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Chapter I

CURRENT TRENDS AND ISSUES IN THE WORLD ECONOMY

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Chapter I

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A. Global growth and trade

In mid-2008 the global economy is teetering on the brink of recession. The downturn after four years of relatively fast growth is due to a number of factors: the global fallout from the financial crisis in the United States, the bursting of the housing bubbles there and in other large economies, soaring commodity prices, increasingly restrictive monetary policies in a number of countries, and stock market volatility. Without strong and internationally coordinated action on macroeconomic policy, a fully-fledged global economic recession seems unavoidable.

Growth in developing and emerging-market economies has been fairly resilient in the first half of 2008, but there is mounting evidence that they cannot escape the global slowdown. Even under benign circumstances in the second half of the year, the pace of world output growth is expected to decline to around 3 per cent in 2008 – almost one percentage point less than in the past two years (table 1.1).

Although a number of relatively large developing countries increasingly rely on domestic demand, many other countries continue to depend on the evolution of external demand and international commodity prices. Their growth rates also depend on how they are using the higher revenues from primary commodity exports (see also chapter II). Despite a slowdown, output growth in China in 2008 can be expected to expand close to a double-digit rate. West Asia and both North Africa and sub-Saharan Africa (excluding South Africa) are the only regions where average rates of output growth are likely to rise compared to the past two years. At about 7 per cent, sub-Saharan Africa is even expected to achieve its highest annual growth rate in more than three decades. However, this acceleration of growth is largely due to higher income from exports of primary commodities, particularly oil, and therefore will be unequally distributed across countries, depending on their trade structure. Moreover, the gains from higher commodity export earnings may have only a marginal effect on the incomes of the poorer segments of the population, as the linkages between the oil and mining sector with the rest of the economy are generally weak.

World trade in 2007 expanded less in real terms than in the preceding four years, but that of developing and transition economies continued to grow unabated (table 1.2). Their exports rose by more than 9 per cent in volume terms, but there are considerable regional differences. As the supply response to higher commodity prices has generally been weak, regions that have a large share of primary commodities in their exports saw lower growth in export volumes than regions that have a large share of manufactures

Table 1.1

WORLD OUTPUT GROWTH, 1991–2008[a]

(Annual percentage change)

Region/country	*1991–2001[b]*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007[c]*	*2008[d]*
World	**3.1**	**1.9**	**2.7**	**4.0**	**3.4**	**3.9**	**3.8**	**2.9**
Developed countries	**2.6**	**1.3**	**1.9**	**3.0**	**2.4**	**2.8**	**2.5**	**1.6**
of which:								
Japan	1.1	0.3	1.4	2.7	1.9	2.4	2.1	1.4
United States	3.5	1.6	2.5	3.6	3.1	2.9	2.2	1.4
European Union	2.4	1.2	1.3	2.5	1.8	3.0	2.9	1.8
of which:								
Euro area	2.2	0.9	0.8	2.0	1.5	2.7	2.6	1.6
France	2.0	1.0	1.1	2.5	1.9	2.2	2.1	1.5
Germany	1.8	0.0	-0.2	1.2	0.9	2.9	2.5	1.8
Italy	1.6	0.3	0.0	1.1	0.0	1.7	1.5	0.4
United Kingdom	2.8	2.1	2.7	3.3	1.9	2.8	3.0	1.6
South-East Europe and CIS	**..**	**4.9**	**7.1**	**7.6**	**6.6**	**7.5**	**8.4**	**7.4**
South-East Europe[e]	..	3.0	2.4	4.5	5.0	5.0	6.0	5.2
Commonwealth of Independent States (CIS)	..	5.2	7.6	8.0	6.8	7.7	8.6	7.6
of which:								
Russian Federation	..	4.7	7.3	7.1	6.4	6.7	8.1	7.5
Developing countries	**4.8**	**3.9**	**5.4**	**7.2**	**6.6**	**7.1**	**7.3**	**6.4**
Africa	2.9	3.7	4.9	5.4	5.7	5.6	5.8	6.0
North Africa, excl. Sudan	3.2	3.4	5.4	4.8	5.4	5.5	5.6	6.0
Sub-Saharan Africa, excl. South Africa	2.8	4.0	5.4	6.4	6.2	5.8	6.5	7.1
South Africa	2.2	3.7	3.1	4.8	5.1	5.4	5.1	3.8
Latin America and the Caribbean	3.1	-0.5	2.2	6.2	4.9	5.6	5.7	4.6
Caribbean	2.2	2.6	2.9	3.9	7.1	8.5	6.2	5.3
Central America, excl. Mexico	4.3	2.8	3.8	4.2	4.6	6.5	6.6	4.6
Mexico	3.1	0.8	1.4	4.2	3.0	4.9	3.2	2.8
South America	3.0	-1.5	2.4	7.4	5.6	5.7	6.7	5.3
of which:								
Brazil	2.8	2.7	1.1	5.7	3.2	3.7	5.4	4.8
Asia	6.1	6.0	6.8	7.9	7.5	7.9	8.1	7.2
East Asia	7.8	7.4	7.1	8.3	8.0	8.8	9.1	8.1
of which:								
China	10.3	9.1	10.0	10.1	10.4	11.1	11.4	10.0
South Asia	5.1	4.5	7.8	7.5	7.7	8.2	8.5	7.0
of which:								
India	5.9	3.6	8.3	8.5	8.8	9.2	9.7	7.6
South-East Asia	4.8	4.8	5.4	6.6	5.7	6.0	6.4	5.4
West Asia	3.6	3.2	6.0	7.9	6.8	5.7	5.1	5.7

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database; and United Nations, Department of Economic and Social Affairs (UN/DESA), *LINK Global Economic Outlook 2008* (May 2008).

a Calculations for country aggregates are based on GDP at constant 2000 dollars.
b Average.
c Preliminary estimates.
d Forecast.
e Albania, Bosnia and Herzegovina, Croatia, Montenegro, Serbia, and the former Yugoslav Republic of Macedonia.

Table 1.2

EXPORT AND IMPORT VOLUMES OF GOODS, BY REGION AND ECONOMIC GROUPING, 2002–2007

(Percentage change over previous year)

	Volume indices of exports						*Volume indices of imports*					
Region/country	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
World	**4.5**	**6.3**	**11.4**	**5.2**	**8.1**	**5.5**	**4.2**	**7.7**	**12.1**	**7.0**	**7.3**	**5.8**
Developed economies	**2.3**	**3.1**	**8.4**	**4.9**	**7.7**	**2.8**	**3.0**	**5.1**	**9.0**	**5.9**	**5.8**	**2.3**
of which:												
Japan	7.7	9.2	13.4	5.1	11.8	8.2	1.1	5.9	6.3	2.0	4.5	0.6
United States	-4.0	2.9	8.7	7.4	10.5	6.8	4.4	5.5	10.8	5.6	5.7	0.8
European Union	3.4	3.3	8.8	4.9	8.3	2.2	2.8	5.5	8.7	5.7	7.0	3.3
South-East Europe and CIS	**8.8**	**9.0**	**12.9**	**-1.5**	**10.3**	**9.2**	**13.7**	**21.5**	**20.1**	**11.5**	**21.8**	**27.3**
South-East Europe	6.2	21.2	26.7	2.7	16.7	19.3	19.6	22.8	17.6	-2.5	8.6	22.2
CIS	9.0	8.3	12.2	-1.4	10.0	8.6	12.5	21.2	20.6	14.6	24.3	28.2
Developing economies	**8.8**	**12.9**	**16.7**	**6.3**	**9.2**	**9.3**	**6.6**	**12.9**	**18.4**	**8.5**	**8.9**	**10.8**
Africa	5.5	10.4	8.6	-0.2	2.4	2.2	6.3	16.0	16.4	9.8	6.5	5.9
Sub-Saharan Africa	6.3	11.5	10.9	-1.0	-2.1	1.9	6.2	22.7	15.0	10.5	8.6	2.1
Latin America and Caribbean	0.5	4.0	9.6	5.0	4.2	4.6	-7.0	1.2	14.1	10.3	13.0	14.2
East Asia	14.8	22.0	24.3	17.1	17.8	16.2	13.4	19.3	19.2	5.9	9.2	11.3
of which:												
China	24.0	35.3	33.0	26.2	24.4	23.3	22.5	35.2	25.9	7.5	11.5	16.1
South Asia	13.8	11.8	11.5	6.7	3.3	8.8	12.0	15.0	15.9	14.9	6.1	5.4
of which:												
India	17.4	13.6	19.5	14.8	10.5	12.3	10.4	18.7	19.4	20.8	6.6	13.1
South-East Asia	6.6	7.7	19.0	6.6	11.2	8.3	5.2	6.9	18.0	10.2	7.2	7.4
West Asia	6.3	7.6	10.8	-0.2	4.9	2.5	8.8	15.5	27.0	11.4	9.5	17.3

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database.

in their total exports. The United States experienced a particularly sharp slowdown in import volume growth, which was associated with a significant improvement in its current-account balance owing to sluggish domestic demand and a sharp depreciation of the dollar.

Overall, the financial turmoil, the commodity price hikes and the huge exchange-rate swings are having an enormous impact on the global economy and are casting a shadow on the outlook for 2009. The fallout from the collapse of the United States mortgage market and the reversal of the housing boom in a number of countries has turned out to be more profound and persistent than was expected in 2007. The shock waves of these events have spread well beyond the countries directly involved, and have triggered widespread uncertainty in the financial markets. A year after the outbreak of the crisis it remains unclear how long it will last.

For a large number of developing countries the outlook depends primarily on future trends in the prices of their primary commodity exports. Although several structural factors support the expectation that prices will remain higher than they have been over the past 20 years, cyclical factors, the end of speculation on higher prices and delayed supply responses could result in a weakening of some commodity prices. In particular, the mood of speculators in commodity futures markets may change abruptly in reaction to events on other markets, such as a recession in goods markets or a recovery of stock markets. Additionally, some developing and transition economies, mainly in Eastern Europe and Central Asia, that have accumulated a substantial stock of external debt and run up large current-account deficits due to overvaluation of their currencies could face a sudden increase in their financing costs and the threat of a sharp reversal of their currency valuations.

The recent experience with contagion and interdependence in the global economy should be reason enough to review the role of public policy and government intervention in influencing market outcomes at both the national and international level. One of the reasons for the current fragile state of the world economy is the shortcomings in the system of global economic governance, in particular a lack of coherence between the international trading system, which is governed by a set of internationally agreed rules and regulations, and the international monetary and financial system, which is not. The financial turbulence, the speculative forces affecting food and oil prices, and the apparent failure of foreign exchange markets to bring about changes in exchange rates that reflect shifts in the international competitiveness of countries suggest that there is an urgent need for redesigning the system of global economic governance.

B. The fallout from the sub-prime crisis

The meltdown of the sub-prime mortgage market, originating in the most sophisticated financial market in the world, has once again exposed the fragility of today's global financial sector. Instead of reducing risk, the complex financial instruments developed in recent years have served to spread the impact of risky investments across continents, institutions and markets. A financial system that every three or four years is subject to a severe crisis that not only hurts actors in financial markets but also has repercussions on the real sector must be deeply flawed. The recurrent episodes of financial volatility seem to be driven by a mix of opaque instruments and massive leverage with which financial firms attempt to extract double-digit returns out of a real economy that is growing at a much slower rate. Since the outbreak of the sub-prime crisis, the risks of securitization have become ever more evident, and there are widespread concerns over the financial industry's ability to generate large temporary profits by applying unsustainable refinancing schemes while passing part of the losses that arise from inevitable market corrections to the public sector and the taxpayer. Indeed, since financial crises can have enormous negative effects on the real economy, policymakers have no choice but to bail out parts of the financial sector when systemic threats loom.

A financial system that experiences a severe crisis every three or four years must be fundamentally flawed.

Until recently, it was thought that moral hazard associated with the explicit or implicit presence of a lender of last resort was a problem only for deposit-taking commercial banks. However, recent actions of the United States Federal Reserve have shown that investment banks and mortgage lenders, too, can be deemed "too big to fail" and that their liabilities are protected by implicit insurance. Given the risks for financial stability, the Federal Reserve was certainly right to provide such insurance and prevent the bankruptcy of a large investment bank and the two largest mortgage lenders in the United States; but insurance should not come for free. If the government decides that different types of financial institutions need to be bailed out because their failure could lead to a systemic crisis, these institutions should be subject to tighter prudential regulation similar to that imposed on deposit-taking banks. The recent crisis has shown once again that market discipline alone is ineffective in preventing recurrent episodes of "irrational exuberance" and that the market mechanism cannot cope with massive drops in financial asset prices.

The latest casualties of the sub-prime crisis are Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation). These agencies, which have the hybrid status of government-sponsored enterprises (GSE), are the most important players in the United States housing market and hold or guarantee $5,200 billion worth of mortgages (corresponding to more than 40 per cent of all mortgage debt in the United States). Even though these agencies are not allowed to extend or guarantee sub-prime loans, they have been badly affected by the fall in housing prices that followed the sub-prime crisis. Their stock price started to decline in mid-2007 and it suddenly collapsed in early July 2008 after it became clear that they were insolvent on a mark-to-market basis. Both the United States Treasury and the Federal Reserve quickly announced their support for these two agencies and the Federal Reserve allowed them to borrow from its discount window. In response, the valuation of the debt issued by these agencies continued to be traded at normal values even after the collapse of their equity value.

As long as the United States Government backs their liabilities, the two agencies will be able to keep rolling over their debt, continue their operations, and thus prevent a further deterioration of the United States real estate market. However, this may generate perverse incentives, because the management of a company with negative or zero equity value but with guaranteed debt might be tempted to "gamble for redemption" (i.e. adopt a strategy which may lead to a high pay-off with low probability and to large losses with high probability). The rationale for adopting such a strategy is its asymmetric pay-off. If the gamble is successful, the shareholders make a profit. If it is not successful, the shareholders do not lose anything (because the equity value was zero from the start) but the public sector then has to pay an even higher cost. This would be another example of a situation where profits are privatized and losses are socialized. If the crisis persists, it would probably be better for the Government to assume temporary full ownership of the two agencies and decide later whether to liquidate them, fully privatize them, or keep them fully and permanently in the public sector.

C. Global economic imbalances and exchange rates

The current crisis not only has implications for the prudential regulation of financial institutions at the national level, but also for macroeconomic policies, especially monetary and exchange-rate policies, at both the national and global levels. The last 25 years have been characterized by limited macroeconomic volatility and low inflation in the developed world. This has led several central banks in many developed and developing countries to focus on national inflation targets and domestic short-term interest rates, while allowing other key variables, such as the exchange rate, to be determined entirely by market forces.

However, this policy approach does not take sufficient account of the fact that countries and economies are closely interlinked, and that the exchange rate plays a key role in these linkages. The recent financial turbulence and the unsustainable position of a number of countries with large current-account deficits in all parts of the world have shown that the current framework for monetary and exchange-rate policies generates temporarily profitable opportunities for speculative activities which eventually have a destabilizing effect. This experience underscores the need for more and better international economic coordination to avoid unsustainable trade and current-account imbalances in the future.

There is a need for better economic coordination at the global level to prevent unsustainable current-account imbalances.

The largest of the global current-account imbalances that have shaped the world economy over the past decade, the United States trade deficit, is receding, thanks to the depreciation of the dollar and the looming recession in the United States. However, in many other countries there has been no correction of the exchange rate and neither is an end to destabilizing speculation in sight. This speculation is still pushing many exchange rates in the wrong direction despite huge and rising current-account deficits in some countries and regions (*TDR 2007*, chap. I, section B). A survey of real exchange rate developments since 2000 is given in the annex to this chapter.

A current-account deficit or surplus is not an economic problem per se. However, when a big and rising deficit coincides with a loss of competitiveness, for example caused by a currency appreciation that is triggered by speculation on short-term interest rate differentials, it is as a rule unsustainable. The disequilibrium will sooner or later have to be corrected even if the correction is very costly in terms of real income losses.

For the past decade or so developing countries as a group have registered a current-account surplus, with concomitant current-account deficits in a number of developed countries and some transition economies. Factors that have contributed to the improvements in current-account balances vary: for some fast growing exporters of manufactures, particularly in East and South-East Asia, these improvements are the result of a further increase in their international competitiveness; for some oil-exporting countries in West Asia and the Commonwealth of Independent States (CIS) they result from the rapidly rising price of oil; and for a number of countries in Africa and Latin America they are due not only to the higher prices of oil but also of other primary commodities, in particular industrial raw materials. While developed countries as a group are in deficit, both the second and the third largest economies in the world – Japan and Germany – continue to register large current-account surpluses, combined with further improvements in their competitiveness.

An adjustment of the United States current-account deficit is now under way.

A new feature of the world economy since the turn of the century is the rapidly rising current-account deficits in a number of countries in Eastern Europe. The accession of several of these countries to the European Union (EU) and their reasonably high growth rates, combined with some degree of monetary stability, raised expectations that they would be able to tackle their economic problems much better than before, which in turn encouraged massive short-term capital inflows. But in most countries the main source of growth has been buoyant domestic demand fuelled by high wage growth and easy access to consumer credit and mortgage lending. This has led to strong growth in private consumption, rising imports and a thriving housing market.

However, inflation rates and interest rates that are higher in these countries than in many other countries have led to the accumulation of a huge amount of mortgage debt in foreign currencies, in particular Swiss franc and yen. This has created an enormous currency mismatch between the earnings of the debtors and their debt service obligations. At the same time, nominal and real currency appreciation has undermined the competitiveness of these economies in the European and the world economy, and this will sooner or later require an exchange-rate depreciation.

From 1999 to 2007, the real effective exchange rate in Eastern Europe and the Russian Federation appreciated by more than 30 per cent. Their average current-account deficit in 2007 reached about 9 per cent of gross domestic product (GDP), more than twice its level in 1999 when the real appreciation started (chart 1.1). The largest current-account deficits were recorded in

Bulgaria, Estonia, Latvia, Lithuania and Romania which reached double-digit levels as a percentage of GDP. In the Russian Federation, soaring exports, particularly of energy and primary commodities, have outpaced import growth but the formerly large surplus on the current account has shrunk.

The real appreciation of the exchange rate in Eastern European countries has been exacerbated by the effect of carry-trade operations, whereby capital flows from countries with low inflation and low nominal interest rates to countries with higher inflation and higher nominal interest rates. This happens when it is expected that the exchange rate will either remain stable or move in a favourable direction, so that there is an "uncovered" interest rate differential. This can lead to the paradoxical and dangerous situation of countries with a current-account surplus (e.g. Japan or Switzerland) facing devaluation pressure on their currencies, and countries with a current-account deficit facing a similar pressure to appreciate, when in fact the opposite would be required to correct the current-account imbalance.[1]

To redress persistent imbalances, adjustment is unavoidable. Countries that have lost overall competitiveness need to restore it to avoid a permanent loss of market shares and growing indebtedness vis-à-vis other countries. As economic history shows, this adjustment can be the outcome of either a deep recession or a large devaluation in real terms. The latter has to come from a large nominal currency devaluation, which will induce a switch of domestic expenditure from more expensive foreign goods to cheaper domestic goods and also shift external demand towards the exports of the devaluating country.

Over the past 10 years, the United States has been the main deficit country. China, Germany, Japan and Switzerland have been the main surplus countries as far as the absolute size of their current-account imbalances is concerned. Although an adjustment of the United States imbalance is now under way, a further reduction of the remaining imbalances would require the surplus countries to expand their domestic demand. If the entire remaining adjustment depends on exchange-rate changes, this can have dramatic negative repercussions for those countries where large currency mismatches have built up.

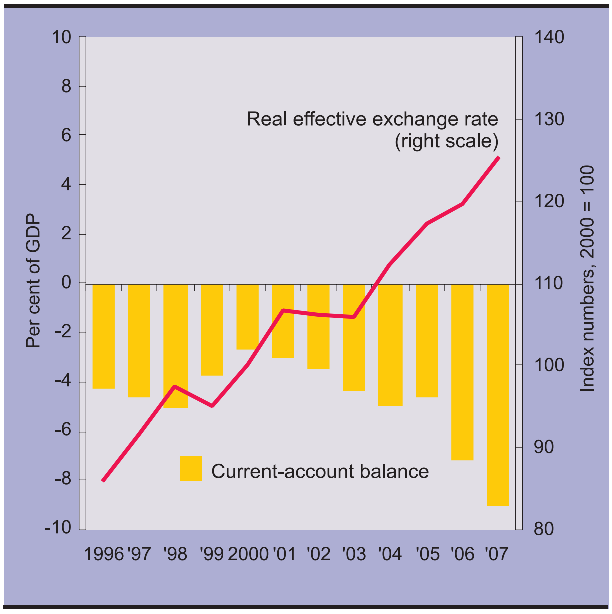
However, not all surplus countries have the same capacity to increase demand. In China, for example, this is much more difficult than elsewhere, as domestic demand is already rising fast and the economy is close to overheating. The continued appreciation of the yuan can nevertheless contribute to a global adjustment of trade balances by slowing down export growth and stimulating import growth. However, given the rising inflow of short-term capital, attracted by government-controlled appreciation and rising foreign-exchange reserves, the Chinese authorities might consider revaluing the yuan to a target rate in one big step rather than a series of incremental steps.

The potential for a strong global expansionary stimulus is much greater in Western Europe, where domestic demand is flat but more than five times the size of China's domestic demand. Germany in particular has been experiencing an unprecedented export boom, with a current-account surplus of more than 180 billion euros in 2007; at the same time real

Chart 1.1

CURRENT-ACCOUNT BALANCE AND REAL EFFECTIVE EXCHANGE RATE IN EASTERN EUROPE AND THE RUSSIAN FEDERATION, 1996–2007

(Simple average)



Source: UNCTAD secretariat calculations, based on IMF, *Balance of Payments*; UNCTAD database on real effective exchange rates; and national sources.

Note: Eastern Europe: Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Poland and Romania.

wage growth has been very slow and there remains a large underutilized potential to stimulate domestic demand. A turnaround in its wage policy and a direct stimulation of domestic demand would help the adjustment process. Interest rate cuts of the European Central Bank (ECB) in the second half of 2008 and into 2009 would support such a stimulus. Although such policies may appear contentious in an environment where rising fuel and food prices have pushed up the consumer price index (CPI), the actual risk of inflation remains low in Europe as the increase in the consumer prices has not been accompanied by a rise in unit labour costs. Indeed, in recent years the German economy has even witnessed a stagnation in unit labour costs because nominal wages have been rising only slightly more than labour productivity (see section D below).

The potential for a strong global expansionary stimulus is much greater in Western Europe than in China.

Japan's situation is similar to Germany's: top performer in exports (which grew at an average annual rate of 9.3 per cent between 2001 and 2007) but lagging in terms of domestic demand (with an average annual increase of only 1.1 per cent in the same period). As in Germany, consumer demand has been sluggish due to many years of falling or stagnating real wages and slow employment growth. In this environment deflation has prevailed. Neither the zero interest rate policy of the Bank of Japan nor expansive budgetary policies or the recent export boom have been able to turn the tide. It appears that direct government intervention in the labour market and a new round of deficit spending will be necessary to eventually get the country out of its deflationary trap and help mitigate the global economic slowdown.

Given their soaring export earnings in a relatively short period of time, net exporters of primary commodities, particularly oil-exporters, may not be able to increase their imports in parallel at the same rate and thereby stimulate output growth in the rest of the world. If these countries have limited capacity to immediately absorb their higher revenues, they could play an active role in promoting financial stability by smoothly and effectively recycling the capital account equivalent of their large surpluses, including through sovereign wealth funds. The fact that sovereign wealth funds of developing countries have been solicited for helping some large European and United States banks in their efforts to rebuild their capital base shows how important this recycling could be.[2]

Nevertheless, some governments are wary of investments by the sovereign wealth funds of developing countries. While there is little transparency in the activities of most of these funds, there is also no evidence that their objectives are fundamentally different from those of other institutional investors. This implies that part of their portfolio may be invested in short-term, and partly speculative, assets. On the other hand, since these wealth funds are operating in the public interest of preserving part of the currently accumulated national wealth for future use, there is reason to believe that a large proportion of their financial investments will be undertaken with a long-term perspective. This implies that they also have considerable potential to support the financing of public infrastructure projects or high-yielding real investments in the manufacturing, services or agricultural sectors of other developing countries. In any case, it will be important to find ways of appropriately using the accumulating surpluses of oil-exporting countries that will satisfy the interests of both their country of origin and the international financial system. This is particularly important because the large current-account surpluses of the major oil-exporting countries are likely to remain a feature of the world economy for several years to come.

Overall, the major central banks have shown considerable coherence and coordination in their response to the sub-prime crises by providing liquidity to affected banks and financial institutions. But their monetary policies diverge more than ever. The United States Federal Reserve has been very aggressive in cutting policy rates, whereas other central banks have been much more timid, and some, including the ECB and the central banks of a number of emerging-market economies, have even raised their interest rates in an attempt to reduce the risk of an acceleration of inflation. Central banks of

Monetary policies are diverging more than ever.

countries directly affected by the unwinding of carry trade positions have even sharply increased their interest rates in order to defend their exchange rates. These divergent polices may invite new speculation in foreign-exchange markets instead of calming the system.

Hence, there is a strong case for more and better coordination of macroeconomic policies and international surveillance of exchange-rate changes. The international community should not neglect the shortcomings in the existing governance of international financial and monetary relations because that may nullify any progress made in multilateral trade negotiations. Arbitrary and large swings of the exchange rate are more damaging for world trade than most tariffs. It is not enough to fight problems induced by increased uncertainty in domestic financial markets; what is also needed is an internationally coordinated approach to tackling the much larger challenges of global imbalances and instability in international financial markets (see also UNCTAD, 2007).

D. Macroeconomic policy responses to the commodity boom

1. *Commodity price shocks and the risk of inflation*

In the past decade, the world has seen an explosion of oil prices for the third time since the end of the Second World War. At more than $140 per barrel in mid-2008, the oil price spiked at a new peak, not only in nominal terms but also in real terms (chart 1.2). In the developed countries the fuel import bill increased from 1.6 per cent of their GDP in 2002 to 3.6 per cent in 2007. With an average oil price of $125 per barrel in 2008 it could reach the equivalent of about 6 per cent in 2008. In developing countries, the fuel import bill rose from 2.7 per cent of GDP in 2002 to about 5 per cent in 2007, and it may reach more than 8 per cent in 2008.

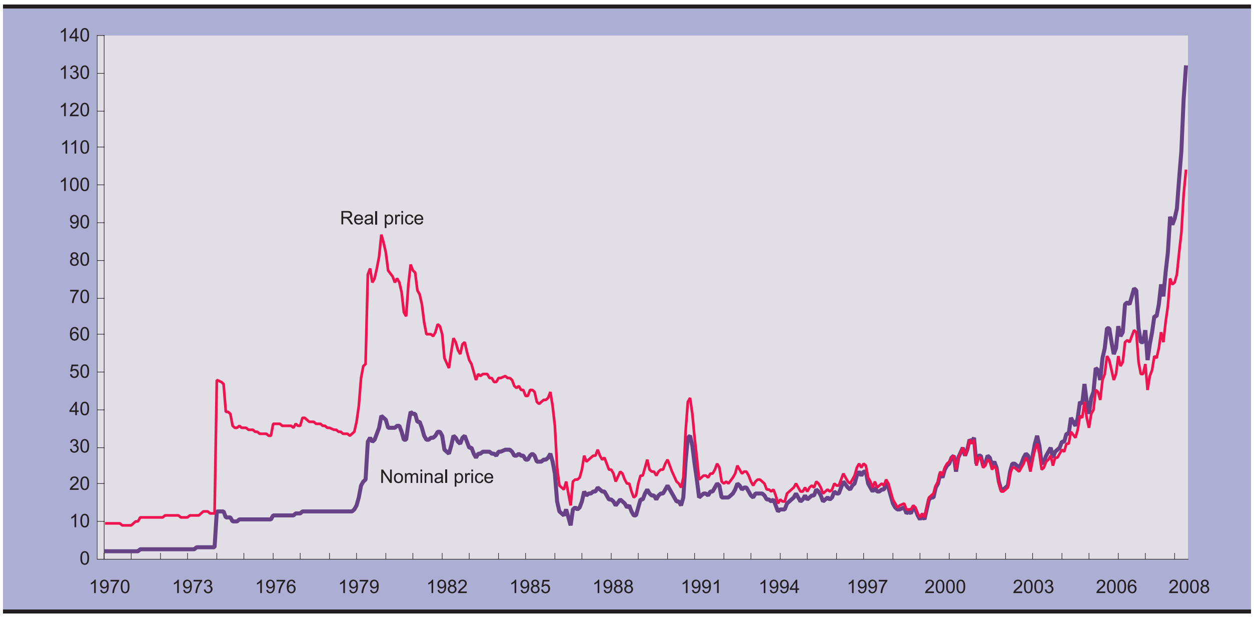
The oil price hike has been accompanied by a massive increase in the prices of several other primary commodities, and this combined price surge has pushed up the CPI in many developed and developing countries. In addition to their direct impact on the CPI, oil prices also affect the prices of many other goods and services for which oil is an important intermediate input. This has raised concerns about inflation amongst many of those responsible for monetary policy and has encouraged calls for rigorous action by central banks to take pre-emptive action against a further acceleration of inflation.

Even though high commodity prices are exerting an upward pressure on prices, a rise in the CPI due to a one-off increase in import costs resulting from structural changes is not the same as inflation, which implies a continuous increase in all prices. Whether higher relative prices cause a once-and-for-all increase in the CPI or trigger an inflationary process largely depends on the response of wages, which are the most important domestic price in any economy. Wages are not only the largest component of production costs in developed and developing countries, they are also the most important source of permanent income for the majority of the population. In the 1970s, higher oil prices induced an increase in nominal wage rates, and higher wage rates then resulted in a further increase in consumer prices, as higher wage costs were passed on by employers to consumers. The wage-price spiral ultimately ended in stagflation and rising unemployment, because central banks in the leading consumer countries stopped this spiral through highly restrictive interest rate policies.

Chart 1.2

CRUDE PETROLEUM PRICES, NOMINAL AND REAL, JANUARY 1970–JUNE 2008

(Dollars per barrel)



Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics* online; IMF, *International Financial Statistics* database; and World Bank, *Commodity Price Data* (Pink Sheet).

Note: Crude petroleum price is average of Dubai/Brent/Texas equally weighted; the real price is the nominal price deflated by United States Consumer Price Index (CPI), 2000 = 100.

The risk that the experience of a combination of galloping inflation, economic recession and increasing unemployment will be repeated today appears to be small. Trade unions in developed countries are rarely demanding exorbitant wage increases, as they have learned their lessons from the past oil crises or have lost negotiating power (Flassbeck and Spiecker, 2008; Krugman, 2008). The risk of galloping inflation also seems to be relatively low in the majority of developing countries in light of the behaviour of the key determinants of inflation in recent years. Between 2000 and 2007 nominal wages (or the compensation per employee) increased faster than the CPI in developed countries, and also in Eastern Europe, Asia and Latin America (chart 1.3). However, over this period, labour productivity also increased in most countries. As a result, unit labour costs rose, on average, at about the same rate as consumer prices. This indicates a low risk of a wage-inflation spiral. In East and South-East Asia unit labour costs fell while consumer prices rose, on average, indicating that the risk of a wage-price spiral is even lower. And also in Latin America, which experienced considerable fluctuations in prices and unit labour costs, the latter did not push up prices in the medium-term. By contrast, in Eastern Europe, on average, unit labour costs rose faster than consumer prices.

The group averages hide considerable cross-country differences. The countries at highest risk of a wage-inflation spiral are those where unit labour costs increased at a faster rate than inflation over the period 2000–2006, and where this trend was not reversed in 2007 (the latest year for which data were available). These countries include Azerbaijan, Iceland, Kazakhstan, Latvia, Norway, Romania, the Russian Federation and Ukraine. Countries with a low or moderate, but increasing risk of an inflationary spiral include Argentina, Australia, Bulgaria, Denmark, Ecuador, Estonia, Lithuania, New Zealand, Poland, Singapore, Sweden and Switzerland. Countries with a moderate or high but decreasing risk of such a spiral include China, Hungary, Indonesia and Mexico. By contrast, in other European countries, Japan and the

Chart 1.3

UNIT LABOUR COST, LABOUR COMPENSATION, PRODUCTIVITY AND CONSUMER PRICE INDEX, SELECTED COUNTRY GROUPS, 2000–2007

(Annual changes in per cent)

Source: UNCTAD secretariat calculations, based on OECD; European Commission, AMECO database; Economist Intelligence Unit databases; and national sources.

Note: Regional groups refer to simple average. Developed economies exclude Eastern Europe. Eastern Europe: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. Latin America: Argentina, Chile, Colombia, Ecuador, Mexico and Peru. Asia: China, Indonesia, the Philippines, the Republic of Korea, Singapore, Taiwan Province of China and Thailand.

United States, as well as most developing economies for which relevant data were available, namely Colombia, Egypt, the Philippines, Peru, the Republic of Korea, Taiwan Province of China, Thailand, and Turkey, unit labour costs have risen less than consumer prices. In short, while commodity prices have continued to increase in 2008, at the beginning of the year unit labour costs remained relatively stable in most developed countries and many developing countries.

Thus, in many countries concerns about inflation and the associated calls for tighter monetary policies may not be well founded, while many observers seem to be underestimating the risk of a global economic downturn. As Krugman (2008) commented, "the only thing we have to fear … is the inflation fear itself, which could lead to policies that make a bad economic situation worse". Following strict inflation targets and tightening monetary policies could indeed turn out to be the wrong strategy, given the fragile state of the global economy. Therefore, consideration should be given to innovative ways of reconciling the objectives of growth and price stability in the face of cost push factors.

2. An effective and measured macroeconomic policy response

In countries where inflation pressure is increasing because of a combination of rising commodity prices and unit labour costs that exceeds the inflation target, tighter monetary policies may ultimately become necessary. In the second quarter of 2008 the central banks of several developing countries, including Brazil, Chile, Colombia, India, Indonesia, Mexico, the Philippines, Peru and Viet Nam, increased interest rates amid inflation fears. Such fears may be justified in some of these countries, due to second-round effects of rising wages. However, the early moves by central banks of the G-7 countries could be more damaging than beneficial for macroeconomic stability. For instance, the decision of the ECB to raise the policy interest rate in early July 2008 in order to prevent the inflation rate from rising even further above the rather low inflation target of 2 per cent, can negatively affect economic growth in the euro area and beyond. Available data casts doubts as to whether the interest rate increase was necessary, given that rising prices of commodities were not accompanied by unsustainable increases in unit labour costs in the majority of the countries in the region.

The experiences with oil price explosions and the global recessions in the 1970s offer a clear policy message: efforts to prevent a decline in real wages as result of commodity price increases can cause second-round effects and inflationary acceleration. A tightening of monetary policy, which seeks to slow down inflation but causes economic recession, can make matters worse. In this situation, only a cooperative approach by labour unions, employers, governments and central banks can prevent a wage-inflation spiral and a counterproductive economic downturn.

This requires a standstill agreement between labour unions and employers when the risk of inflation is acute. At the same time it requires commitments by governments and central banks to actively pursue the objective of full employment. Furthermore, governments must be prepared to help the poorest households that are the hardest hit by the fall in real wages, with transfer payments that enable these households to satisfy their basic needs. The main policy target of this approach should be to keep nominal wage growth within a range determined by the sum of productivity growth and the official target rate of inflation (rather than the actual inflation rate) (Flassbeck and Spiecker, 2008). In addition, fiscal policies could also be used to compensate for any negative effect on domestic demand growth.

Tightening of monetary policy can make matters worse.

Globally, an increase in commodity prices eventually leads to a redistribution of real income from the countries that consume scarce commodities to countries that produce and export them. As discussed above, the global economic effects of such a redistribution depend on how commodity-producing countries use their windfall profits. A global fall in demand can be avoided if windfall profits are used for increased imports or are channelled smoothly through capital markets into productive investments in other countries. The stark lesson to be learned from former experiences with oil price explosions is that this process must be supported by accommodative monetary policies at the global level.

The current situation should not be viewed by governments and central banks as a dilemma. An assessment of the risks shows that, on average, the risk of economic recession associated with an orthodox policy response is great, whereas the risk of galloping inflation, associated with heterodox policy responses, is considerably overestimated. Although rising commodity prices have lifted general price levels, most developed economies and many developing and transition economies do not yet face the threat of uncontrollable inflation. ■

Notes

1 *TDR 2007* explained carry trade with the following example: "For example, an established speculator such as a hedge fund might borrow 120 yen in Japan, buy $100 dollars in the United States, invest this amount in United States bonds and obtain an interest revenue equal to the difference between the borrowing rate in Japan, say 0.25 per cent, and the higher lending rate in the United States, say 5 per cent. Exchange rate changes between the time of borrowing and paying back the funding currency can add to the gains, or induce smaller gains or even losses. But with stable exchange rates, the *interest rate gain* amounts to 4.75 per cent. However, both gains and losses are largely magnified by high leverage ratios, since traders typically use huge amounts of borrowed funds and very little equity. For instance, owning a capital of $10 and borrowing 10 times the equivalent of that value in yen, the leverage factor of 10 leads to a net interest return on equity of 47.5 per cent."

2 International Financial Services London (IFSL, 2008) estimates that sovereign wealth funds have invested over $60 billion in United States and Swiss bank equities since the start of the sub-prime crisis. For a more detailed analysis of recent activities by sovereign wealth funds, see UNCTAD, 2008.

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Annex table to chapter I

REAL EFFECTIVE EXCHANGE RATES, 2001–2007

(Index numbers, 2000 = 100)

Region/country	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
Developed countries							
Australia	97.8	103.8	116.7	126.8	130.7	129.9	138.9
Canada	96.3	95.7	106.7	113.1	119.8	125.9	131.2
Czech Republic	106.2	112.2	108.8	113.9	119.7	124.9	127.3
Denmark	101.3	103.3	108.3	108.8	107.1	106.1	107.1
Euro area	100.4	104.8	116.1	117.3	113.6	110.8	113.9
Austria	99.6	100.9	103.8	104.2	103.2	101.6	101.2
Finland	100.5	102.6	108.2	105.7	101.4	99.5	100.2
France	99.9	101.9	107.8	108.6	107.5	105.5	107.3
Germany	98.7	100.2	105.3	106.4	104.1	102.5	103.8
Greece	100.1	104.3	110.1	111.7	110.9	110.1	111.9
Ireland	102.6	107.9	119.3	122.4	121.6	123.3	126.3
Italy	100.4	103.6	110.9	112.2	109.7	108.3	109.6
Netherlands	103.7	107.0	111.7	109.2	107.2	105.7	109.0
Portugal	102.4	104.8	109.3	109.2	107.9	107.1	108.7
Spain	100.9	104.3	109.9	111.8	112.1	113.0	114.6
Hungary	107.9	103.8	104.8	125.9	126.5	118.3	130.4
Japan	89.2	83.9	85.7	87.0	81.3	73.7	68.3
New Zealand	98.9	108.4	125.3	134.7	140.8	129.9	140.2
Norway	102.7	110.8	110.5	104.0	106.7	105.7	106.7
Poland	111.9	100.0	89.0	92.9	102.5	103.2	105.4
Romania	101.6	103.4	100.4	100.5	117.6	124.3	133.3
Slovakia	100.5	94.2	107.3	127.7	128.7	135.0	147.6
Sweden	91.8	93.9	101.0	100.6	95.5	93.9	96.8
Switzerland	102.6	106.9	108.0	106.6	103.9	100.8	97.2
United Kingdom	96.9	97.3	93.6	101.5	100.0	99.8	96.0
United States of America	104.9	104.9	98.9	94.5	91.7	90.2	86.2
South-East Europe and CIS							
Albania	104.1	106.4	99.7	107.5	110.5	112.6	112.6
Armenia	95.2	90.3	82.7	87.2	93.8	97.8	109.7
Azerbaijan	98.2	89.9	75.8	74.7	82.7	85.3	92.4
Belarus	92.5	98.3	96.2	93.5	97.2	97.0	92.7
Bosnia and Herzegovina	100.5	98.8	98.8	96.8	98.1	101.6	101.9
Croatia	102.8	103.4	103.6	104.7	106.9	108.4	108.5
Georgia	102.6	98.2	94.4	104.5	101.6	109.4	111.1
Kazakhstan	101.0	98.1	95.9	99.6	104.1	112.4	112.2
Russian Federation	117.2	121.0	123.3	130.4	139.4	151.7	156.3
Serbia and Montenegro	134.5	171.9	189.6	174.8	161.7	258.6	297.4
The former Yugoslav Republic of Macedonia	101.8	103.1	103.9	101.5	97.3	95.8	94.1
Turkmenistan	80.7	67.7	58.2	52.8	47.8	41.4	39.8
Ukraine	111.0	109.0	100.6	97.2	104.9	107.9	106.7
Uzbekistan	53.1	46.8	36.6	33.9	30.8	29.1	28.1

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Annex table to chapter I (continued)

REAL EFFECTIVE EXCHANGE RATES, 2001–2007

(Index numbers, 2000 = 100)

Region/country	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
Developing economies							
Africa							
Algeria	104.2	96.5	87.9	90.6	85.9	85.9	86.6
Angola	115.2	120.0	132.7	163.7	183.1	222.3	246.6
Benin	102.7	103.5	117.1	122.9	123.4	116.4	118.4
Burkina Faso	103.9	107.7	118.5	120.5	125.7	121.9	123.4
Cameroon	102.2	102.7	105.6	109.0	103.6	105.2	108.0
Chad	110.5	115.6	122.9	134.0	141.3	149.2	162.7
Congo	100.5	108.9	128.7	134.7	136.6	137.9	153.5
Côte d'Ivoire	100.6	101.5	108.2	110.7	114.0	111.6	113.2
Egypt	90.4	78.6	56.5	55.0	59.9	61.4	61.4
Equatorial Guinea	104.9	115.3	132.1	147.3	150.6	158.0	170.0
Gabon	98.9	101.5	117.0	122.4	118.2	119.2	127.9
Ghana	101.7	99.9	100.5	98.8	108.8	114.9	112.5
Kenya	106.3	106.9	114.2	113.4	122.1	141.4	149.0
Madagascar	111.7	119.2	114.0	80.0	85.5	84.8	98.9
Mali	107.2	111.7	120.6	122.3	125.9	118.8	121.3
Mauritius	95.5	94.5	92.9	89.5	84.7	83.2	84.2
Morocco	96.4	97.0	94.1	92.4	89.9	91.5	91.1
Mozambique	86.2	89.2	77.9	77.4	79.8	80.2	94.0
Nigeria	109.7	113.1	108.4	116.2	129.2	135.4	137.2
Senegal	101.1	103.7	106.8	109.9	107.7	107.4	108.7
South Africa	87.7	75.8	100.2	109.8	110.9	105.0	114.7
Sudan	108.5	116.8	117.9	127.7	143.0	179.2	199.3
Tunisia	99.2	101.3	96.3	91.2	88.7	89.6	86.1
Uganda	96.5	91.8	77.0	78.7	82.9	81.4	82.6
United Republic of Tanzania	98.5	87.4	76.4	65.5	66.6	61.3	63.9
Zambia	111.0	111.5	109.0	112.2	134.0	181.3	188.4
Latin America and the Caribbean							
Argentina	105.9	44.4	49.2	47.0	47.0	46.0	45.1
Barbados	102.5	100.1	97.7	92.8	94.7	98.5	98.6
Bolivia	99.6	97.0	91.4	88.7	83.7	79.4	79.0
Brazil	83.0	74.0	76.0	80.8	99.3	110.9	118.9
Chile	89.8	84.4	80.2	85.6	91.8	95.4	93.5
Colombia	94.6	92.5	82.2	92.5	104.6	102.6	115.2
Costa Rica	102.5	99.9	94.6	92.8	93.4	91.5	92.7
Cuba	92.1	96.3	84.9	78.1	78.4	81.7	76.3
Dominican Republic	102.9	97.0	72.3	77.1	107.4	101.3	103.8
Ecuador	136.7	151.0	153.7	152.1	147.6	147.2	141.9
El Salvador	100.9	100.5	100.2	100.9	100.1	99.4	98.6
Guatemala	104.3	111.3	112.5	116.8	126.2	129.1	130.8
Haiti	96.3	87.2	82.8	108.6	112.3	123.6	142.7
Honduras	102.7	101.4	100.1	99.6	101.5	103.2	106.5
Jamaica	99.5	97.4	83.1	82.8	88.0	89.8	85.1

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Annex table to chapter I (concluded)

REAL EFFECTIVE EXCHANGE RATES, 2001–2007

(Index numbers, 2000 = 100)

Region/country	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
Mexico	105.2	105.4	95.6	92.9	96.1	96.2	96.2
Nicaragua	92.4	87.7	83.9	82.2	81.5	81.8	85.2
Panama	99.0	97.8	92.4	87.8	86.0	83.8	82.1
Paraguay	98.9	92.9	90.6	98.9	89.1	98.8	108.0
Peru	102.8	100.3	97.1	96.5	97.1	94.7	94.0
Trinidad and Tobago	105.4	107.0	107.4	107.4	109.9	112.6	116.9
Uruguay	99.6	75.9	62.9	62.5	70.8	69.5	70.3
Venezuela (Bolivarian Republic of)	103.9	78.0	69.6	71.0	70.3	74.8	84.3
Asia and Oceania							
Bahrain	101.5	98.7	94.1	92.0	90.2	88.6	86.6
Bangladesh	95.6	91.4	85.7	83.0	80.2	77.1	74.5
Brunei Darussalam	105.3	102.1	97.4	92.3	90.5	88.3	90.2
Cambodia	96.5	97.4	92.1	89.0	95.3	96.1	100.7
China	103.9	101.7	96.3	94.2	92.7	92.8	96.1
India	100.2	98.8	99.6	100.1	102.6	100.6	109.7
Indonesia	95.7	116.4	125.8	120.8	118.5	137.3	137.6
Iran (Islamic Republic of)	110.2	109.6	97.0	96.9	100.7	107.5	117.5
Jordan	98.3	95.2	98.4	99.2	98.6	98.8	97.1
Kuwait	107.8	107.7	103.6	100.0	100.3	100.8	101.0
Lebanon	99.7	98.0	92.6	91.0	86.5	86.3	81.6
Malaysia	104.9	104.9	99.9	95.3	95.0	97.0	99.2
Nepal	97.9	95.2	95.1	94.4	98.5	100.6	101.3
Oman	104.9	102.8	97.5	92.8	89.7	87.2	84.7
Pakistan	90.2	92.5	90.7	89.2	90.2	91.7	89.9
Papua New Guinea	95.9	88.3	95.7	95.8	98.6	99.8	96.1
Philippines	95.2	95.8	89.6	87.1	92.7	102.9	111.8
Qatar	111.1	111.9	106.6	105.4	108.9	121.5	131.4
Republic of Korea	93.1	97.2	99.9	101.5	111.8	118.0	116.1
Saudi Arabia	103.4	101.3	94.6	89.2	86.6	86.3	84.2
Singapore	99.4	97.3	95.3	94.6	93.1	95.0	95.1
Sri Lanka	98.6	98.1	96.8	90.8	98.5	104.0	97.1
Syrian Arab Republic	106.1	97.3	81.8	76.2	84.1	91.5	94.2
Thailand	94.5	96.9	96.0	96.0	97.5	104.3	110.0
Turkey	78.9	89.2	98.5	102.9	115.1	113.4	116.4
United Arab Emirates	110.3	112.4	108.4	105.8	107.1	116.0	119.0
Viet Nam	99.4	96.3	90.8	90.8	94.0	95.2	94.9
Yemen	111.1	116.8	120.3	127.6	131.8	141.7	144.0

Source: UNCTAD secretariat calculations, based on IMF, *Direction of Trade* and *International Financial Statistics* databases.
Note: Real effective exchange rate index is the index of the trade-weighted average nominal exchange rate adjusted for changes in the consumer price index. A rise in the index indicates a loss of competitiveness.