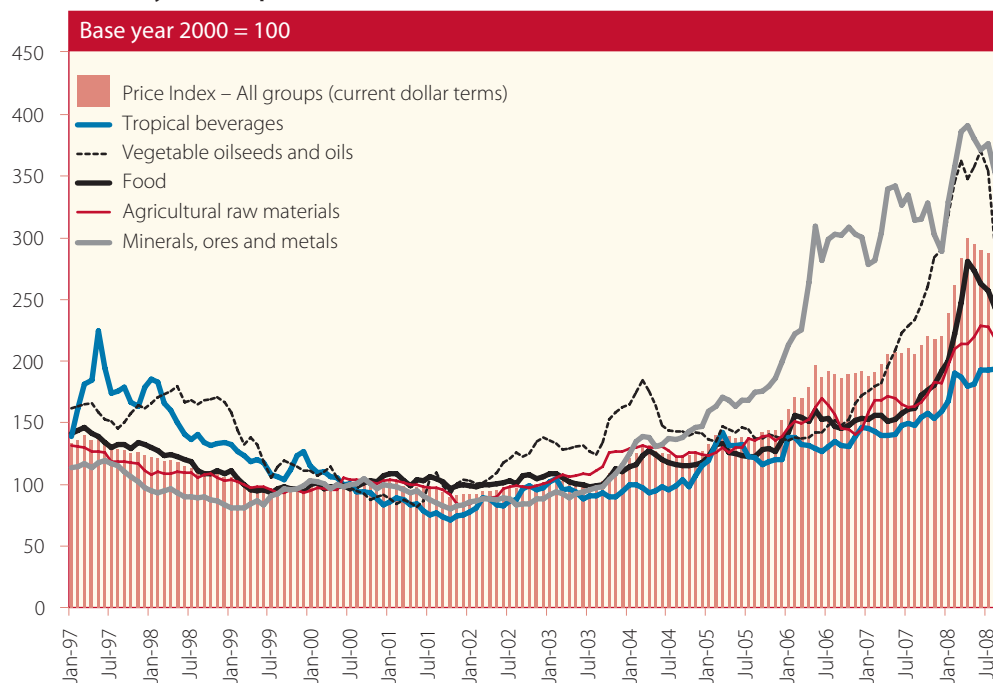


Table II. 6  
Commodity price indices in real dollar terms, 1974-2008

Base year 2000 = 100					
	1st half 1974	1st half 1997	1st half 2008	1997-2008 change (percentage)	1974-2008 change (percentage)
<b>All non-oil commodities</b>	<b>317.8</b>	<b>121.9</b>	<b>197.3</b>	<b>61.9</b>	<b>-37.9</b>
Food	386.7	126.2	175.8	39.2	-54.5
Tropical beverages <sup>a</sup>	617.7	161.9	129.8	-19.8	-79.0
Vegetable oilseeds and oils	433.9	144.3	248.6	72.3	-42.7
Agricultural raw materials	203.1	115.0	151.3	31.5	-25.5
Minerals, ores and metals	239.7	103.8	262.0	152.5	9.3

Source: UNCTAD, Commodity Price Statistics and Infocomm.

<sup>a</sup> The highest prices for tropical beverages were recorded in 1977, which for this group of commodities is used as the year of reference instead of 1974.

ply fell short of what was needed to match the increase in demand, and inventories became depleted. At that point, the financial crisis had arrived, rendering the question of how long the demand momentum could be maintained irrelevant. For other commodities such as agricultural raw materials, the supply response had been sufficiently large early on.

Exchange-rate fluctuations and speculative activity, among other factors, have increased commodity price volatility

It is also likely that the depreciation of the dollar since 2002 fuelled expectations of further price increases as investors tried to preserve international purchasing power by raising prices in dollar terms. Although difficult to ascertain with precision, the influence of speculation by financial investors has been considerable. Speculation in the actual, physical exchange of commodities certainly influenced prices as speculators bought and stored commodities, betting on price increases. Such positions have temporarily reduced the supply of goods and have no doubt affected price movements directly. The impact of speculation in futures markets (that is to say, where speculators do not physically trade any commodities) on price trends is much more difficult to determine, however. Futures trades are bets on buying or selling goods entitlements which are continuously rolled over. It is therefore not clear whether such trading does more to commodity prices other than increase their volatility. It could, however, be argued that increased global liquidity and financial innovation has also led to increased speculation in commodity markets. Conversely, the financial crisis contributed to the slide in commodity prices from mid-2008 as financial investors withdrew from commodity markets and, in addition, the United States dollar appreciated as part of the process of the deleveraging of financial institutions in the major economies (see chapter I).

As explained in Box II.1, the turmoil experienced in stock markets owing to the global financial crisis initially shifted speculative investments towards markets for basic grains, for example. But as the financial vulnerability of large investors surfaced later in the year, the need for liquidity to refinance bad debts and recapitalize ailing financial institutions seems to have abruptly stopped financial investments in commodity and futures markets. The credit crunch is also expected to have a negative impact on international commodity trade by raising import financing costs. This will reduce import demand and contribute to further declines in commodity prices. As economic actors expect a further downturn of the global economy, this may already have been translated into lower futures market prices.<sup>4</sup>

Trends in commodity stocks provided an early signal of price gyrations

Trends in commodity stocks have signalled impending shortages. Production conditions of many commodities were characterized by excess capacity in the 1990s. The resulting excess supply suppressed prices and provided little incentive to new investment. As demand gradually rose, spare capacity declined. Similarly, inventories, which in many cases had been built up to very high levels, started falling. Eventually, supply responded, but in many cases only after prices had reached unprecedented levels. Figure II.3 shows the surplus of supply over demand for lead and zinc, which in many ways are typical of the minerals and metals industry. A surplus of both metals in the early years of the twenty-first century turned into a widening deficit around 2004, and the industry did not return to surplus until 2008. Figure II.4 shows London Metal Exchange (LME) stocks for the same two metals.

<sup>4</sup> See, for example, United Nations Conference on Trade and Development, *Trade and Development Report 2008: Commodity prices, capital flows and the financing of investment* (United Nations publications, Sales No. E.08.II.D.21), chapter 2, p. 24; Institute for Agriculture and Trade Policy, "Commodities market speculation: The risk to food security and agriculture", IATP Report, November 2008; W. Meyers and S. Meyer, "Causes and implications of a food price surge", background paper for the present report, available from [http://www.un.org/esa/policy/publications/wesp\\_background\\_papers.htm](http://www.un.org/esa/policy/publications/wesp_background_papers.htm); and Organization for Economic Cooperation and Development, Trade and Agriculture Directorate, Committee for Agriculture, "The relative impact on world commodity prices of temporal and longer term structural changes in agricultural markets: A note on the role of investment capital in the US agricultural futures markets and the possible effect on cash prices", Document No. TAD/CA/APM/CFS/MD(2008)6, 28 February 2008.

## Box II.1

### The making of the food crisis

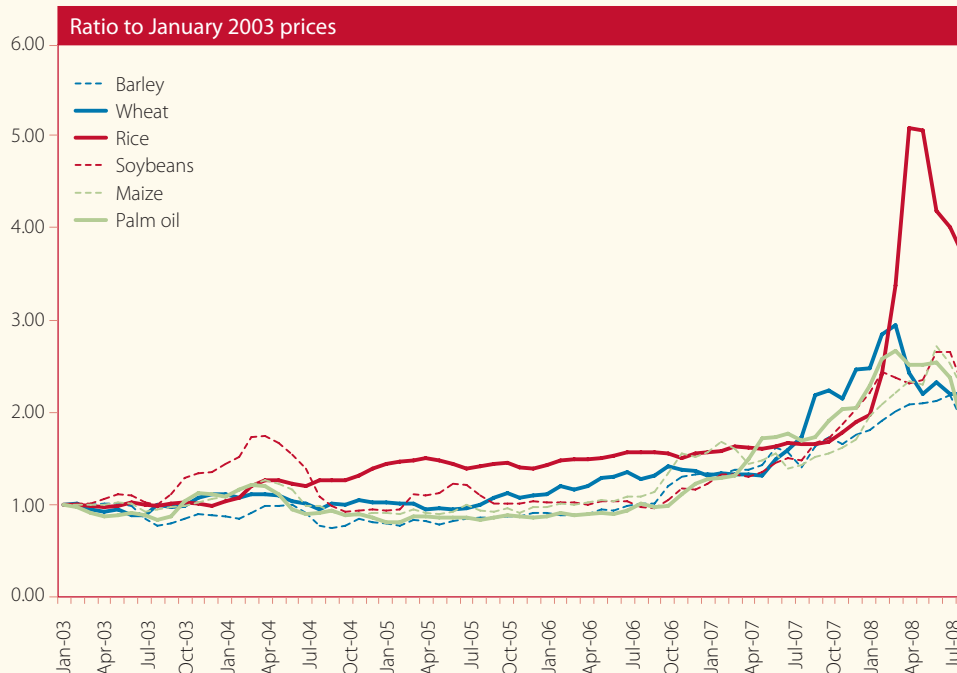
In the years leading up to the food crisis of early 2008, demand for basic grains (rice, wheat, barley, maize and soybeans) exceeded production. As a result, stocks fell to 40 per cent of their levels in 1998/99, and the stocks-to-use ratio reached record lows for total grains and multi-year lows for maize and vegetable oils. Given such tight conditions, the market could not absorb the events that occurred on the demand and supply side, culminating in a “perfect storm”, and leading to soaring prices and rampant food shortages in many developing economies.

There are differences in how prices evolved among food commodities, as well as in the triggers that sparked the price surges. Some grain prices began an upsurge as early as the end of 2006; nevertheless, by September of 2007, all international grains prices had doubled from their 2003 price levels (see figure A below). The apparent common factor that affected all price dynamics was the comovement of the depreciation of the United States dollar and the rise in crude oil prices.

The United States dollar began to depreciate more steeply in 2006, and crude oil prices rose simultaneously. This not only increased production and transport costs for commodities but also stimulated an increase in biofuel production, increasing the demand for, and the price of, maize and vegetable oils. It has also been argued that biofuel production has increased the demand for agricultural inputs, energy and labour, thereby having the impact of increasing food prices in general. Increasing maize prices induced crop substitution towards more profitable maize production and led to the substitution on the demand side for feed and food, thereby increasing prices of other crops. Subsequently, higher crude prices raised the production costs of all crops, livestock and dairy, and these effects permeated throughout the agricultural sector raising the farm-to-retail margins and increasing the cost of food.

Shortfalls in grain production also emerged because of bad harvests, most notably in Australia and Europe. While these events would normally not have been such large market movers, in this case the effect on prices was dramatic given the record-low level of cereal stocks and the continuing strong global demand.

**Figure A**  
Patterns of price developments among food commodities, 2003-July 2008



**Source:** W. Meyers and S. Meyer, “Causes and implications of a food price surge”, background paper for the present report, available from [http://www.un.org/esa/policy/publications/wesp\\_background\\_papers.htm](http://www.un.org/esa/policy/publications/wesp_background_papers.htm).

## Box II.1 (cont'd)

The reaction to rising international food prices at the domestic level only served to exacerbate an already tenuous situation. Numerous exporting countries either banned, taxed or otherwise limited exports of grains and oilseeds, while importing countries reduced import tariffs, subsidized consumers or increased imports as precautionary measures. The most dramatic impact was on the price of rice, but wheat was also affected. Rice exports were banned in Cambodia, Egypt, India (except basmati), Indonesia and Viet Nam, and China introduced a 5 per cent export tax. Since the international market for rice is very thin (amassing no more than between 6 and 7.5 per cent of rice consumption), the trade restrictions generated market panic resulting in private hoarding and the delay of emergency food deliveries.

Increased consumption, most notably in China and India, is frequently seen as another factor in the price surges. While part of a longer-term trend, counterfactual evidence suggests that increased food demand in these emerging markets only played a role coming as it did on top of already emerging supply shortages. In general, growth in the demand for corn for food and feed has not been above trend over the past 10 years. It was the steep rise in the demand for maize for ethanol production in the United States (which, in turn, was driven by subsidies and the surge in fossil fuel prices) which—along with emerging supply shortages in China—contributed to the surge in the world price of corn in late 2006. This spilled over into other markets. The price of soybeans increased steeply following the shift of 5.5 million hectares of arable land from soybean to maize production in the United States in response to the rising maize prices. This further led to a decline in world oilseed production. As demand for oilseeds remained strong, especially in China, prices of other oilseeds surged as well.

Increased activity in futures markets by financial investors also had an impact on short-term price movements, as explained in the main text. This increased price volatility pushed up commodity prices in futures contracts well beyond what they would otherwise have been during the boom. Similarly, the withdrawal of financial investors at the emergence of the financial crisis exacerbated their decline. While clearly affecting price volatility, it is less evident whether speculation in futures markets is also having any lasting effect on seasonal average prices or long-term conditions affecting demand and supply.<sup>a</sup>

Next to this storm of short-term factors pushing up food prices were longstanding policy failures that weakened the agricultural sector in many developing countries, making it harder for them to cope with market shocks and avoid a major-scale crisis. Thanks to the Green Revolution and development policies that spanned from the sixties through the eighties, world food prices decreased persistently from the late 1980s until 2002, providing self-sufficiency to many developing countries and helping to reduce poverty. However, the policy shift towards more confidence in price signals to stimulate production and less attention to government support for infrastructure investment and research and development for agricultural technology, together with lower official development assistance (ODA), has been most detrimental to agricultural productivity growth. In particular, sub-Saharan Africa has suffered the most from the present food crisis because of poorer social and physical infrastructure, making it harder to assimilate new technologies triggered by the Green Revolution. In 2003, African Governments committed themselves to raising their share of spending on agriculture to 10 per cent by 2008 in support of the Comprehensive Africa Agriculture Development Programme (the Maputo Declaration goal). In reality, however, such spending has dropped dramatically in recent decades and the target is far from being met (see figure B).

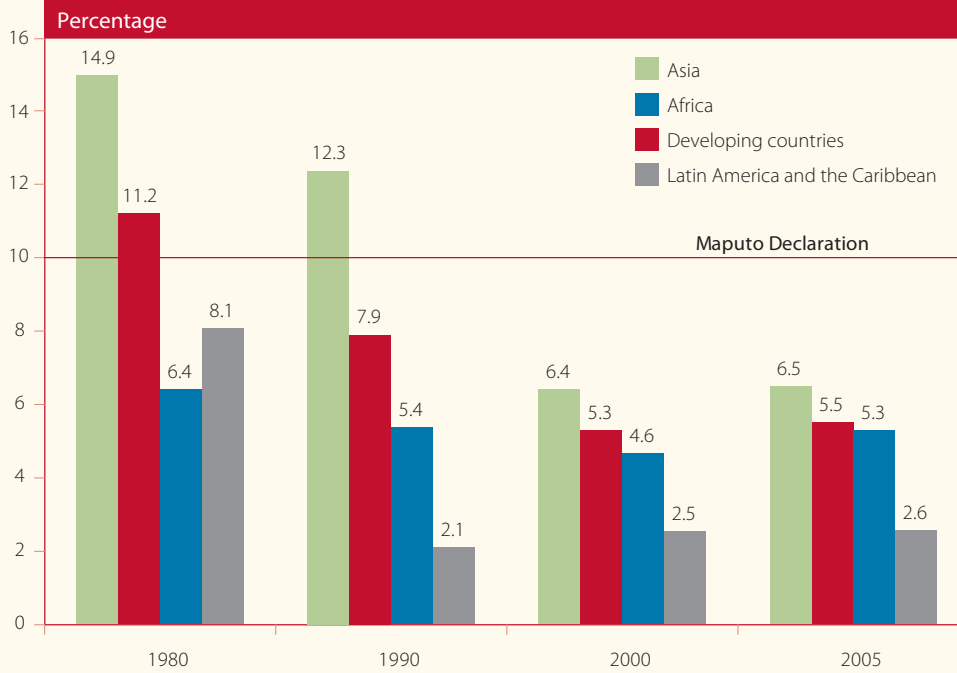
Donors have also neglected agriculture. The share of total ODA for agriculture declined from 13 per cent in the early 1980s to 2.9 per cent in 2005-2006. In addition, ODA allocated to other productive activities and economic infrastructure, which can have positive externalities for agriculture, also suffered from a significant drop in international support during the same period.

The downside of weakening investment and agricultural support measures in developing countries is that productivity growth for major food crops has stalled, and there has been no significant increase in the use of cultivated land. Thus, production has fallen woefully short of growth in food demand. Unless the problem of underinvestment in agriculture is addressed, beyond the short-term swings, food prices may remain on a longer-term upward trend.

<sup>a</sup> See, for example, Commodity Futures Trading Commission, Written testimony of Jeffrey Harris, Chief Economist before the Senate Committee on Homeland Security and Governmental Affairs, United States Senate, 20 May 2008, available from <http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/eajeffharristestimony052008.pdf> (accessed on 10 November 2008); Scott H. Irwin, Philip Garcia, Darrel L. Good and Eugene L. Kunda, "Recent convergence performance of CBOT corn, soybean and wheat futures contracts", *Choices*, vol. 23, No.2, 2nd quarter 2008, pp. 16-21, available from [http://www.choicesmagazine.org/magazine/pdf/issue\\_4.pdf](http://www.choicesmagazine.org/magazine/pdf/issue_4.pdf) (accessed on 11 November 2008).

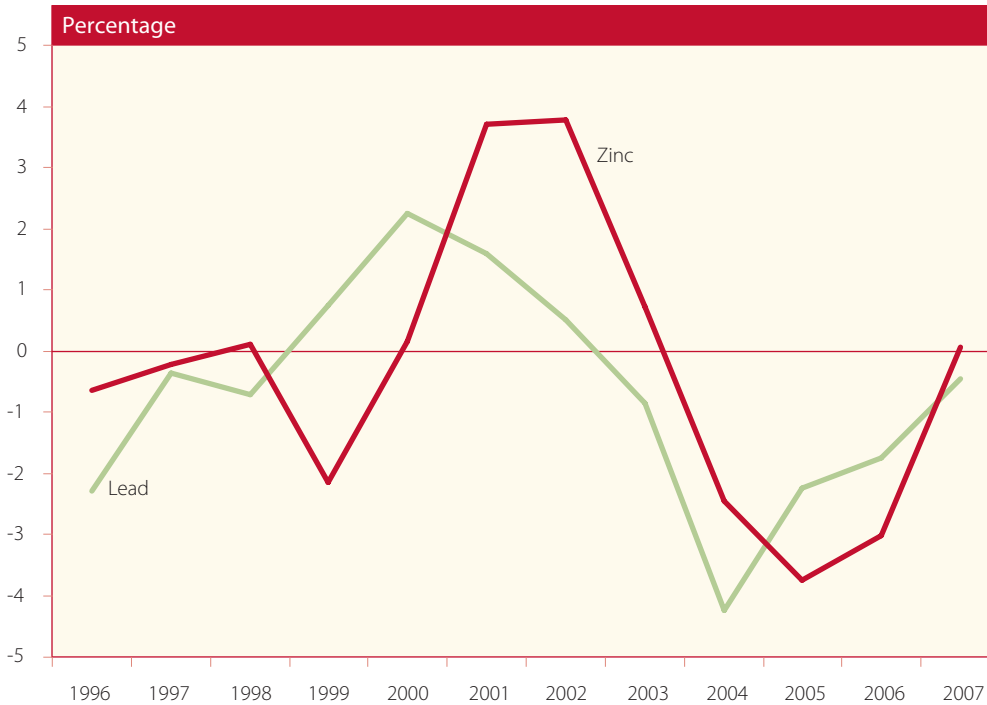
Box II.1 (cont'd)

Figure B  
Public agricultural expenditures in developing countries, 1980-2005



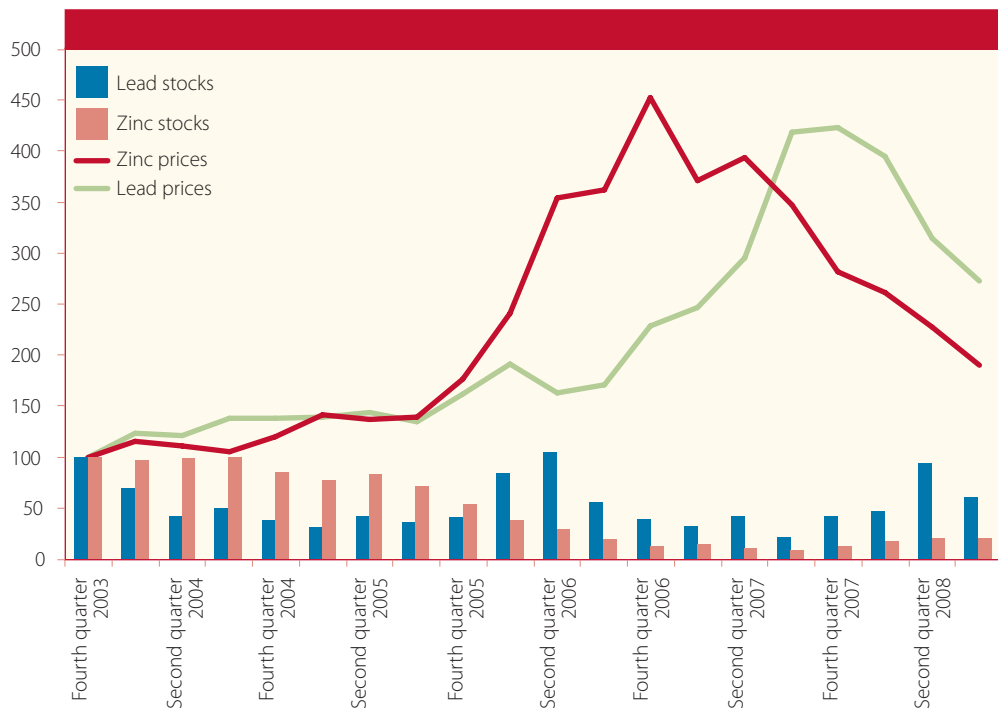
Source: Based on data from Shenggen Fan and Anuja Saurkar, "Tracking agricultural spending for agricultural growth and poverty reduction in Africa", *Regional Strategic Analysis and Knowledge Support System*, Issue Brief No. 5, available from <http://www.resakss.org/publications/Expenditure%20trends%20brief.pdf>.

Figure II.3  
Surplus or deficit of global production over usage for lead and zinc, 1996-2007



Source: International Lead and Zinc Study Group, available from [www.ilzsg.org/static/statistic.aspx?from=1](http://www.ilzsg.org/static/statistic.aspx?from=1) (accessed on 15 November 2008).

Figure II.4  
Inventories and prices of lead and zinc,<sup>a</sup> fourth quarter of 2003–second quarter of 2008



Source: London Metal Exchange.

<sup>a</sup> Average quarterly cash prices (percentage of fourth quarter 2003 prices) and end of quarter inventories of lead and zinc (per cent of end 2003 inventories).

Since LME inventories are stocks of last resort, a severe decline in these stocks is possibly the best indicator of an acute physical shortage. Other metals have followed similar paths, commonly with a price peak around the time when inventories were at their lowest, followed by declines in prices as production caught up and inventories started to accumulate.

Developments regarding agricultural products have been roughly similar, although, after speculative forces, the explanation of price fluctuations lies in large part in supply-side factors. Among these are weather conditions—in the short term—and policy neglect, lack of long-term infrastructure and capacity investment, and insufficient technological innovation, in the longer term. An apparently relevant factor affecting both the demand and supply of agricultural products was the continuous rise of the dollar price of oil, which raised costs of production and transportation, on the one hand, and influenced substitution for biofuels on the other. It is not coincidental that some countries have resorted to export controls or bans to ensure adequate food supplies for their own populations, and this may have exacerbated price pressures. Such export restrictions were a response to the ongoing surge in prices rather than the initial cause.

According to data from the International Grains Council,<sup>5</sup> after two years of production deficits and a year of relative balance between supply and demand in 2007/08, global *grains* stocks should remain unchanged in 2008/09, at 281 million tons, owing mainly to good harvests. At the same time, world trade in grains is expected to fall as the global economy slows. It is likely, therefore, that the decline in prices observed in the second half of 2008 will continue in the near future.

The decline in the prices of most grains, beverages and vegetable oils will continue as the global economy slows

<sup>5</sup> International Grains Council, *Grain Market Report*, GMR No. 383, 30 October 2008; and, GMR No. 380, 31 July 2008.



The *tropical beverage* price index, which had increased steadily until mid-2008, declined thereafter (figure II. 2). In real terms, present price levels will remain well below the pre-crisis level in the immediate outlook. This will have severe implications for coffee growers, for example, prompting calls for the putting in place of compensatory mechanisms in Colombia and Brazil, which will perhaps be followed elsewhere.

The *vegetable oils* and *oilseeds* price index rose by almost 174 per cent between January 2006 and June 2008, partly owing to the indirect effect of increased production of biofuels which competed for agricultural inputs and capital utilization. However, prices fell by 30 per cent between June and September 2008, along with falling prices of fossil fuels and most basic grains.

Developments in agricultural raw material prices were dominated by price increases for *cotton*. With a price average of \$75.8 per pound over the first six months of 2008, the Cotlook 'A' index increased by 30 per cent compared with its level in January 2006. Nominal prices surged to levels not recorded since 1997. Between June and September 2008, however, cotton prices fell by 4.5 per cent, following the trend in other commodity prices, albeit less dramatically. World production contracted by 5 per cent in 2008 compared with the preceding year, in particular on account of a sharp decline (of 25 per cent) in production in the United States. Global demand for cotton increased by 1 per cent, leading to a tightening of the market. The price of *natural rubber* rose by 73 per cent from January 2006 to June 2008, mainly influenced by rising petroleum prices which drive the price of *synthetic rubber*. Declining *oil* prices pushed down the prices of natural and synthetic rubber by 10 per cent between June and September.

The prices of most *minerals, ores* and *metals* increased during the commodity price boom, although they peaked at different times. The prospect of a worldwide recession depressed prices in the second half of 2008 as projections for demand fell well short of current capacity. This does not take into account the capacity that is scheduled to enter operation in response to recent high prices. The outlook for next year for most minerals is that supply will exceed demand, allowing a build-up of inventories from present low levels and contributing to a fall in prices. The situation with regard to *gold* may perhaps be different. Prices in 2008 remained at historically very high levels, about \$800 per ounce, owing in part to its use as a safe storage of wealth in times of economic and currency turmoil. A decline in the course of the second semester of 2008 may be mainly explained by a contraction in consumption demand, especially in the jewellery market, where demand fell by 24 per cent year over year in the second quarter of 2008. In addition, China became the largest gold-producing country in 2007 with a total production of 276 tons, outstripping South Africa's 272 tons. The extent to which the decline in the price of gold was also triggered by "margin calls" is uncertain, however, and thus it remains unclear whether, in the near future, gold will regain its privileged character of wealth storage as the financial crisis deepens.

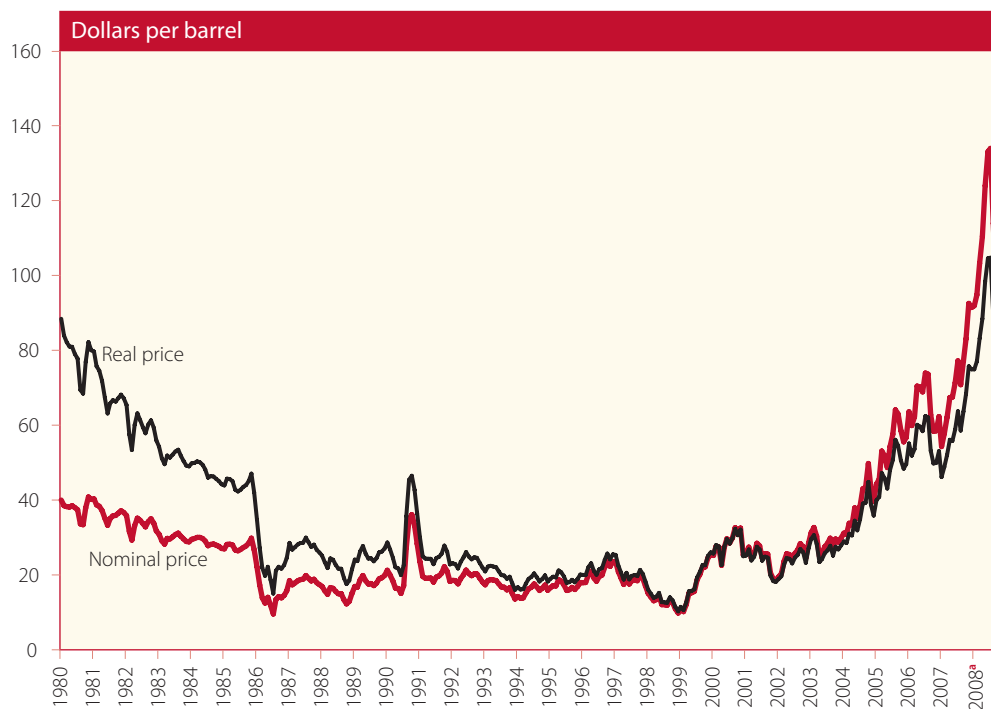
Cheaper derivatives of petroleum will win over natural fibres

Prices of most metals peaked between 2007 and mid-2008

### Crude oil: the turnaround that was to be expected in a global slowdown

*Oil* prices were on a roller coaster ride throughout 2008 until the global commodity boom came to an abrupt end in the summer. The price of Brent crude, which stood at about \$100 per barrel (pb) in early January, rose to an all-time high of \$145 pb in July before dropping sharply to \$60 pb in November (see figure II.5). As was the case with other commodities, the surge in oil prices during the first half of 2008 reflected both a tight balance between supply and demand and increased speculation and herding behaviour.

Figure II.5  
Nominal and real Brent crude oil prices, 1980-2008



Source: UN/DESA, based on IMF International Financial Statistics CD-ROM, November 2008.

Note: United States consumer price index was used as the deflator for the nominal price of Brent oil.

a Partly estimated.

Demand conditions explain to a great extent the fluctuations in the price of oil price

Fundamental conditions included fast-growing oil demand in transition and developing countries, weak supply from oil-producing countries that are not members of the Organization of the Petroleum Exporting Countries (OPEC), and geopolitical concerns. The upward price movement was reinforced by speculative activities, mostly in future markets, as investors built positions in anticipation of further price increases. In addition, speculative buyers used oil and other commodities as a hedge against inflation and a weakening United States dollar, pushing prices further in a self-propelling upward spiral.

This process went into reverse around the middle of July 2008 when concerns about slowing demand from developed countries coincided with rising supply in a larger number of oil-producing countries (more than offsetting declines in some others) and the depreciation of the dollar ended abruptly, for the reasons explained in chapter I. As the financial crisis in the United States deepened in September 2008 and increasingly spread across the globe, the oil-price decline accelerated, while daily prices became increasingly volatile. In October, international crude oil prices registered their biggest monthly drop ever as expectations mounted that a severe global economic downturn would sharply reduce demand for oil in 2009. Prices continued to slide even when OPEC decided to lower production considerably in late October and announced further cuts in subsequent months. Despite the steep decline in the second half of 2008, the price of Brent crude averaged \$101 pb for the year as a whole, almost 40 per cent above the average annual price of \$72.5 pb in 2007.

World demand for oil stagnated in 2008, caused by offsetting trends: falling demand in developed countries and rising demand in developing countries

The high average price of oil and the significant slowdown in global economic growth kept world oil demand flat in 2008, averaging 86.1 million barrels per day (mbd). Robust growth in demand by developing and transition economies offset a substantial contraction in the developed countries, particularly in the United States, where yearly oil demand saw its biggest fall since 1982.

Oil demand in the developed countries fell by approximately 3 per cent in 2008 as consumers faced sharply higher energy bills in the first half of the year and a severe economic downturn in the second. The United States, which currently accounts for 22 per cent of total world demand, registered the largest decline among developed economies, with demand for crude oil dropping by about 5 per cent as gasoline prices rose, increasing by 35 per cent between January and July. Oil demand in Europe continued its downward trend in 2008, mostly owing to shrinking demand for transportation fuels in the large economies of the EU. Demand for gasoline dropped sharply during the summer months in Germany, France, Italy, Spain and the United Kingdom, as very high retail prices and slowing economic growth reinforced the structural decline. Oil demand in the Pacific region decreased in 2008 for the third consecutive year as a result of weak gasoline and diesel demand in Japan.

However, in developing and transition economies, oil demand continued to expand significantly in 2008, growing on average by 3.8 per cent. All regions registered increasing demand owing to continuing robust, albeit slowing, economic growth. As in previous years, demand for transportation fuels rose sharply in China, India and Western Asia. Total oil demand increased by about 6 per cent in China and Western Asia, by almost 5 per cent in India, and by approximately 4.5 per cent in Latin America and the Caribbean. Soaring international fuel prices had only a limited effect on demand as price controls and subsidies in many developing countries continued to shield consumers partially from the cost increases. However, a number of South and East Asian countries, including China, Indonesia, Malaysia and Taiwan Province of China, cut fuel subsidies during 2008 to reduce the burden on the fiscal budget.

Global oil supply averaged 86.4 mbd in 2008, representing an increase of 0.9 per cent over average supply in 2007. This increase was entirely due to higher production by OPEC member countries during the first three quarters of the year (and despite more recent supply reductions). Non-OPEC supply, by contrast, remained virtually unchanged in 2008 as declining output in Mexico and Europe was compensated by higher production (which included liquid gas and biofuels as well as crude oil) in Brazil, China and the United States.<sup>6</sup> Overall, weakness in non-OPEC supply could have been a key factor behind the surge in prices during the first half of 2008. Given rapidly growing demand in developing countries and constrained non-OPEC production, OPEC increasingly gained control over marginal supply. This sparked fears among market participants that future supply shortfalls would lead to further price hikes. However, as the financial crisis hit developed economies, these fears gave way to more short-term concerns of faltering demand.

After increasing quotas in the last quarter of 2007, OPEC left them unchanged during the period in which oil prices surged between January and July 2008, despite mounting pressure from major oil-importing countries to increase them. New members, Angola and Ecuador, which joined OPEC in 2006 and 2007, respectively, had formal quotas assigned to them from January 2008 onwards, whereas Iraq continued to be exempted from the quota system.<sup>7</sup> Actual production—including all three of these countries—fluctuated somewhat during the first part of the year, primarily as a result of production outages in Iraq and Nigeria. From May onwards, as oil prices spiralled upwards, the largest producer in OPEC, Saudi Arabia, raised its output steadily. In July 2008, Saudi Arabian production increased by 0.6 mbd since April to 9.7 mbd, its highest level since 1981, and

Increases of supply by OPEC countries in 2008 compensated shortfalls by non-OPEC oil exporters

<sup>6</sup> In assessing the supply and demand for oil to illustrate price fluctuations, the convention of the International Energy Association is to include both natural gas liquids and biofuels.

<sup>7</sup> Ecuador had previously been an OPEC member, having become an oil exporter in the early 1970s, but it left the cartel in 1985 and rejoined in 2007.

about 8 per cent above its quota. As a result, total OPEC production reached a high of 37.7 mbd in July, when oil prices peaked. As the global economic outlook increasingly deteriorated and oil prices fell rapidly, OPEC members decided in September 2008 to return to the agreed quotas, mainly putting pressure on Saudi Arabia to lower output. However, prices continued to decline sharply in October, forcing OPEC to reduce quotas and cut production by a total of 1.5 mbd as of November 2007.

The upward price spiral has ended with the financial crisis and may be on a further downward path with the global slowdown

The oil market outlook for 2009 essentially depends on how deep and long the economic slowdown in major oil-consuming countries will be. The developed economies in particular, which account for the lion's share of global demand for energy, will be facing recession. Net oil-importers among emerging economies will experience a marked slowdown. In the baseline scenario, total oil demand in developed economies is expected to decline by about 3 per cent in 2009, similar to the rate in 2008. Since Japan, the United States and all large European economies have entered into recession, oil demand will remain subdued even though consumers face significantly lower prices for retail gasoline, diesel and heating oil. Meanwhile, oil demand growth in developing and transition countries is anticipated to slow down to about 3 per cent owing to decelerating economic growth in all regions.

Price falls and defensive supply cuts will act as disincentives to long-term investments

With global demand slowing and oil prices continuing to fall despite lower production, OPEC is likely to reduce supply further in 2009. Average OPEC output in 2009, including natural gas liquids (NGLs), is forecast at 36.1 mbd, almost 3 per cent below the average in 2008. This compares to expectations of slightly increased production in non-OPEC countries, where several new project start-ups are expected to bring total average output to 50.2 mbd. Based on experience in previous years, downward risks to production remain in a number of OPEC and non-OPEC countries. Actual output may fall short of target levels owing to accidents, technical problems, political unrest, security challenges or weather-related outages. It is plausible that increasingly low international oil prices may come close to or below marginal costs of production for many new projects, thus placing supply in jeopardy in the medium term. Output from existing fields is declining at a rapid pace; hence, global oil supply will depend fundamentally on exploration and production from new fields. This will require massive investments by private and public oil companies over the coming years and is likely to lead to upward pressure on prices in the medium- and long-run.

Given these expected shifts in demand and supply, during 2009 the price of oil is expected to fall back to levels seen in 2006. In the baseline scenario, oil demand is anticipated to decline slightly to 85.8 mbd and the average price of Brent crude is forecast at \$64 pb on average for the year 2009. If a more pessimistic global growth scenario plays out, prices could fall well below that level. On the other hand, if the world economy bounces back in the second half of 2009, oil prices will likely start rising again. Much uncertainty surrounds these prospects and, consequently, the price of oil is expected to remain highly volatile in the outlook.

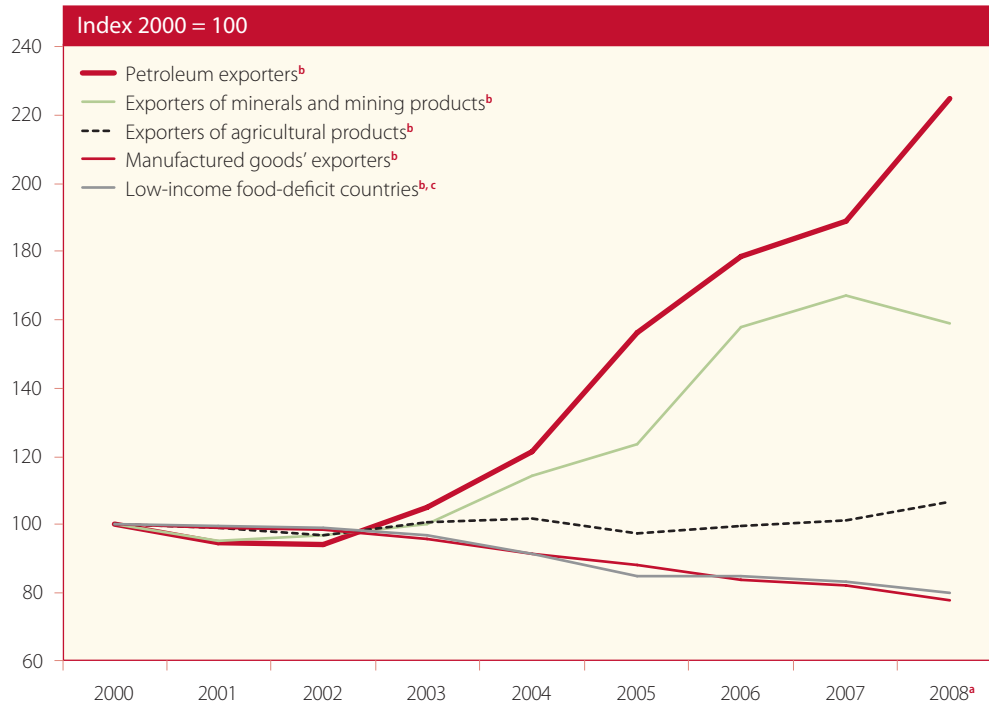
## Terms of trade for developing countries and economies in transition

Main energy and primary exporters benefited from net terms-of-trade gains in 2008

As discussed above, during 2008, most commodity prices experienced sharp changes, with abrupt rises in the first part of the year followed by falls in the second half. By the end of 2008, world market prices of most primary products had dropped below levels posted at the beginning of the year. In the case of oil and most mining and food products, however, average prices for 2008 remained above those of 2007. Because of the importance of these

commodities in their trade, many primary exporters experienced, on balance, terms-of-trade gains in 2008, with significant gains for net oil exporters in particular (figure II.6).

Figure II.6  
Terms of trade by trade structure, 2000-2008



Source: UNCTAD, *Trade and Development Report 2008* and UNCTAD Commodity Price Statistics.

<sup>a</sup> Partly estimated.

<sup>b</sup> Selection of developing and transition economies (see UNCTAD, *Trade and Development Report 2008*, chapter 2, section 2).

<sup>c</sup> Excluding fuel, minerals and mining exporters.

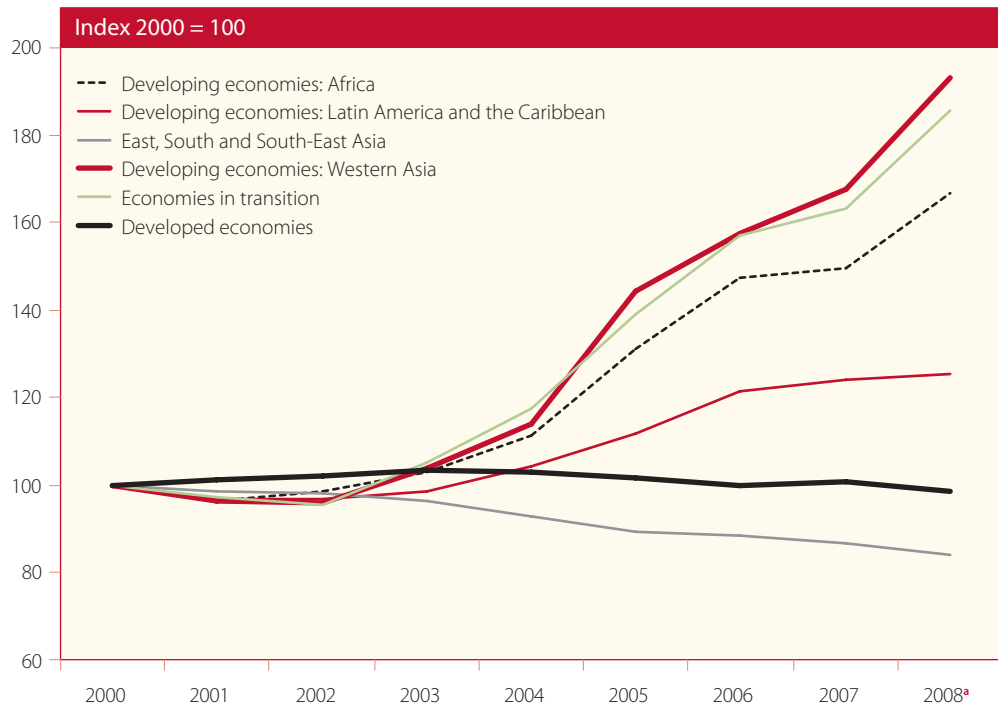
Regions with a large weight of oil in total exports recorded sizeable gains in their terms of trade in 2008, as was the case in Western Asia, the economies in transition and Africa (figure II.7). Exporters of agricultural products also saw their terms of trade improve as the skyrocketing food prices in the first half of the year were not fully offset by the subsequent fall. Most exporters of mineral and mining products, in contrast, saw their terms of trade decline somewhat on average for the year as a consequence of the sharp reversal in the prices of metals and minerals and because many of these economies are also net importers of oil and food.

Developing countries relying on exports of manufactures, particularly those in East and South Asia, registered a further deterioration in their terms of trade, as they were affected by higher prices of oil, food and some industrial raw materials of which they are net importers. The low-income countries that are net importers of food and do not export oil or mining products also experienced a significant deterioration in their terms of trade in 2008. The terms of trade of the developed countries, in contrast, are not greatly affected by the sharp swings in commodity prices and have undergone only very small changes in recent years. This is mainly due to the fact that the bulk of both their imports and exports comprise manufactured goods.

Most of these trends in the terms of trade are likely to be reversed in 2009, as the sharp correction in commodity prices resulting from the global financial crisis and the economic slowdown become fully reflected in annual data. Price declines for oil and minerals and metals should lead to a reduction in the terms of trade of developing countries which export these products, while food- and fuel-importing countries should find some relief from the softening in agricultural and energy prices.

Exporters of manufactures in East and South Asia faced further deteriorating terms of trade

Figure II.7  
Terms of trade by region, 2000-2008



Source: UNCTAD, *Trade and Development Report 2008* and UNCTAD Commodity Price Statistics.

a Partly estimated.

**Volatile terms of trade are damaging to long-term growth and development**

**Improved compensatory financing mechanisms are needed to support countries coping with large terms-of-trade shocks**

Terms of trade can be very volatile in countries where the structure of exports differs considerably from that of imports. Fluctuations are especially strong in countries with high export concentration in a few primary products as this causes large swings in their external balances, income growth and employment. Commodity price volatility tends to affect investment and production planning of both sellers and buyers adversely and complicates the macroeconomic management of economies that are highly vulnerable to such instability. Renewed efforts at the domestic and international levels to mitigate the pass-through effects of world market volatility onto the domestic economy can therefore contribute to long-term growth and development, especially in low-income countries.

In the past, attempts have been made to support producers in coping with global price fluctuations through price stabilization funds. In the present-day context, securing new international price stabilization mechanisms has low political feasibility. Stricter regulatory measures that help prevent excessive speculation on commodity markets could be a more feasible step in the short run for stemming price volatility. As discussed in chapter I, improvements in available compensatory financing mechanisms are also needed to help low-income countries cope with commodity price shocks, provided such mechanisms allow for swift disbursements and are free of the sometimes onerous policy conditionality attached to existing mechanisms. Such mechanisms could also contribute to the creation of more space for national Governments to implement counter-cyclical macroeconomic policies. Countries should consider further strengthening institutional arrangements, such as stabilization funds, in order to smooth domestic development spending from export gains over time.<sup>8</sup>

<sup>8</sup> For a more detailed discussion of the problem of instability in commodity markets, see United Nations Conference on Trade and Development, *Trade and Development Report 2008*, op.cit., chapter 2.

## Trade policy developments: dealing with multilateral negotiations in the midst of financial and food crises

After nine days of intense negotiations at the ministerial level, the Doha Round broke down once again at the end of July. Some measure of convergence had been achieved with respect to both the agricultural and the non-agricultural market access (NAMA) components of the negotiations, but the remaining differences proved unbridgeable. In the crucial area of agriculture, of a “to-do list” of 20 issues, 18 had seen some narrowing of positions. On one issue, the special safeguard mechanism (SSM)—which would allow developing countries to raise tariffs on agricultural products temporarily in order to deal with import surges and price falls—there was a clear divergence between developed countries (led by the United States) and others (led by India) on the so-called “trigger” (the size of the import surge needed to trigger the tariff increase). Developing countries expected a low trigger (above the base import volume) in order to safeguard their domestic producers, while developed countries wanted the trigger to be as high as possible to avoid abuse of the safeguard.

The difficulty in dealing with the special safeguard scheme was, however, not the sole reason negotiations collapsed;<sup>9</sup> rather, the breakdown appears to have reflected more deep-seated policy concerns among developing countries about the direction the Doha Round had taken, as well as fresh worries related to the state of the world economy.

The structural weaknesses, evident in the stop-and-start history of the Doha Round since its inception in 2001, refer to persistent concerns among developing countries related to their not being allowed to define the Round’s development content, as originally envisaged in the Doha Ministerial Declaration and subsequently agreed ministerial texts. This revived memories of the Uruguay Round negotiations which, despite the promises at the time, finally came to be viewed as a lopsided bargain. Such unease surfaced relatively early on in the process, particularly in academic and civil society circles, leading to political controversy over the treatment of such issues as cotton subsidies as well as over the perceived neglect of a series of development-related issues which were either left outstanding at the end of the Uruguay Round or became apparent during its implementation.<sup>10</sup> More recently, in July 2007, the Secretary-General of UNCTAD proposed five key objectives

The failure to complete the Doha Round reflects deep-seated differences in policy concerns between developing and developed countries

Key concerns are to preserve the intended development content of the Doha Round

<sup>9</sup> This was the conclusion of Ambassador Crawford Falconer, Chairman of the Agricultural Committee of the WTO, in his assessment of the breakdown of the WTO Trade Negotiating Committee. In particular, he noted that in any subsequent effort to revisit the SSM, “we must recognize that it was not, for any of the participants involved (and those participants include Members that were not in the G7, it should be added), a purely technical breakdown. It was a political divide. In fact there was progress made on it politically, and technically, during that week. But it was simply not sufficient to bridge a political divide that had been enduring since at least Hong Kong. So, illusion number one to guard against is that it can be resolved essentially technically”. See “Report to the Trade Negotiations Committee by the Chairman of the Special Session of the Committee on Agriculture, Ambassador Crawford Falconer”, WTO Committee on Agriculture Special Session, JOB(08)/95, 11 August 2008.

<sup>10</sup> For example, at the 2004 Annual Bank Conference on Development Economics of the World Bank, Professor Gerry Helleiner argued that “it is more important for the WTO and other rules systems to be broadly fair and acceptable, however long it may take to get them right, than to rush to further liberalization as interpreted by major economic powers. If the current round of WTO negotiations fails it will not necessarily be, as some suggest, a disaster for development”, as cited in C. Raghavan, “Even patched-up, procedural deal in Hong Kong will be worse than failure”, *South-North Development Monitor*, No. 5935, 13 December 2005.

that needed to be attained for the Doha Round to realize its development promise. As reported in *World Economic Situation and Prospects 2008*, these objectives embraced critical issues such as real market access for developing countries' exports of goods and services; improvements in multilateral trade rules to address existing asymmetries between developed and developing countries; adequate policy space for developing countries to align trade agreements with national development strategies and to allow a more effective special and differential treatment of developing countries; "development solidarity" in meeting the implementation costs implied in the adjustments that developing countries would be required to undertake; and coherence between regional and multilateral trade agreements. Failure to make real headway on these counts would appear to go a long way in explaining why the negotiations could not reach a successful and balanced conclusion.<sup>11</sup>

The food crisis and the global financial crisis have increased concerns about appropriate trade policy strategies for developing countries

In addition, the critical situation of the world economy at the time of the July 2008 ministerial meetings may also have acted as a further constraint. There were already clear signs, particularly in the United States, that financial markets had become fragile, with potentially catastrophic consequences for all countries if a crisis were to break and spread to the real economy. The July ministerial meetings also coincided with growing concerns in many developing countries about their food and energy security. In addressing them, some net importers of grains were overwhelmed by the skyrocketing costs of food subsidies, while many food producers introduced new export restrictions to enhance national food security. It hardly seems surprising, therefore, that one of the stumbling blocks leading to the halt of negotiations related to provisions allowing developing countries to temporarily increase tariffs on agricultural products in times of economic and social difficulty.<sup>12</sup> It is also not surprising, therefore, that the WTO ministerial meeting scheduled for December 2008 was cancelled, as positions had not changed and no progress in the negotiations was to be expected.

Now, the overriding issue for trade negotiators is the financial crisis that has already caused economic problems in advanced countries and is rapidly spreading to developing countries. There is growing recognition that global financial conditions weigh heavily in shaping trade patterns. Therefore, the financial architecture should not be set aside from trade negotiations. In particular, it has become evident, as discussed earlier, that unregulated finance in a global setting has also expressed itself through commodity and currency speculation, leaving countries totally unprotected in a largely liberalized trading system.

The current context calls for a more integrated approach to regulating both trade and finance

Hence, the present circumstances call not only for meaningful reforms of the institutional arrangements that emerged from Bretton Woods to address new threats to global economic stability but also for a more integrated perspective on the reform agenda which would move beyond the false dichotomy between trade and finance issues. Regulating trade and finance should be considered jointly. Moreover, a proper, fair and well-regulated system of global finance and currency exchanges has to be in place for develop-

<sup>11</sup> Again, the remarks of Ambassador Crawford Falconer are telling: "But our task does not begin and end with SSM. I need only mention Cotton—one of the other three or four potential deal-breakers, which was not at all seriously addressed before things broke down with SSM. There is tariff quota creation. There is tariff simplification. Yes, one might well take the view that these can fall into place. But we also have to actually make that happen. And, while one might well rightly have held the view that key elements elsewhere were essentially on the brink of resolution, not all of those affected were in the room, and that would have needed further effort to ensure finalisation." See WTO Committee on Agriculture Special Session, *op. cit.*

<sup>12</sup> For a detailed review of the WTO negotiations, see, for example, International Centre for Trade and Sustainable Development, *Bridges Weekly Trade News Digest*, vol. 12, No. 27, 7 August 2008.



ment concerns truly to become the centre of multilateral trade negotiations. This was well understood by the original architects of the Bretton Woods system. John Maynard Keynes explicitly argued for such a comprehensive approach: “Whilst other schemes are not essential as prior proposals to the monetary scheme, it may well be argued, I think, that a monetary scheme gives a firm foundation on which the others can be built. It is very difficult while you have monetary chaos to have order of any kind in other directions... [I]f we are less successful than we hope for in other directions, monetary proposals instead of being less necessary will be all the more necessary. If there is going to be great difficulty in planning trade owing to tariff obstacles, that makes it all the more important that there should be an agreed orderly procedure for altering exchanges... [S]o far from monetary proposals depending on the rest of the programme, they should be the more necessary if that programme is less successful than we all hope it is going to be”.<sup>13</sup>

At this critical juncture, as policymakers seek a stable and efficient system for global finance, it is important that it not be separated from the goal of a fair and inclusive system for international trade which allows for the full participation of developing countries in line with their development objectives and potential. Devising a coherent, rule-based and authentically multilateral international system requires an integrated approach. Given the open channels between the international trade, financial and banking systems, a truly global, cooperative and non-partisan approach to tackling the most important issues, such as commodity and currency speculation, must be found. But developing countries have only a limited voice in international financial institutions. The global institution that possesses the most credibility for implementing such an approach is therefore, more than ever, the United Nations. The Member States of the United Nations recognized the need for a more integrated approach of that nature and for better coordination among the institutions on global economic governance at the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus, held in Doha from 28 November to 2 December 2008. The outcome document calls for a “review of the international financial and monetary architecture and global economic governance structures in order to ensure a more effective and coordinated management of global issues. Such a debate should associate the United Nations, the World Bank, IMF and the World Trade Organization, should involve regional financial institutions and other relevant bodies and should take place in the context of the current initiatives aimed at improving the inclusiveness, legitimacy and effectiveness of the global economic governance structures”.

The United Nations is in a privileged position to support an inclusive process for revisiting the state of global trade and finance issues

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<sup>13</sup> J. M. Keynes, “Letter to Lord Addison, May 1944” in *The Collected Writings of John Maynard Keynes*, Volume XXVI: Activities 1941-1946, Shaping the Post-War World, Bretton Woods and Reparations, ed. Donald Moggridge (London: The MacMillan Press. Ltd., 1980), pp. 5-6.