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Chapter I

THE IMPACT OF THE GLOBAL CRISIS AND THE SHORT-TERM POLICY RESPONSE

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Chapter I

THE IMPACT OF THE GLOBAL CRISIS AND THE SHORT-TERM POLICY RESPONSE

A. Recent trends in the world economy

1. Global growth and international trade

The world economy is experiencing its first contraction since the Second World War. Even before the problems in financial markets turned into a full-blown crisis in September 2008, the growth of gross domestic product (GDP) had ground to a halt in most developed countries. The bursting of the housing bubble in a number of countries, the subprime financial crisis in the United States, rising commodity prices, and in several countries, restrictive monetary policies led the global economy to the "brink of recession" in the first half of 2008 (*TDR 2008*: 1). Whereas the exhaustion of credit-based demand growth brought these economies to a standstill, the collapse of credit supply and financial asset prices pushed it into a severe recession. After slowing down from 3.7 per cent in 2007 to 2 per cent in 2008, global GDP is expected to fall by more than 2.5 per cent in 2009 (table 1.1).

This crisis is unique, not only in terms of its depth but also in the extent of its global reach: virtually no economy has remained unaffected. Even economies that are expected to grow this year, such as those of China and India, are slowing down significantly from their previous years of rapid growth. It shows to what extent national economies around the globe have become interdependent, which makes it difficult for them to "decouple" from the global economic slump, especially as the initial shock originated in the largest economy. The speed at which the crisis spread to different countries was also remarkable: many developing and transition economies that had enjoyed robust growth until the second or third quarter of 2008 experienced a fall in GDP already in the last quarter of the year.

In the highly integrated international system, the financial shock propagated extremely rapidly. It spread to the real economy mainly through those segments of aggregate demand that are largely financed with credit, such as fixed investments and the consumption of durable goods. This is why the crisis has been felt the most acutely in manufacturing and construction, while other sectors like non-financial services have been less affected. With increasing uncertainty about levels of disposable income and demand, acquisitions of durable and capital goods were deferred and producers of these goods reduced inventories, resulting in a sharp contraction of production within a very short period of time. Available data for the first quarter of 2009 indicate double-digit reductions in gross fixed capital formation (GFCF) and manufacturing output in most of the world's major economies.

Table 1.1

WORLD OUTPUT GROWTH, 1991–2009[a]

(Annual percentage change)

Region/country	1991–2002[b]	2003	2004	2005	2006	2007	2008[c]	2009[c]
World	**2.8**	**2.7**	**4.1**	**3.4**	**3.9**	**3.7**	**2.0**	**-2.7**
Developed countries	**2.5**	**1.9**	**3.0**	**2.4**	**2.8**	**2.5**	**0.7**	**-4.1**
of which:								
Japan	1.0	1.4	2.7	1.9	2.0	2.4	-0.6	-6.5
United States	3.3	2.5	3.6	2.9	2.8	2.0	1.1	-3.0
European Union	2.3	1.3	2.5	1.9	3.1	2.9	0.9	-4.6
of which:								
Euro area	2.2	0.8	2.1	1.7	2.9	2.6	0.8	-4.7
France	2.1	1.1	2.5	1.9	2.4	2.1	0.7	-3.0
Germany	1.8	-0.2	1.1	0.8	3.0	2.5	1.3	-6.1
Italy	1.6	0.0	1.4	0.7	1.9	1.5	-1.0	-5.5
United Kingdom	2.8	2.8	3.3	1.8	2.9	3.1	0.7	-4.3
EU-12[d]	2.5	4.2	5.6	4.8	6.4	6.0	3.9	-3.6
South-East Europe and CIS	**..**	**7.1**	**7.7**	**6.7**	**7.5**	**8.4**	**5.4**	**-6.2**
South-East Europe[e]	..	2.6	5.3	5.7	5.3	6.0	4.0	-2.2
Commonwealth of Independent States (CIS)	..	7.6	8.0	6.8	7.8	8.6	5.5	-6.6
of which:								
Russian Federation	..	7.3	7.1	6.4	6.7	8.1	5.6	-8.0
Developing countries	**4.7**	**5.4**	**7.2**	**6.6**	**7.2**	**7.3**	**5.4**	**1.3**
Africa	2.9	4.9	5.3	5.6	5.7	6.0	5.1	1.2
North Africa, excl. Sudan	3.3	5.5	4.9	5.3	5.7	5.7	5.7	3.0
Sub-Saharan Africa, excl. South Africa	2.8	5.4	6.1	6.4	5.9	6.7	5.4	1.0
South Africa	2.3	3.1	4.9	5.0	5.4	5.1	3.1	-1.8
Latin America and the Caribbean	2.8	2.2	6.2	4.9	5.8	5.8	4.2	-2.0
Caribbean	2.3	3.1	3.8	8.1	9.4	6.2	3.5	0.3
Central America, excl. Mexico	4.2	3.8	4.5	4.8	6.5	6.8	4.4	-1.1
Mexico	3.1	1.4	4.2	2.8	4.8	3.2	1.4	-7.0
South America	2.7	2.4	7.4	5.6	6.0	6.8	5.5	-0.3
of which:								
Brazil	2.6	1.2	5.7	3.2	4.0	5.7	5.1	-0.8
Asia	6.0	6.8	7.9	7.5	8.0	8.1	5.9	2.6
East Asia	7.6	7.1	8.3	7.9	8.8	9.2	6.3	3.7
of which:								
China	10.1	10.0	10.1	10.2	11.1	11.4	9.0	7.8
South Asia	5.1	7.8	7.5	8.0	8.5	8.3	6.8	4.2
of which:								
India	5.8	8.4	8.3	9.2	9.7	9.0	7.3	5.0
South-East Asia	4.6	5.5	6.6	5.8	6.2	6.4	4.1	-0.8
West Asia	3.4	6.0	8.2	6.6	5.8	5.0	4.5	-1.3

Source: UNCTAD secretariat calculations, based on United Nations, Department of Economic and Social Affairs (UN/DESA), *National Accounts Main Aggregates* database, and *World Economic Situation and Prospects (WESP) 2009: Update as of mid-2009;* OECD, 2009a; ECLAC, 2009a; and national sources.

a Calculations for country aggregates are based on GDP at constant 2000 dollars.

b Average.

c Preliminary estimates for 2008 and forecasts for 2009.

d New EU member States after 2004.

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, 2003–2008

(Annual percentage change)

	Volume of exports						Volume of imports					
Region/country	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*
World	**6.1**	**11.2**	**6.3**	**8.9**	**5.5**	**4.3**	**7.1**	**11.7**	**7.4**	**8.2**	**6.4**	**4.0**
Developed countries	**3.4**	**8.5**	**5.4**	**8.3**	**3.7**	**3.2**	**5.2**	**9.0**	**6.1**	**7.1**	**3.6**	**0.7**
of which:												
Japan	9.2	13.4	5.1	11.8	6.8	4.8	5.9	6.3	2.0	4.3	0.8	-0.8
United States	2.9	8.7	7.4	10.5	6.8	5.5	5.5	10.8	5.6	5.7	0.8	-3.7
European Union	3.5	8.6	5.6	8.6	2.9	2.9	5.5	8.5	6.6	8.8	4.5	2.2
South-East Europe and CIS	**7.9**	**11.7**	**-0.2**	**5.4**	**7.1**	**18.6**	**17.6**	**18.7**	**12.4**	**21.1**	**26.4**	**22.5**
South-East Europe	19.3	22.6	6.1	16.9	18.2	12.1	16.4	16.2	-0.7	8.9	23.2	13.5
CIS	7.2	11.2	-0.4	4.8	6.5	19.3	17.9	19.2	15.2	23.5	26.9	23.9
Developing countries	**11.8**	**16.8**	**9.2**	**10.5**	**8.3**	**4.7**	**11.1**	**17.5**	**9.9**	**9.4**	**10.4**	**8.5**
Africa	3.7	7.6	4.2	0.8	6.9	1.5	5.5	12.5	13.0	9.6	10.0	18.6
Sub-Saharan Africa	3.3	8.9	3.6	-0.6	6.8	2.1	14.7	9.9	13.3	12.4	8.6	8.6
Latin America and the Caribbean	3.8	9.5	6.3	5.7	2.3	-1.0	0.7	13.6	10.5	13.3	11.7	6.7
East Asia	21.1	23.4	17.8	18.5	15.1	8.3	18.4	18.8	6.6	10.3	10.4	4.5
of which:												
China	33.4	31.7	26.9	25.4	21.9	12.5	32.9	24.6	8.4	13.2	14.2	7.7
South Asia	8.9	11.1	9.3	7.9	7.1	7.2	13.4	15.9	16.7	8.4	8.0	13.4
of which:												
India	11.1	18.2	16.1	10.2	12.8	9.5	17.1	18.6	22.2	7.8	12.2	17.7
South-East Asia	7.8	19.9	6.4	10.0	6.9	6.4	6.5	18.4	10.0	7.3	7.1	11.1
West Asia	6.9	11.3	0.2	2.9	-1.4	4.2	13.2	23.4	16.8	4.8	16.1	11.5

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

World trade slowed down in 2007 and 2008, and has been shrinking at a fast rate since November 2008, in both volume and value. Trade volume growth decelerated first in the United States and other developed countries. Indeed in 2008, import volume growth actually turned negative in the United States and Japan. Trade expansion was more resilient in developing and transition economies. In particular, countries that had benefited from terms-of-trade gains until mid-2008 (i.e. mainly countries in Africa, the Commonwealth of Independent States (CIS), Latin America and the Caribbean, and West Asia), were able to increase their imports significantly, although in some cases the volume of their exports slowed down or even declined (table 1.2).

In the final months of 2008, the contraction in investment and consumption of durable goods in many countries was reflected in lower private domestic and foreign demand, leading to a sharp reduction of trade in manufactures. Lower demand by producers for raw materials added to the unwinding of speculative positions by financial investors in primary commodity markets, causing a sharp correction of previously rallying prices in these markets (see section A.2). In 2009, world trade is thus set to shrink considerably, by 11 per cent in real terms and by more than 20 per cent in current dollars (UN/DESA, 2009a and b).

All the major developed economies are in recession.[1] In the *United States,* economic activity is

likely to fall by some 3 per cent. The credit crunch and declining incomes and wealth in that country have adversely affected personal consumption, which has been on a downward trend since mid-2008. As the prices of real estate began to tumble from 2006 onwards, residential fixed investment dragged down growth. More recently there has also been a strong reduction in non-residential fixed investment, owing to falling corporate profits, credit cuts and depressed demand. Government spending continued to grow moderately during 2008, compensating only slightly for the plummeting private demand. Net exports made the only significant contribution to growth in the United States, as imports fell faster than exports. Extensive support to the financial sector and some industries, most notably car manufacturers, has helped contain the worsening of the crisis, and an unprecedented fiscal stimulus package (see section D.4) may eventually result in a turnaround in domestic demand.

In *Japan*, the crisis had a direct impact on the two main engines that had sustained economic growth until 2007: exports and private non-residential investment. In the first quarter of 2009, they were down from the previous year by 37 per cent and 21 per cent, respectively. To some extent, the steep fall in export demand was due to the appreciation of the yen as carry-trade operations unwound with the financial crisis; but it was mainly the result of the sharp drop in international demand for machinery, electronic goods and automobiles, which struck at the heart of Japan's industry. Household consumption also fell, owing to declining employment and personal incomes, as well as wealth losses resulting from plunging asset prices. Consequently, real GDP was 8.8 per cent lower in the first quarter of 2009 than the year before. Some improvements can be expected in the second half of the year, as depleting inventories in other Asian countries could cause a recovery in demand for Japanese manufactures. In addition, the large fiscal stimulus package will help boost domestic demand. Nevertheless, Japan is likely to register a drop in GDP of between 6 and 7 per cent – one of the strongest among countries of the Organisation for Economic Co-operation and Development (OECD).

Countries of the *European Union* (EU) had already slipped into recession in the third quarter of 2008, and when the financial crisis entered a more dramatic phase in September 2008, it exacerbated the economic slump. In 2008 as a whole, annual GDP growth was still positive. Since most of the slowdown in economic activity occurred in the last quarter of 2008 and the first quarter of 2009, the bulk of the setback in production will be reflected in the statistics for 2009. Output in the EU is expected to fall by at least 4 per cent from its 2008 level, even on the basis of an optimistic scenario that production will stabilize or recover slightly in the second half of 2009. The turmoil had a direct impact on economies in which the financial sector accounts for a large share of GDP, such as Ireland and the United Kingdom, but most other European economies also suffered from the credit crunch and falling asset prices. The crisis also revealed that, after several years of large net capital exports, the financial sector of many European countries was heavily exposed to risks generated in the United States and other deficit economies, as many banks had sought to make high profits by accumulating risky assets abroad. Credit shortages, negative wealth effects and mounting unemployment affected private consumption and investment, and particularly construction, in many European economies. Spain, a country that based much of its recent growth on the construction sector, was especially hard hit. The sharp drop in international trade, particularly in capital goods and durable consumer goods, greatly affected countries that rely on exports of manufactures, such as Germany.

In *Eastern Europe*, lower demand from the euro area has mainly affected industrial production and exports of manufactures. Many countries in this region had posted significant and growing trade deficits in previous years, due partly to high domestic investment and partly to currency overvaluation that led to a loss of competitiveness of domestic producers in international markets. As carry-trade operations unwound and capital began to flee to safer forms of investment, several currencies in the region came under heavy pressure to depreciate. Some countries had to turn to the International Monetary Fund (IMF) for financial support, in some instances complemented by EU loans. This financial support has served to smooth currency depreciation in countries such as Hungary, while in others, such as the Baltic States, it has helped to maintain the exchange-rate peg. External financial assistance in all these countries has also aimed at preventing the collapse of their banking systems. If these were to fold, it would have grave consequences for Western European creditor banks. As IMF support for these countries is linked with traditional conditionalities, including monetary

and fiscal tightening, it has had the effect of further depressing domestic demand following the bursting of the real estate bubble and the reversal of business and consumption credit. As a result, Baltic countries are likely to post double-digit negative growth rates in 2009.

In the *CIS,* GDP may fall by more than 6 per cent in 2009, led by recession in Ukraine, the Russian Federation and Kazakhstan. Export value has been declining in most countries due to lower prices and, in general, also smaller volumes. As international investors and lenders turned away in the search for reduced risk exposure, capital outflows and currency depreciations in several countries revealed the vulnerability of their banking sector. Tightening credit and deteriorating employment conditions caused a fall in domestic investment and consumption just when foreign demand also receded. In the first few months of 2009, year-on-year industrial output dropped in the Russian Federation and Ukraine by about 20 and 30 per cent respectively. The recession in the largest economies greatly affected other CIS countries, as exports and remittance inflows fell. The Governments of the Russian Federation and Kazakhstan launched sizeable stimulus plans, using financial reserves accumulated from the high oil revenues of the past few years.

In *Africa,* after five consecutive years of real GDP growth of between 5 and 6 per cent, the rate is likely to slow down to close to only 1 per cent in 2009, which means a significant reduction in per capita GDP. So far, the global crisis has affected the continent mainly through trade. Exporters of oil, mining products and agricultural raw materials have been particularly hard hit by the sharp fall in the prices of primary commodities. This means that governments whose revenues are directly linked to primary exports will have to adjust their expenditure programmes. More diversified African economies that have a significant share of manufactures in their total exports have been affected mainly by a fall in export volumes. In the last months of 2008, some food and oil importers in sub-Saharan Africa partly reversed the losses they had incurred from unfavourable terms of trade in 2007 and the first half of 2008, but they have not been able to translate such gains into higher growth. Growth remains constrained on the demand side by lower remittances and a slump in global demand for goods and services, including tourism, and on the supply side by insufficient investment.

In *Latin America and the Caribbean*, GDP is likely to fall, on average, by around 2 per cent in 2009. Mexico has felt the impact of the crisis the most strongly, with a loss of GDP in the order of 7 per cent in 2009; together with several Central American and Caribbean countries, it has been more affected than others by the decline in external demand for manufactures and reduced tourism. The impact of the crisis is reflected in the lower volume of trade, fixed investment and manufacturing output. Most of these variables showed double-digit contraction in all major countries in late 2008 and early 2009. South American countries have been affected largely by the fall in primary commodity prices, which have lowered their export and fiscal revenues. In some countries, this has put a brake on public spending that had been growing rapidly in recent years. In other countries, governments have been able to provide a fiscal stimulus – in some cases by using funds accumulated through surpluses in recent years – in order to compensate for lower private domestic and foreign demand. Most countries in the region were in a relatively strong macroeconomic position at the onset of the global crisis. Consequently, no banking or balance-of-payments crisis has occurred so far. Many countries allowed the depreciation of their currencies, but were able to avoid overshooting. Governments in the region have largely avoided adopting the procyclical policies that had aggravated the earlier crises between 1995 and 2001. In the present crisis, Latin American countries enjoy wider room for manoeuvre than in other episodes of crisis, and have been taking advantage of this for countercyclical measures.

In 2009, GDP is set to fall in several economies in *East and South-East Asia* that strongly rely on exports of manufactures, particularly capital and durable consumer goods. The dense production network of industries in the region has caused a parallel fall in industrial production and international trade. The countries that have been better able to resist recessionary pressures are those where the domestic market plays a more important – and growing – role in total demand, such as China and Indonesia. Moreover, proactive countercyclical policies may attenuate the effects of the economic slump in several countries. The impact of higher public spending on infrastructure as well as credit expansion is already visible in China, where output growth is likely to exceed 7 per cent in 2009. By contrast, Taiwan Province of China, Hong Kong (Special Administrative Region of China) and Singapore are expected to experience a

sharp downturn. Overall, East Asia should be able to maintain a positive growth rate, while GDP in South-East Asia will probably decline, albeit less than the average for the world economy.

Almost all the *South-Asian* economies should continue to grow in 2009, but at a slower pace. They are feeling the impact of the crisis through reduced capital inflows, lower migrants' remittances and falling external demand. But since domestic demand accounts for a large and increasing share of total demand, South Asia, particularly India, is expected to see continued growth in 2009.

In *West Asia* as a whole, GDP is expected to fall only slightly, although growth performance will differ significantly among countries within the region. Several countries have been directly affected by the turmoil in financial markets, with sharp falls in real estate and stock prices, and attendant negative effects on private wealth. In some cases, banks' balance sheets and credit supply have also been badly hit. The oil exporting countries, like many others, have been affected by lower export earnings, mainly due to tumbling prices. In addition, reduced quotas agreed by the Organization of the Petroleum Exporting Countries (OPEC) have meant cuts in oil production in real terms. Private consumption and investment are expected to fall. In some countries, especially Saudi Arabia, higher public spending will compensate, at least partially, for lower private spending. In non-oil- or gas-exporting countries, economic growth is likely to decline due to lower remittances, exports and tourism receipts. In Turkey, GDP plummeted in the last quarter of 2008 and the first quarter of 2009, dragged down by reduced private consumption, investments and exports. A strong increase in public expenditure was not sufficient to prevent overall economic contraction, which will be the most severe for Turkey out of all the countries in the subregion.

By mid-2009, prospects for an economic recovery remained very uncertain. In several developed countries, the contraction of economic activity decelerated, compared to the almost free fall of previous months. Financial indicators show a recovery from the lows reached in the first quarter of 2009. Interest rate spreads on emerging debt and corporate bonds decreased, and prices of stocks and many commodities, as well as exchange rates of emerging-market currencies, rebounded. These indications are being interpreted by some observers as the "green shoots" of an imminent economic revival. But the main factors behind the economic crisis still prevail: massive write-downs of financial assets and continuing deleveraging by financial agents are hindering the supply of credit by the financial system; asset depreciation and rising unemployment are further constraining private demand; and overinvestment in real estate and underutilized productive capacity, together with bleak prospects for final demand, will continue to weigh down investment demand for some time to come. Taking these factors into account, the rebound in the prices of financial assets and commodities is more likely to be just a correction of the preceding downward overshooting in 2008, which was as irrational as the bullish exuberance in previous years. Furthermore, there are strong indications that recent improvements in the financial markets are largely due to a recovery of "risk appetite" by financial agents, but this could be reversed at short notice depending on speculators' mood or possible changes in macroeconomic policy stances.

If governments of the largest economies maintain their expansionary policies (see section D), GDP contraction may recede by 2010 and growth could return, although at a slower pace. According to estimates by the United Nations Department of Economic and Social Affairs (UN/DESA), world output might grow at 1.6 per cent in 2010, compared to its average growth of 3.6 per cent between 2003 and 2007.

2. Recent trends in primary commodity markets

(a) Price developments

The commodity price boom, which had continued unabated since 2002, came to an end in mid-2008, and turned into a sharp decline during the second half of the year. In the first half of 2009, the prices of many primary commodities rebounded although market fundamentals remained weak (OPEC, 2009; IEA, 2009a; RGE *Monitor*, 2009). Much of the recent developments in commodity prices can be attributed to the greater presence of financial investors in the markets for primary commodities (see chapter II).

Prices of all commodity groups except tropical beverages reached historic highs in nominal terms in 2008. In real terms, however, when deflated by the export unit value of manufactured goods of developed countries, only the prices of the metals and minerals group and oil reached record levels. Nevertheless, real prices for the other groups were significantly higher than at the beginning of the decade and also higher than their long-term trend. The price increases during the boom years were impressive for practically all commodities (table 1.3). But equally exceptional was the sharp and widespread price decline thereafter (chart 1.1). The price swings were more moderate for tropical beverages and agricultural raw materials than for other commodities.

While the deterioration of global economic prospects in 2008 caused a fall in commodity demand, the downturn in commodity prices was first triggered by a reorientation of speculative influences in these markets. Despite the downward correction in the second half of 2008, prices for all commodity groups, except oil, remained above their average of the past 10 years. A large number of commodity prices seemed to have bottomed out by December 2008,[2] but at this point prices of most commodity groups had only retreated back to about the levels of 2007. Only oil and minerals and metals had fallen roughly to the levels of 2005. The prices of oil, minerals and metals, and agricultural raw materials were worse hit than others by the slowdown in demand resulting from the slump in industrial production in developed countries (chart 1.1B).[3] Although producers of minerals and metals significantly reduced production, weak demand outpaced these supply adjustments, resulting in a build-up of inventories during the second half of 2008 (Desjardins, 2009).

The revival in some mineral and metal prices in early 2009 appears to be related to stock replenishments by manufacturing companies around the world and also to increases in strategic reserves, notably in China (Ulrich, 2009).[4] This could mean that the upward swing in prices may be short-lived if stockpiling ends before real demand picks up significantly. On the other hand, the influence of the speculative forces that also caused a rise in financial asset prices and some exchange rates against the trend in fundamentals could well compensate for this effect. Moreover, precious metals, mainly gold, have recently benefited from high demand as investors seek traditional safe havens in uncertain times.

Developments in oil prices have been leading price movements in other commodity markets. Oil prices may affect prices of other commodities through their impact on the production of substitutes for cotton (synthetic fibres) and natural rubber (synthetic rubber), their contribution to production and transportation costs, and by influencing the demand for food commodities for biofuel production as an alternative source of energy.[5] The price of oil has exhibited the highest volatility of all in recent months. The monthly average oil price increased from $53.4 per barrel in January 2007 to $132.5 per barrel in July 2008, and then dropped to $41.5 per barrel in December 2008. It increased thereafter to reach $68.5 in June 2009 (UNCTAD, 2009a).[6]

As the global financial and economic crisis continued to unfold, oil demand fell during the first months of 2009. By June 2009, forecasts were for an overall decline of 2.9 per cent in 2009, mainly on account of lower demand by members of the Organisation of Economic Co-operation and Development (OECD) (chart 1.2). This would represent the sharpest fall in a single year since 1981 (IEA, 2009a and b). In view of the low prices, between September and December 2008 the Organization of the Petroleum Exporting Countries (OPEC) announced cuts in production quotas to a total of 4.2 million barrels per day, equivalent to 4.8 per cent of 2008 world supply. Non-OPEC supply has remained flat. Due partly to the high compliance with OPEC production cuts, and partly to speculation, oil prices rebounded in the first half of 2009. OPEC production quotas remained unchanged during this period, and the International Energy Agency (IEA, 2009b) revised its forecasts for oil demand upwards for the first time in about a year. However, only China and other Asian countries showed signs of rising real demand, while demand in OECD countries showed no signs of recovery owing to declining industrial production (chart 1.1B).[7]

As for agricultural commodities, short-term price developments are determined not so much by changes in demand; they are mainly linked to factors that affect supply, such as weather, pests and diseases, and crop cycles. In early 2009, prices of tropical beverages have been propped up by crop shortages in major producing areas due to adverse weather conditions. This is the case for coffee in Colombia, Central America and Brazil (where coffee is in a low production year of its biennial crop cycle), cocoa in Côte d'Ivoire and Ghana, and tea in India, Kenya and

Table 1.3

WORLD PRIMARY COMMODITY PRICES, 2002–2008

(Percentage change over previous year, unless otherwise indicated)

Commodity group	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2002–2008*[a]	*Jan.–Dec. 2008*[b]
All commodities[c]	**8.1**	**19.9**	**11.7**	**30.4**	**12.9**	**23.8**	**164.0**	**-22.5**
All commodities (in SDRs)[c]	**-0.2**	**13.5**	**12.1**	**30.7**	**8.5**	**19.4**	**115.0**	**-19.3**
All food	**4.1**	**13.2**	**6.3**	**16.3**	**13.3**	**39.2**	**129.8**	**-11.8**
Food and tropical beverages	**2.3**	**13.2**	**8.8**	**17.8**	**8.6**	**40.4**	**126.3**	**-5.2**
Tropical beverages	6.2	6.4	25.5	6.7	10.4	20.2	100.8	-8.3
Coffee	8.7	19.8	43.8	7.1	12.5	15.4	160.3	-15.8
Cocoa	-1.3	-11.8	-0.7	3.5	22.6	32.2	45.1	10.9
Tea	8.4	2.1	9.1	11.7	-12.3	27.2	50.4	-0.9
Food	1.9	13.9	7.2	19.0	8.5	42.5	128.8	-5.0
Sugar	2.9	1.1	37.9	49.4	-31.7	26.9	85.9	-1.8
Beef	0.4	17.8	4.1	-2.4	1.9	2.6	25.8	-8.3
Maize	6.5	5.0	-12.0	24.4	38.2	34.0	126.7	-25.4
Wheat	-0.7	6.8	-1.4	26.6	34.3	27.5	126.6	-38.7
Rice	4.1	23.1	17.1	5.5	9.5	110.7	265.3	40.2
Bananas	-28.7	39.9	9.9	18.5	-0.9	24.6	60.3	23.8
Vegetable oilseeds and oils	**17.4**	**13.2**	**-9.5**	**5.0**	**52.9**	**31.9**	**154.8**	**-45.4**
Soybeans	24.1	16.1	-10.4	-2.2	43.0	36.1	145.8	-33.5
Agricultural raw materials	**19.8**	**13.4**	**4.0**	**15.0**	**11.2**	**19.4**	**115.6**	**-25.6**
Hides and skins	-16.8	-1.7	-2.1	5.1	4.5	-11.3	-22.1	-44.6
Cotton	37.2	-3.3	-11.6	5.9	10.2	12.8	54.4	-24.3
Tobacco	-3.5	3.6	1.8	6.4	11.6	8.3	30.8	9.8
Rubber	41.7	20.3	15.2	40.4	8.6	14.3	242.2	-53.6
Tropical logs	20.1	19.2	0.3	-4.7	19.5	39.3	127.8	-1.4
Minerals, ores and metals	**12.4**	**40.7**	**26.2**	**60.3**	**12.8**	**6.2**	**283.0**	**-37.0**
Aluminium	6.0	19.8	10.6	35.4	2.7	-2.5	90.6	-39.0
Phosphate rock	-5.9	7.8	2.5	5.3	60.5	387.2	755.8	84.2
Iron ore	8.5	17.4	71.5	19.0	9.5	65.0	369.8	0.0
Tin	20.6	73.8	-13.2	18.9	65.6	27.3	356.0	-31.2
Copper	14.1	61.0	28.4	82.7	5.9	-2.3	346.1	-56.5
Nickel	42.2	43.6	6.6	64.5	53.5	-43.3	211.6	-65.0
Tungsten ore	18.0	22.9	120.7	36.2	-0.6	-0.3	332.4	-3.0
Lead	13.8	72.0	10.2	32.0	100.2	-19.0	361.6	-63.0
Zinc	6.3	26.5	31.9	137.0	-1.0	-42.2	140.7	-52.9
Gold	17.3	12.6	8.7	35.9	15.3	25.1	181.2	-8.2
Crude petroleum	**15.8**	**30.7**	**41.3**	**20.4**	**10.7**	**36.4**	**288.9**	**-54.3**
Memo item:								
Manufactures[d]	**9.2**	**8.3**	**2.5**	**3.2**	**7.5**	**4.3**	**40.6**	**..**

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

Note: In current dollars unless otherwise specified.

a Percentage change between 2002 and 2008.

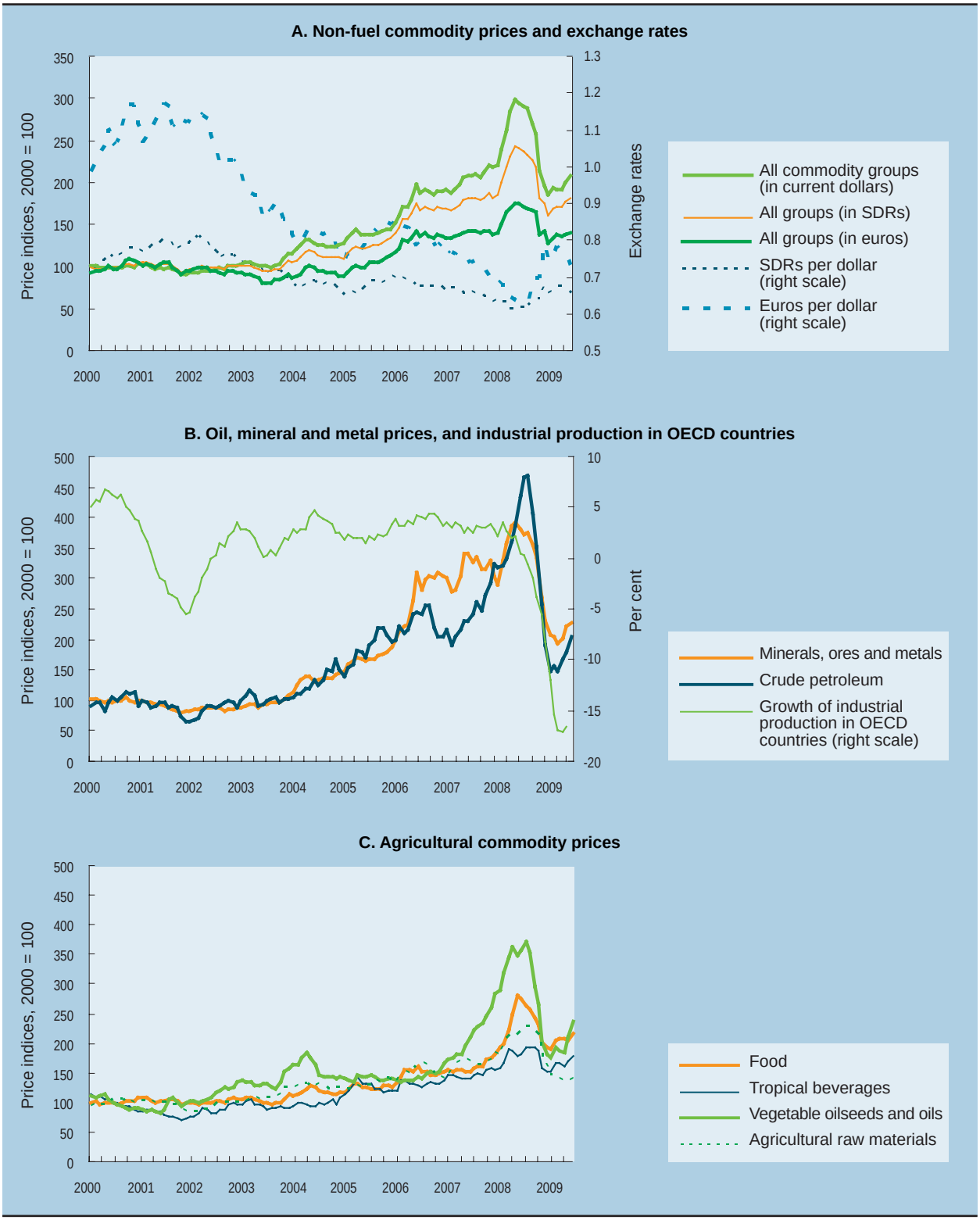
b Percentage change between January 2008 and December 2008.

c Excluding crude petroleum.

d Export unit value of manufactured goods of developed countries.

Chart 1.1

MONTHLY EVOLUTION OF COMMODITY PRICES, EXCHANGE RATES AND INDUSTRIAL PRODUCTION IN OECD COUNTRIES, JANUARY 2000–MAY 2009



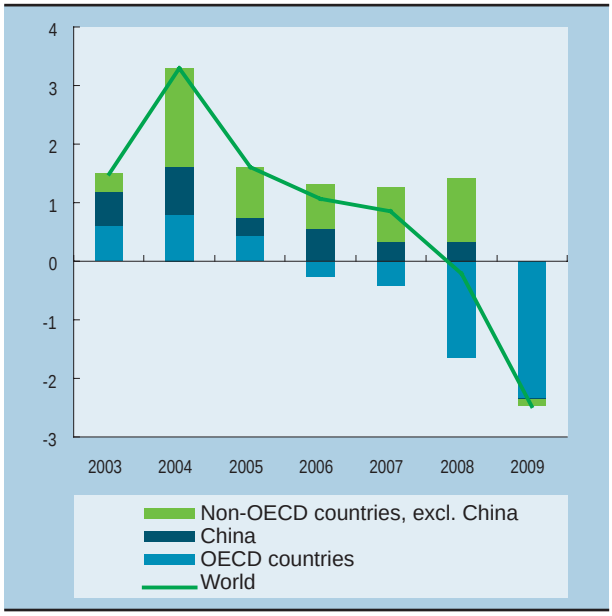
Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics Online*, *UNCTAD Handbook of Statistics* database; and OECD, *Main Economic Indicators* database.

Note: Industrial production in OECD countries refers to year-on-year changes.

Chart 1.2

CHANGE IN OIL DEMAND, 2003–2009

(Million barrels per day)



Source: UNCTAD secretariat calculations, based on International Energy Agency, *Oil Market Report* (various issues).
Note: 2009 data are forecasts.

Sri Lanka. Similarly, sugar prices in India, the world's largest sugar consuming country, have surged due to a lower harvest, which has also caused it to import this commodity. Reduced use of more expensive fertilizers and difficulties in financing inputs have also contributed to lower yields of some commodities. Moreover, higher prices for alternative crops have led farmers to switch plantings, particularly for cotton.[8] Demand for food commodities is not so vulnerable to the cycles of economic activity because their income elasticity of demand is much lower than that of other commodity groups. This has made agriculture more resilient to the global economic downturn (OECD-FAO, 2009).

In order to understand the extreme volatility of many commodity prices since 2007 it is important to take into account the closer links between commodity markets and financial markets. These may explain, for example, why oil prices in nominal terms increased by 289 per cent between 2002 and 2008, and in real terms (deflated by the United States consumer price index (CPI)) by 224 per cent, while the demand for oil rose by 10.4 per cent and oil supply by 12.5 per cent.[9] In addition, as commodity prices are typically denominated in dollars, the exchange rate of the dollar may have had an effect on price changes. Changes in commodity prices calculated on the basis of Special Drawing Rights (SDRs) are more moderate than those calculated in dollars (chart 1.1A), and even more moderate when the index is calculated in euros. The increase in dollar prices since 2002 was associated with the depreciation of the dollar against the euro, while the 2008 slump in prices occurred alongside dollar appreciation. The rebound in the prices of a number of commodities in early 2009 has again been accompanied by dollar depreciation, which mitigates the impact of increases in dollar prices on consumer prices and reduces the incentives to increase supply for producers in countries whose currencies are not pegged to the dollar.

(b) Commodity supply response and market outlook

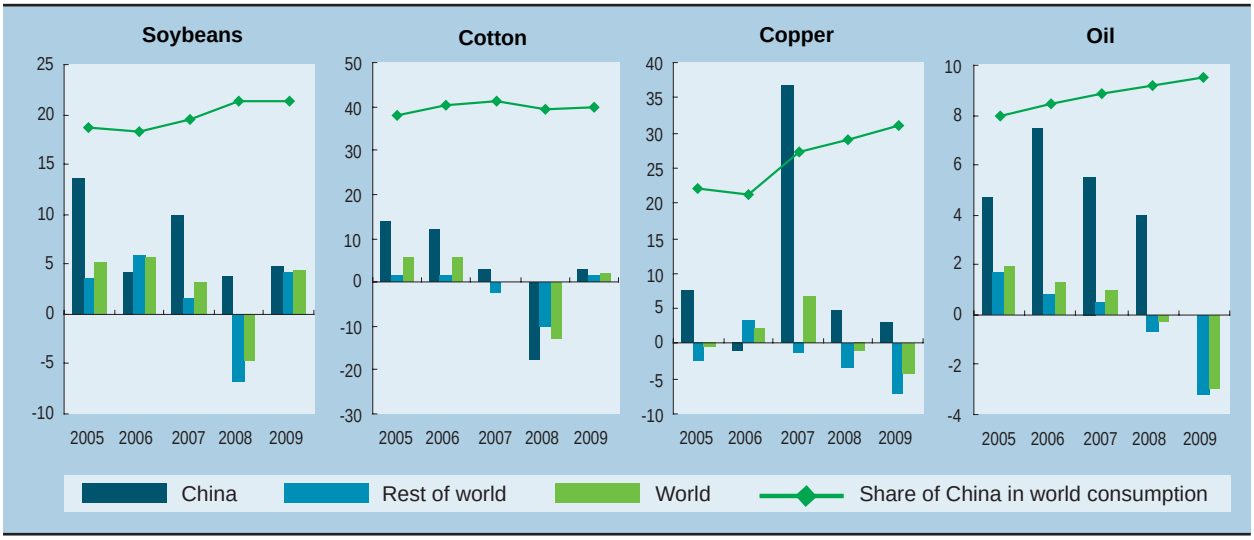
There are indications that the upward trend in investment in new production capacities, triggered by the rise in the prices of minerals and metals, sharply and quickly reversed by the end of 2008 and early 2009. This was due to expectations of falling demand following the global economic crisis, growing inventories, and increasing difficulties in financing new investment. Mining companies have been cutting back production, laying off workers and postponing or abandoning exploration projects. BNP Paribas (2009) estimates that world capital expenditure in the metal and mining industries in 2009 and 2010 will be cut by about half from its level in 2008.[10]

The initial decline in output in the extractive industries is most probably the result of a reduction in mining capacity utilization,[11] so that production might recover quickly once demand prospects improve. In addition, given the time lag between mining investment and actual metal production, in the short term there may be some increases in supply resulting from the higher exploration expenditures of recent years. However, as demand for minerals and metals will rebound in response to an eventual recovery of the global economy, spare capacity and inventories will be eroded and there will be a need for new sources of supply. Thus, in the medium to long term, project delays and the current declines in exploration

Chart 1.3

GROWTH IN COMMODITY CONSUMPTION: CHINA AND REST OF THE WORLD, 2005–2009

(Per cent)



Source: UNCTAD secretariat calculations, based on USDA, *Oilseeds World Markets and Trade*, June, 2009; ICAC, *Cotton this week* (various issues); IEA, *Oil Market Report* (various issues); and Chilean Copper Commission (COCHILCO), *Copper Market Quarterly Review* (various issues).

Note: 2009 data are forecasts by USDA for soybeans, ICAC for cotton, COCHILCO for copper and IEA for oil.

expenditures may well lead to supply shortages (Ernst &Young, 2009). The situation is similar in the oil and gas sector, where investment also increased during the boom years, but investment budgets for 2009 fell by more than 20 per cent compared with 2008 as a result of lower prices and more difficult financing conditions (IEA, 2009c).[12]

In the agricultural sector, supply may react faster to changes in market conditions, particularly for commodities with crop cycles of around one year. On the other hand, the global food crisis has revealed the constraints that small farmers in developing countries face in increasing productivity (see also the annex to this chapter). As a result of the credit crunch, farmers have difficulty financing inputs, such as seeds and fertilizers, as well as new investments, forcing them to reduce plantings (von Braun, 2008; FAO, 2008). Reduced plantings worldwide, stemming also from lower agricultural prices and a slow downward adjustment of input prices, are expected to lead to lower harvests in the 2009/10 season.[13] In general, tighter credit conditions are a greater problem for farmers in developed and middle-income developing countries. However, the direct financial impact of the crisis most probably has been proportionately lower for producers of agricultural commodities than for producers in the energy or mineral and metals sectors. This is because of the generally more conservative financing strategies in the agricultural sector (OECD-FAO, 2009). Over the medium to long term, however, any delayed investment for improving agricultural productivity will perpetuate existing supply constraints in developing countries.

Overall, demand from China continues to play a key role in world commodity market developments (chart 1.3), and has tended to have a stabilizing effect in the context of the current crisis. Given the continuing growth dynamics of China and a number of other large emerging-market economies, commodity prices could turn upwards again in response to signs of a global recovery. However, they may not return to the peaks registered in the first half of 2008 any time soon unless price movements caused by fundamental factors get amplified by speculative trading on commodity markets. The economic stimulus packages introduced in many countries can play an important role in boosting demand for commodities from its current low levels in the short term, because they

have a strong infrastructure investment component. Prices are also likely to remain very volatile due to considerable uncertainty in the markets and to the intense financialization of commodity markets. From a longer term perspective, however, there may be increasing pressure on natural resources, and commodity markets could tighten again in a few years' time.

B. The unfolding of the current global crisis

The present economic crisis was not a bolt from the blue; it broke out following years of huge disequilibria within and among major national economies. The most visible evidence of imbalances was the large current-account deficits in the United States, the United Kingdom, Spain and several East European economies, on the one hand, and large surpluses in China, Japan, Germany and the oil-exporting countries, on the other. These international imbalances were accompanied by mounting domestic tensions. In the United States, economic growth was dependent on debt-financed household consumption, made possible by reckless credit distribution and a growing bubble in the housing market. In China, growth based on exports and extremely high investment ratios accentuated economic, social and regional disequilibria, and prompted a policy reorientation aimed at promoting social expenditure and domestic consumption. In the euro area, tensions arose between member States as wage increases in Germany were kept below productivity gains, which undermined the competitiveness of producers in other countries.

Clearly, such disequilibria could not continue indefinitely. A globally coordinated adjustment whereby surplus countries would expand domestic demand was consistently advocated by many observers and institutions, including UNCTAD in several of its *Trade and Development Reports* (*TDRs*).[14] However, policymakers failed to acknowledge the need for an internationally balanced macroeconomic management of demand, and, in several cases, greatly overestimated inflationary risk.[15] A hard-landing scenario was thus predictable. It could have occurred in international markets, if continuous current-account imbalances had eventually led to a dollar crisis. Instead, the crisis erupted in the United States financial system when the housing bubble burst, revealing the insolvency of many debtors and translating into a full-blown financial crisis which rapidly spread throughout the international financial system.

The current financial crisis has much in common with previous crises: it followed the classical sequence of expansion, euphoria, financial distress and panic (Minsky, 1975; Kindleberger, 1978). During the expansionary phase, new profit opportunities attract investors and tend to increase asset prices; the resulting wealth-effect reinforces economic growth through higher demand. In the euphoria phase the process feeds on itself, since, unlike what typically happens in goods markets, rising prices of financial assets tend to increase demand for them, and this reinforces the belief of investors and speculators that the upward price trends will persist. This process can continue for quite a while, especially if investors can leverage their positions through credit, and thereby sustain the demand for financial assets. Indeed, the increasing market value of financial assets leads to an underestimation of risk by both borrowers and creditors, and facilitates access to ever more credit. The rising indebtedness of the non-financial sector and the growing leverage of financial institutions increase the vulnerability of the entire system to asset price changes.

In the build-up of the financial crisis, a large proportion of the credit expansion in the United States and other developed economies financed real estate acquisitions, fuelled asset price inflation and

spurred debt-financed private consumption. After 2000, household debt increased rapidly in many countries (chart 1.4). The increase was particularly rapid in those economies where current-account deficits widened and, as a result, external liabilities were accumulated by what are sometimes referred to as Anglo-Saxon economies (Australia, Ireland, the United Kingdom and the United States) and by a number of Eastern European countries where household debt increased more than threefold, albeit from relatively low levels. This was similar to developments in Spain, where household debt had already started to rise in the mid-1990s. In other major developed economies, such as Germany and Japan – two of the main surplus economies – such debt rose more slowly, or even fell.

What makes this crisis exceptionally widespread and deep is the fact that financial deregulation and innovation raised credit leverage to unprecedented levels. Blind faith in the "efficiency" of deregulated financial markets led authorities to allow the expansion of a "shadow" financial system, in which investment banks, hedge funds and special investment vehicles were allowed to operate with little or no supervision and capital requirements (see chapter III). Moreover, the underestimation of risks, typical during financial booms, was aggravated by deficiencies in the operations of the rating agencies.

The euphoric phase came to an end when GDP growth in the United States began to slow down in mid-2006, the housing market there ceased to expand and the rise in asset prices – a vital condition for many debtors to remain solvent – levelled off. By that time it had become clear that economic growth led by debt-financed private consumption was unsustainable (*TDR 2006*, chap. I, section C.3).

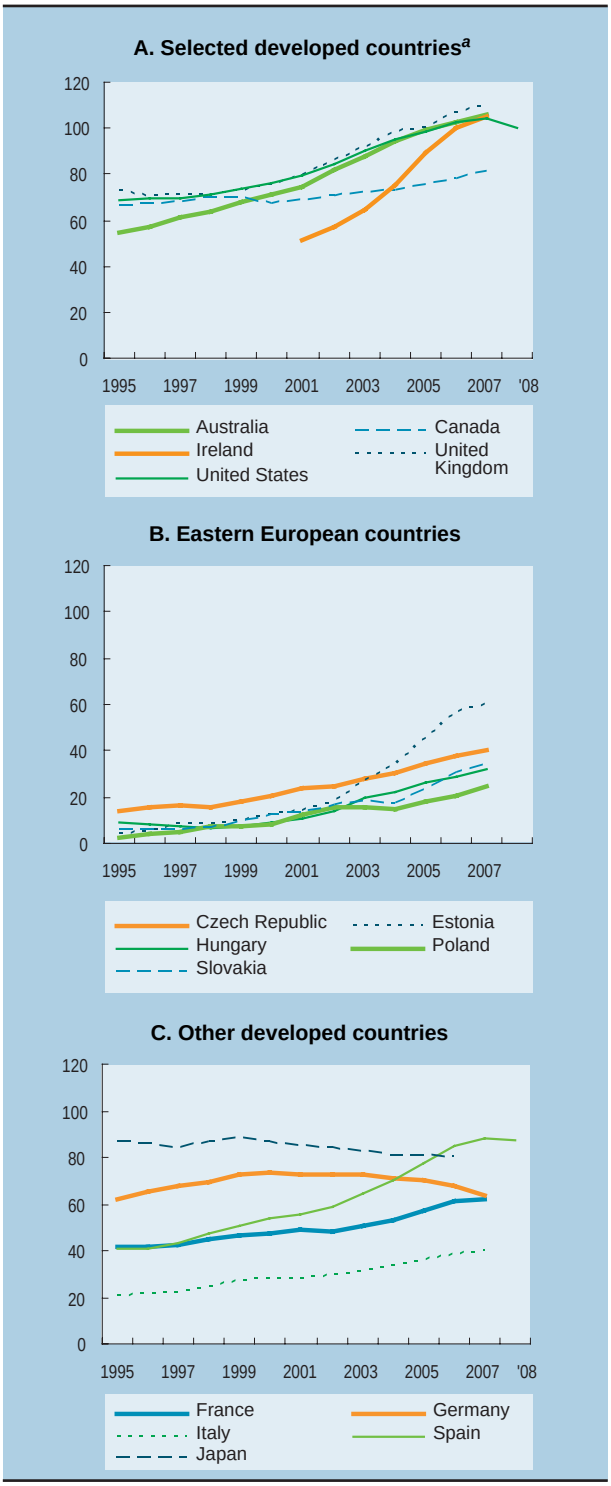
The financial crisis rendered a soft landing impossible. Credit supply came to a sudden halt, as banks and other financial intermediaries ran out of liquidity and assets that had served as collateral for the debt of households and firms lost value at increasing speed. Asset depreciation led many debtors to insolvency and dramatically worsened the quality of financial institutions' portfolios.

The emergency provision of liquidity by central banks prevented large-scale bankruptcies, but it could not ensure the continuity of credit flows. Commercial banks had to be recapitalized, not only because they were suffering losses from non-performing loans, but

Chart 1.4

HOUSEHOLDS' LIABILITIES IN SELECTED COUNTRIES, 1995–2008

(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on OECD, *National Accounts* database; and national sources.

a These comprise countries which are sometimes referred to as Anglo-Saxon countries, and Canada.

also because the remaining assets suddenly became more risky and – following the Basel II prudential criteria – required higher capital coverage. In order to comply with more stringent capital requirements, their provision of credit had to be cut back. Other financial institutions (e.g. investment banks, hedge funds and special investment vehicles), which relied heavily on short-term credit for covering long-term positions, were thus forced to sell part of their assets in order to meet short-term liabilities. The sudden contraction of credit supply exerted additional downward pressure on asset prices, causing a further deterioration in the solvency of borrowers and financial intermediaries alike,[16] and accelerating the process of debt-deflation (Fisher, 1933).

In this process, financial distress spread rapidly to the "real" sector of the economy. Overindebtedness and insolvency, credit shortages and negative wealth effects due to losses in real estate and financial assets led to a contraction of final demand, especially for business and residential investment and durable consumer goods, all of which rely on credit finance.[17] As a result, year-on-year industrial production in the United States in the period January to April 2009 plunged by 12 per cent, and the volume of goods imports fell by 19.6 per cent. United States merchandise exports fell (by 15.9 per cent), as economic activity in its main trading partners also declined. Once the recession had set in, increasing unemployment led to a second round of falling demand. Between June 2008 and March 2009 unemployment grew further, from 5.6 to 8.5 per cent in the United States and from 7.4 per cent to 8.9 per cent in the euro area. Unemployment is expected to rise to double-digit levels in 2010.[18]

C. The ramifications of the spreading crisis

The world economy is experiencing a synchronized downturn: financial markets, capital flows, international trade and economic activity have been affected in all the regions of the world. The relative importance of the different channels of transmission between countries and markets has varied across countries, depending on factors such as initial current account and foreign asset or liability positions, exposure to private international capital flows, composition and direction of international trade in manufactures and services, dependence on primary commodity exports and inflows of migrants' remittances.

1. *Financial contagion, speculation and adjustment*

Since September 2008, financial markets for very different types of assets and in all major countries have been hit almost simultaneously by a financial shock of unprecedented magnitude. Financial distress spread from one market to another, regardless of long-term "fundamentals". The financial shockwave submerged stock and bond markets in many countries, exchange rates of some emerging-market currencies and primary commodity markets all at the same time (chart 1.5).

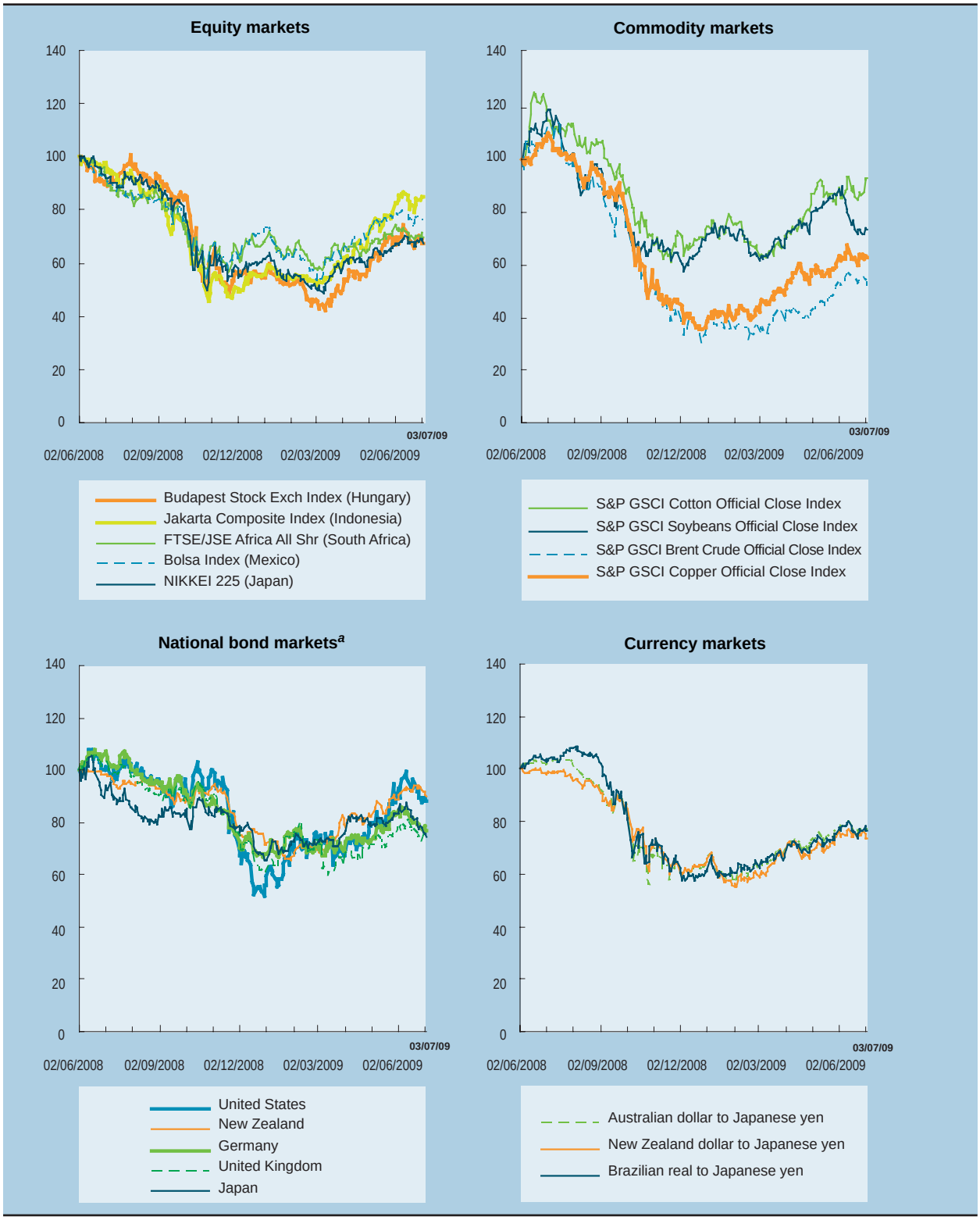
The uniform reaction of so many different markets is often taken as an indication of the interdependence of these markets in a globalized economy. But there is more to it. The high correlation of the day-to-day price movements in many different markets that are not linked by economic fundamentals is largely due to the strong influence of speculative behaviour in all these markets (UNCTAD, 2009b).

According to the Bank for International Settlements (BIS, 2009), external bank assets, which had grown at an annual rate of 20 per cent between March 2002 and March 2008, declined by 14 per cent during the remainder of 2008. As net bank financing shrank, outstanding bank assets fell significantly, not only in

Chart 1.5

EVOLUTION OF PRICES IN SELECTED MARKETS AND COUNTRIES, JUNE 2008–JULY 2009

(Index numbers, 2 June 2008 = 100)



Source: UNCTAD secretariat calculations, based on Bloomberg.
a Yields on 10-year bonds.

developed countries but also in developing countries and offshore centres. Overall, private capital flows to emerging markets are expected to fall sharply. Preliminary data show a 50 per cent decline in such flows in 2008 to $466 billion, from a record level of $929 billion in 2007 and a further fall is forecast in 2009, to estimated flows of only $165 billion. To the extent that much of this capital was not used for productive purposes, the effect on investment and growth in developing countries may be small. However, lower capital inflows may complicate the rollover of foreign debt in a number of countries. Distinct from private capital flows, official flows to developing countries, mainly from international financial institutions, increased from $11 billion in 2007 to $41 billion in 2008 (IIF, 2009).

In response to the flight from risk, some smaller developed economies have taken measures to contain the effects of capital inflows on their economies and on their future exposure to the vagaries of liberalized capital markets. For example, in early 2009, the Swiss National Bank decided to systematically intervene in the currency market to limit the revaluation of the Swiss franc. This currency had depreciated over several years in the run-up to the financial crisis as it was one of the currencies, together with the yen, in which carry trade activities had led to massive capital outflows. As risk aversion grew with the financial crisis, capital flows and exchange-rate trends turned around. Similarly, the Austrian financial authorities decided in June 2009 to ban Austrian households from borrowing in foreign currency, which in the past mostly took the form of mortgages in Swiss francs.

Global foreign direct investment (FDI) flows fell sharply, by 14.5 per cent in 2008, mainly on account of a strong reduction in inflows to European countries in the form of mergers and acquisitions (UNCTAD, 2009c). In developing and transition economies, FDI inflows continued to rise in 2008, although at slower rates than in previous years. Preliminary data for 2009 indicate a general decline in FDI inflows, in developed, developing and transition economies alike. In the first quarter of the year FDI fell by 50 per cent year-on-year. This reflected a generally lower propensity to invest in real productive capacity, owing to shrinking final demand, tightening credit conditions and falling corporate profits (UNCTAD, 2009d).

Different kinds of financial shocks have had varying impacts on diverse economies. Losses in previously overvalued stock prices have reduced perceived household wealth more in developed countries than in developing countries. In the United States, household wealth in terms of outstanding financial assets fell by $10 trillion, and in terms of real estate value by $3 trillion in only 15 months. As a result, the net worth of households shrank from 629 per cent of disposable income in the third quarter of 2007 to 483 per cent in the last quarter of 2008.[19] For other developed economies, partial data suggest a similar trend. For example, in addition to losses from stock prices, falling real estate prices caused losses of 14 per cent in the United Kingdom, and 7 per cent each in France and Spain.[20] Such reductions affected consumption demand mainly in countries where household savings rates had fallen during the boom, based on the expectation that the high valuations of stocks and other assets would persist. The impact of stock market developments on the real economy has been smaller in most developing countries, as stock markets are not a major source of finance for their firms and only a small percentage of private savings is held in corporate shares.[21]

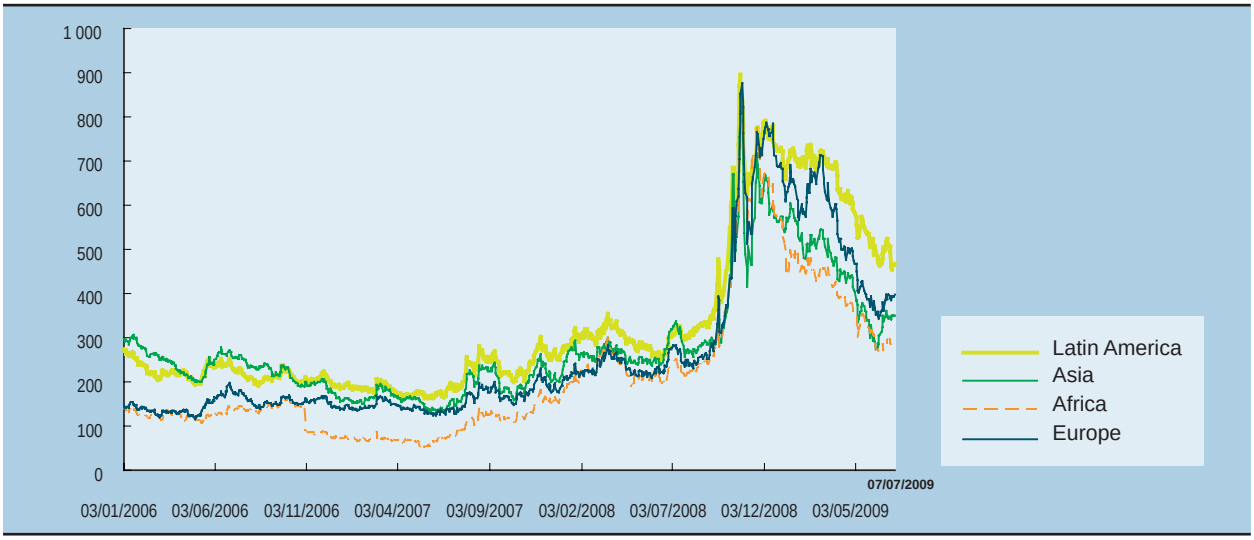
Many developing and transition economies have felt the impact of the flight to safety and the revised risk evaluation by rating agencies through worsening conditions for longer term external financing. Spreads over United States Treasury bonds for emerging-market sovereign debt rose steeply in September 2008, following several years of being rather low (chart 1.6). Interest spreads shrank significantly in the second quarter of 2009, reflecting a renewed "risk appetite" among investors.

Those economies that had posted current-account surpluses for several years before the crisis and accumulated significant amounts of international reserves have proved less vulnerable in the current crisis than in previous crises. This is the case particularly for several Asian and Latin American developing countries that had experienced financial and currency crises between 1997 and 2001. Countries that have been pursuing active exchange-rate policies to prevent overvaluation have not only been able to avoid large current-account deficits, but their cushion of foreign exchange reserves, stabilization funds and/or sovereign investment funds, also give them greater financial and policy flexibility to cope with the consequences of the global crisis. As these countries are not rigidly committed to either fixed or entirely flexible exchange rates, they accepted

Chart 1.6

YIELD SPREADS ON EMERGING-MARKET BONDS, JANUARY 2006–JULY 2009

(Basis points)



Source: Bloomberg.
Note: Data refer to JPMorgan Emerging Markets Bond Index, EMBI+.

a depreciation of their currencies in September–October 2008, instead of trying to stick to the peg by steeply raising their interest rates, as had frequently been the practice between 1997 and 2001. Their sale of international reserves and a moderate use of monetary tools in response to the pressures on their currencies have prevented excessive exchange-rate depreciations. The domestic banking systems have also remained resilient because, in drawing lessons from financial crises in the not-too-distant past, financial policies have been able to keep private sector indebtedness and the degree of leverage of the banking sector relatively low. Moreover, in these countries, deposits have been the basic counterpart of credit in banks' balance sheets. As a result, their banking systems were not hit by credit deleveraging when other sources of funding dried up.

The situation has been quite different in countries which have experienced huge losses in international competitiveness and rising current-account deficits over the past few years. This is particularly true for several emerging-market economies in Europe and the CIS. These countries had seen enormous gross and net inflows of capital, largely attracted by interest rate differentials. Such inflows led to substantial overvaluation of the local currencies with a concomitant loss of international competitiveness of their domestic producers. This resulted in extreme financial fragility, with mounting domestic and external indebtedness, and currency mismatches between debt and income. When the external shock from the subprime crisis hit the global economy the flight from risk stopped short-term private capital inflows and forced currency devaluation in a number of countries with huge current-account deficits and debt commitments, such as Hungary, Iceland and Ukraine. Other countries, such as the Baltic States and Pakistan, renewed their commitment to a fixed peg. The central banks of these countries were forced to use a large share of their international reserves to contain currency depreciation, but as the reserves were insufficient, they also had to turn to the IMF and the EU for financial support (see also section D.5).

In the second quarter of 2009, prices in most of the world's stock markets began to recover. Prices for several primary commodities followed a similar pattern, and several currencies that had suffered attacks in late 2008 also moved in parallel. These developments confirm the strong correlation between markets that are not fundamentally related to each other but are subject to the same kind of global portfolio management decisions. For example, the

increase in the price of oil is closely correlated with the recovery of the Australian dollar and the Hungarian forint, the price of cotton rises in parallel with stocks in Malaysia, and the price of soybeans moves in tandem with government bond yields in a number of countries (see chart 1.5 above). In addition to the puzzle of the correlation of such unrelated markets, there is a glaring discrepancy between the situation in the real economy and in financial markets: these markets are showing signs of "recovery" despite the continuing global recession.

Are the financial markets signalling a recovery or are they only testing the water in anticipation of a recovery, as is typical of a so-called bear run? Recent trends appear to be the result of financial market analysts' simplistic and misleading interpretations of a few "green shoots" in leading economic indicators. Since gains in financial markets are based on the principle of "first come, first served", the markets are always ready for a take-off, be it justified or not. Indeed, they tend to interpret a situation as being driven by real factors even if the real factors are just mirages, such as perceived signs of economic recovery in certain economies or fears of forthcoming inflation. As long as financial prices are largely determined by speculative flows – with correlated positions moving in and out of risk – markets cannot deliver an efficient outcome. Speculative positions distort important prices instead of sending price signals that help improve the allocation of resources in the real sector of the economy. Recognizing the lack of economic logic of these markets is key to understanding the roots of the current crisis, and should be the basis for further policies and reforms aimed at stabilizing the financial system.

2. International trade

The evolution of international trade has mirrored that of economic activity. The volume of trade of developed countries levelled off in mid-2007, while GDP and trade in developing countries continued to expand in real terms until the third quarter of 2008. The worsening of the financial crisis in September 2008 radically changed economic conditions, leading to an abrupt downturn in production and trade across all the regions (chart 1.7). In the first quarter of 2009, the volume of world trade was 19 per cent below its level of the previous year. It was even dramatically lower when measured in current dollar prices, as prices of most primary commodities fell sharply in the second half of 2008. Indeed, owing to the "financialization" of commodity markets (see chapter II), the recent boom and bust cycle of primary commodity prices can be interpreted as a symptom of the financial crisis itself.

It has also been suggested that financing international trade has become more difficult, particularly for exports from developing countries, due not only to the more generalized credit crunch, but also to more stringent capital requirements of banks for their short-term exposure to low-income countries (Caliari, 2008). Some observers argue that implementation of Basel II has eroded the incentive of banks to provide trade finance, which constitutes a particular problem for small and medium-sized enterprises. The Banking Commission of the International Chamber of Commerce (ICC, 2009) has reported that, on average, the capital intensity of trade credit under Basel II is four to five times higher than it was under Basel I. In the current situation, a tightening of trade financing conditions in the context of reforms in banking regulation is paradoxical, because trade credit involves financial instruments that are of the utmost importance for international trade activities. Moreover, historically these activities have involved very low risk, whereas the financial crisis was caused by a number of high-risk activities in the financial sector that have been almost entirely unrelated to activities in the real sector.

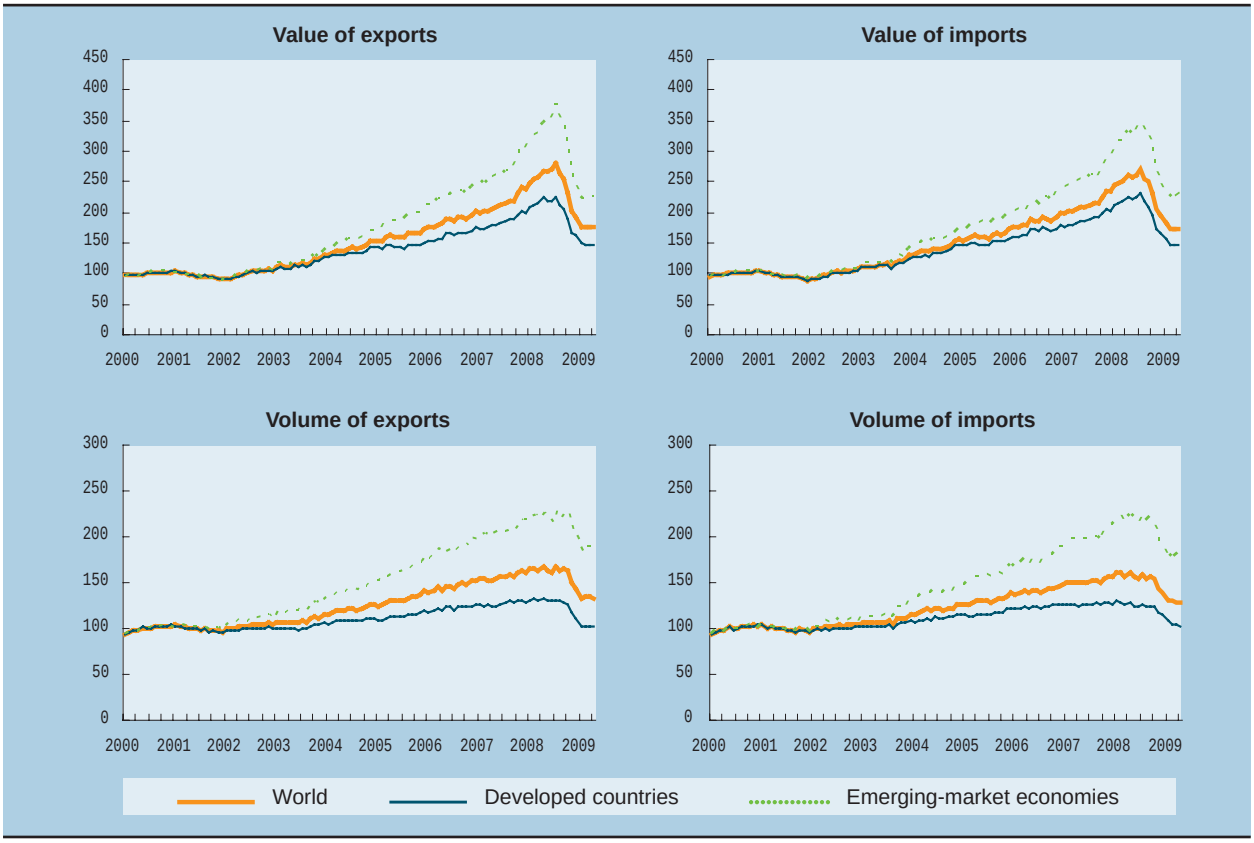
As the ICC explains, the lower availability of trade credit is not the result of an explicit recommendation for the treatment of credit in an effort to achieve a more appropriate capital adequacy ratio; rather it is due to the way in which a more general recommendation is implemented. While trade financing typically has a maturity of six months or less, the Basel II framework applies a one-year maturity floor for all lending facilities, which artificially inflates the capital costs of trade financing. It is therefore desirable for governments and international financial institutions to encourage national regulators to use the discretion they have to waive this floor for trade credits in order to prevent financial regulation reforms from having an unnecessary and procyclical impact on trade and production activities.

The simultaneous decline of exports and imports in all regions and subregions is another symptom of

Chart 1.7

WORLD TRADE BY VALUE AND VOLUME, JANUARY 2000–APRIL 2009

(Index numbers, 2000 = 100)



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

the global nature of this crisis. In countries with a high share of manufactures in their export structure, and especially in countries that participate in international production networks, lower foreign demand leads to lower imports of raw materials and intermediate products. In primary commodity exporters, lower prices reduce the purchasing power of their exports. This effect of a parallel decline of exports and imports in most countries differs from that of more localized crises in the past, when the imports of the affected countries fell due to lower domestic demand, but their exports were much more resilient as demand in foreign markets continued to grow.

It is mainly the demand for investment and durable consumer goods that is falling. This is because the consumption of such goods can be more easily deferred than that of food and basic services, but also because their acquisition partly relies on credit, which at present is more difficult and costly to obtain. As a result, countries that have a high share of investment and durable consumer goods in their total output have experienced a larger fall in industrial production and overall GDP growth than others. Among developed countries, Germany and Japan, for instance, have been worse affected by their declining exports of manufactures than other countries (table 1.4).

Several developing economies in Asia that are closely integrated into a dense production network for manufactures, and for which exports of manufactures represent a substantial share of GDP, such as Malaysia, the Republic of Korea, Singapore, Taiwan Province of China and Thailand, are also experiencing

Table 1.4

GDP, MANUFACTURING OUTPUT, GROSS FIXED CAPITAL FORMATION AND EXPORTS IN SELECTED COUNTRIES, FIRST QUARTER 2009

(Year-on-year percentage change)

	Real GDP	Manu-facturing output	Gross fixed capital formation	Exports (Current $)		***Memo item:*** *Share of manufacturing exports in GDP, 2008 (Per cent)*
				Total	Manu-factures	
Developed countries						
Australia	0.4	-7.9	-1.3	-4.5	-27.5	2.8
France[a]	-3.2	-18.7	-7.0	-21.6	-29.3	16.8
Germany[a]	-6.9	-20.9	-11.2	-21.0	-22.4	35.6
Japan	-8.8	-34.0	-14.9	-39.7	-40.6	14.1
United States	-2.6	-11.5	-14.5	-22.3	-20.8	6.9
Emerging-market economies						
Brazil	-1.8	-12.6	-14.0	-19.4	-29.1	5.9
Chile	-2.1	-9.1	-9.3	-41.5	-30.2	7.5
China	6.1	9.7	28.6	-19.7	-19.7	30.2
China, Taiwan Province of	-10.2	-33.1	-33.8	-36.7	-36.9	65.9
Colombia	-1.1	-7.6	-0.1	-13.2	-10.3	4.8
Costa Rica	-5.0	-16.9	-13.2	-14.9	-18.5	20.6
Hungary	-5.4	-23.2	-5.5	-38.7	-39.5	60.0
India	4.1	-0.2	6.4	-28.1	..	8.1
Indonesia	4.4	-3.7	-3.4	-31.8	-24.7	10.3
Malaysia	-6.2	-16.3	-10.8	-20.0	-18.2	48.5
Mexico	-8.6	-10.9	-11.8	-28.6	-22.8	21.1
Republic of Korea	-4.3	-16.8	-6.2	-24.9	-30.0	34.6
Russian Federation	-9.8	-19.6	-16.3	-47.7	-37.1	5.1
Singapore[b]	-10.1	-24.3	-14.8	-31.1	-26.1	67.4
South Africa	-1.3	-13.2	2.6	-31.3	..	15.0
Thailand	-7.1	-18.5	-15.8	-23.1	-21.9	45.9
Turkey	-13.8	-24.7	-29.7	-26.2	-32.7	14.1

Source: UNCTAD secretariat calculations, based on United Nations, *UN COMTRADE* database; OECD, *StatsExtracts* database; ECLAC, *CEPALSTAT* database; Economic Intelligence Unit (EIU); and national sources.

a Exports in euros.

b Exports exclude re-exports.

a strong contraction in economic activity, with GDP growth plunging between 4 and 10 per cent in the first quarter of 2009. In other Asian countries, such as China, India and Indonesia, declining exports of manufactures have had a less dramatic effect on industrial output and GDP owing to their large and still expanding domestic markets.

In Latin America, exports have fallen in all countries, but the impact of the crisis has been particularly strong in countries such as Mexico and Costa Rica, where GDP has been contracting rapidly since the last quarter of 2008. These economies rely heavily on exports of manufactures to the United States, and they have also been affected earlier and to a greater

extent than other countries by lower income from tourism and workers' remittances. Although South American countries are also experiencing shrinking exports of manufactures, these exports contribute a lower share to total GDP: between 5 and 8 per cent in Brazil, Chile and Colombia, compared with more than 20 per cent in Costa Rica and Mexico and more than 30 per cent in many Asian economies (table 1.4). On the other hand, they are more vulnerable to the falling prices of primary commodities.

These declined sharply in the second half of 2008 (see above section A.2), with attendant consequences for the terms of trade. Like the preceding boom, the price slump associated with the global recession is affecting developing countries differently, according to their commodity trade structure. It has brought some relief to most energy- and food-importing countries, but in many cases this has been tempered by lower prices of other commodities that they export. The strongest negative impact of terms-of-trade changes are being felt in Africa and the least developed countries (LDCs), but also in many countries in Latin America, West Asia and the CIS that are highly dependent on oil. Lower export prices for commodities often have an impact on public finances, as many developing countries depend heavily on tax revenues from such exports, and translate into lower public consumption and investment. In some countries that had built financial cushions during the commodity boom, public expenditure could be maintained or even expanded. Nevertheless, in most oil or mining exporters in West Asia, North Africa and South America the losses from deteriorating terms of trade have contributed to a marked slowdown of GDP growth.

The global financial and economic crisis has also affected trade in services. The growth of world exports of transport, travel and other commercial services decelerated from 19 per cent in 2007 to 11 per cent in 2008. Based on available data, year-on-year global exports of commercial services in the fourth quarter of 2008 fell by 7–8 per cent (WTO, 2009). Maritime transport services reacted rapidly to the slowdown of global demand. Data on the deployment of both dry and liquid bulk, as well as on container ships, confirm an increasing withdrawal of vessels from service. Accordingly, the crisis has led to reduced port traffic. In addition, freight rates fell substantially during the final months of 2008. After reaching a peak in May 2008, the Baltic Dry Index plunged to its lowest level by the end of October (UNCTAD, 2009e).

Lower demand for travel services has also served to spread the economic crisis across countries. International tourist arrivals declined by 2 per cent in the second half of 2008, compared with an increase of 6 per cent in the first half of the year. Data for January and February 2009 indicate a roughly 8 per cent year-on-year fall. All regions have registered negative growth, with the exception of Africa, Central and South America.[22] West Asia, South Asia and Europe have been among the worst affected regions, with declines of 28.2, 14.6 and 8.4 per cent respectively. The World Tourism Organization (UNWTO) expects international tourism to stagnate or even decline by 2 per cent in 2009 (UNWTO, 2009).

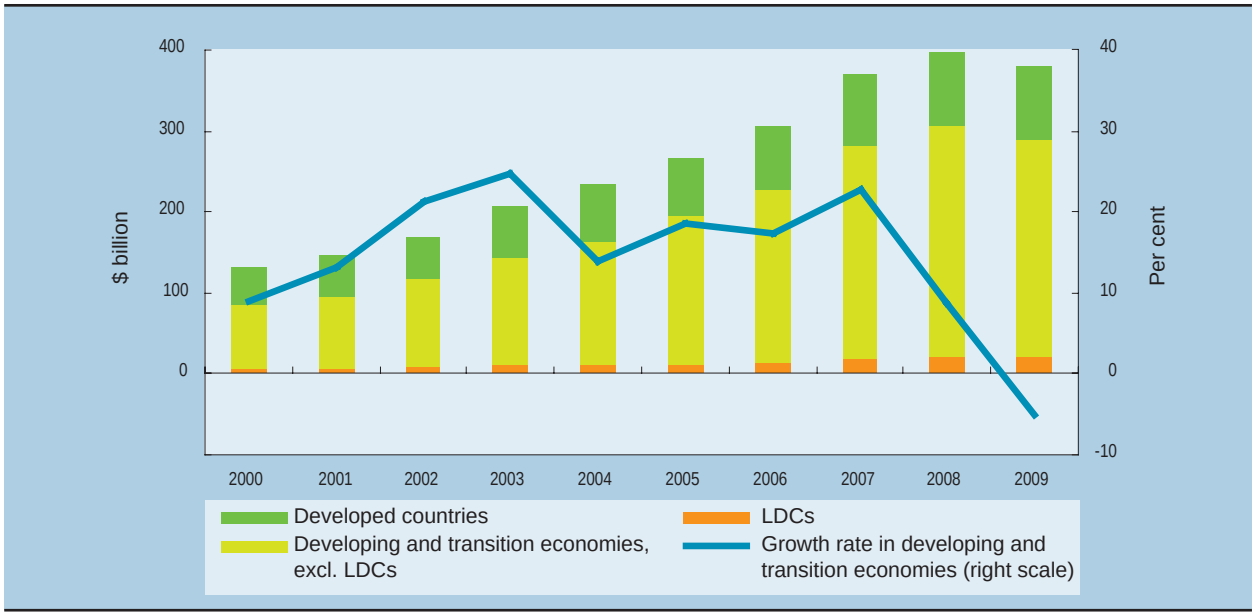
3. Migrants' remittances

In recent years, migrants' remittances have become an important source of foreign exchange earnings for many developing and transition economies. At the microeconomic level they help sustain the living standards of many households, often lifting them out of poverty. They are also a source of financing for small enterprise and for residential investments. Statistical data on the evolution of migrants' remittances do not reflect the large proportion of remittances that are transferred through informal channels, which therefore are not recorded in balance-of-payments statistics. Although workers' remittances have frequently displayed countercyclical tendencies, as workers tend to send more money home when their home economies are experiencing adverse economic conditions, there is likely to have been only a small countercyclical effect, if any, in the current context, owing to the global reach of the crisis.

The strong rise in recorded remittances after 2000 was followed by a deceleration of flows to developing and transition economies in 2008 (chart 1.8). Over the year as a whole, remittances still rose by 8.8 per cent compared with 2007, to a total of $305 billion. Not counting the largest recipient, India – which benefited from a particularly strong rise in 2008 – the growth rate was only 6.1 per cent. In the second half of 2008, migrants' remittances began to decline, and in 2009 they are expected to fall by between 5 and 8 per cent (Ratha and Mohapatra, 2009), with reductions expected in all regions (table 1.5).

Chart 1.8

MIGRANTS' REMITTANCES, BY ECONOMIC GROUP, 2000–2009



Source: UNCTAD secretariat calculations, based on Ratha, 2009; and Ratha and Mohapatra, 2009.
Note: Migrant's remittances are workers' remittances, compensation of employees and migrants' capital transfers. Data for 2008 are preliminary estimates; data for 2009 are forecasts.

Table 1.5

GROWTH OF WORKERS' REMITTANCES TO DEVELOPING AND TRANSITION ECONOMIES, BY REGION,[a] 2000–2009

(Average annual percentage change)

	2000–2006	*2007*	*2008[b]*	*2009[c]*
Developing and transition economies	16.9	22.7	8.8	-5.0
of which:				
Europe and Central Asia	19.6	31.5	5.4	-10.1
Latin America and the Caribbean	19.0	6.6	0.2	-4.4
Middle-East and North Africa	10.9	21.6	7.6	-1.4
East Asia and the Pacific	19.6	23.2	7.2	-4.2
South Asia	15.2	31.5	26.7	-4.2
Sub-Saharan Africa	17.2	44.4	6.3	-4.4

Source: UNCTAD secretariat calculations, based on Ratha, 2009; and Ratha and Mohapatra, 2009.
a Country groups as listed in the source.
b Preliminary estimates.
c Forecast.

Migrants' remittances are concentrated in a relatively small number of recipient countries: 10 countries account for more than half of total remittances, and the three largest recipients (India, China and Mexico) for more than one third. Whereas workers' remittances to India increased by more than a quarter in 2008, they already started to decline in Mexico (table 1.6). But remittances have a relatively large weight in many smaller – and mainly low-income – economies. In 2004, there were only two economies (Jordan and Lesotho), where remittance inflows amounted to 20 per cent of GDP or more, but by 2008 their number had quadrupled. In 16 developing and transition economies the share of inward remittance flows in GDP exceeded 10 per cent. Countries where such remittances account for a considerable share of GDP are particularly vulnerable to recession in the main immigration economies (i.e. countries of the European Union and the Gulf Cooperation Council, the Russian Federation and the United States), especially the sharp contraction in the construction and services sectors, which employ the largest number of foreign workers.

Table 1.6

MAJOR REMITTANCE-RECEIVING DEVELOPING AND TRANSITION ECONOMIES IN 2008

	Inflow of migrants' remittances	Annual change	Share of remittances in GDP
	($ million)	(Per cent)	
Ranked by volume			
India	45 000	27.6	3.7
China	34 490	5.0	0.8
Mexico	26 212	-3.4	2.4
Philippines	18 268	12.1	10.8
Nigeria	9 979	8.2	4.7
Egypt	9 476	23.8	5.8
Bangladesh	8 979	36.8	11.0
Pakistan	7 025	17.1	4.2
Morocco	6 730	0.0	7.8
Indonesia	6 500	5.3	1.3
Lebanon	6 000	4.0	20.7
Viet Nam	5 500	0.0	6.1
Ukraine	5 000	11.0	2.8
Colombia	4 523	0.0	1.9
Russian Federation	4 500	9.7	0.3
Ranked by share in GDP			
Tajikistan	1 750	3.5	34.1
Lesotho	443	0.0	27.4
Moldova, Republic of	1 550	3.5	25.3
Guyana	278	0.0	24.0
Lebanon	6 000	4.0	20.7
Honduras	2 801	6.7	19.6
Haiti	1 300	6.4	18.0
Nepal	2 254	30.0	17.8
Jordan	3 434	0.0	17.1
Jamaica	2 214	3.3	17.1
El Salvador	3 804	2.5	17.0
Kyrgyzstan	715	0.0	14.2
Nicaragua	771	4.2	11.5
Guatemala	4 440	4.4	11.2
Bangladesh	8 979	36.8	11.0

Source: UNCTAD secretariat calculations, based on Ratha, 2009; and *UNCTAD Handbook of Statistics* database.

Despite the crisis and the concomitant fall in migrants' remittances to developing countries, these remittances will nevertheless provide a larger foreign exchange inflow than official development assistance (ODA). However, the outlook for remittances, similar to that for exports of goods and services, depends on the effectiveness of economic stimulus packages, but also on possible changes in legislation pertaining to immigration of foreign workers in response to rising unemployment.

4. Developing-country debt and official development assistance

The financial crisis and the resultant global economic recession have undermined many of the fundamentals that had led to improvements in the debt situation of developing countries since 2002. The impact of the crisis on the debt positions has varied from country to country in terms of both timing and magnitude, depending on their initial economic conditions, the size and composition of their external debt, and the composition of their foreign exchange earnings. Unfavourable terms-of-trade changes, declining export demand, contraction in tourism and lower remittances resulting from the global economic crisis have reduced foreign exchange reserves and the ability of countries to service their external debt without compromising their imports.

Several transition economies in Eastern Europe and Central Asia had a large stock of foreign debt and current-account deficits even before the crisis, and their debt indicators are likely to become still worse in the context of stagnant or falling foreign exchange earnings. By contrast, due in part to its large accumulation of international reserves, Asia is better prepared than other regions to cope with the impacts of the global economic crisis. For the majority of countries in that region, it is unlikely that debt-to-GDP ratios will worsen significantly, despite a substantial deceleration of growth owing to their heavy reliance on exports. Most countries in Latin America had also increased their foreign exchange reserves, in addition to reducing their external debt, thanks to their current-account surpluses in 2005, 2006 and 2007. The ratio of external debt to GDP for Latin American countries fell, on average, from 42 per cent of GDP in 2003 to 19 per cent in 2008. In 2008, the region's current account went into deficit, which is expected to increase further in 2009 (to 2.3 per cent of GDP), despite the partial recovery in commodity prices (ECLAC, 2009a). Accordingly, debt indicators are likely to worsen for some Latin American countries, which will require additional official financing.

African countries have been the most seriously affected by the fall in primary commodity prices and the shortage of trade finance, but less so by reduced access to credit from private capital markets to which they have limited access even in normal times. Current debt servicing and debt sustainability has become more problematic, particularly in low-income countries, including several heavily indebted poor countries (HIPCs) that have passed the completion point under the HIPC debt relief initiative. In June 2008, 38 low-income countries, most of them in Africa, were estimated to have reserve holdings equivalent to less than three months of imports (IMF/IDA, 2008). In March 2009, the debt-to-GDP ratios of 28 low-income countries were reported to exceed 60 per cent – twice the value of the threshold level for debt sustainability for weak performers (IMF, 2009a).

The increasing difficulties of governments to honour their public debt servicing obligations are closely related to their deteriorating fiscal positions. About a quarter of low-income countries will face a fall in public revenue of more than 2 percentage points of GDP in 2009, and budget deficits in Africa are expected to rise, on average, by 4.7 percentage points of GDP (World Bank/IMF, 2009). To make matters worse, with the flight of international banks to safety after September 2008 exchange rates of many low-income countries depreciated, raising the domestic-currency equivalent of their debt servicing burden and their debt-to-GDP ratio. For instance, the dollar exchange rate of Zambia depreciated by 30 per cent, that of Ghana by 9 per cent and that of Uganda by 25 per cent.

A significant number of HIPCs that have passed completion point for debt relief will continue to remain at moderate or high risk of debt distress. As of June 2009 only 8 out of 24 HIPCs in this group could be considered as having low risk of debt distress, while four countries (Burkina Faso, Burundi, Gambia and Sao Tome and Principe) had a high risk of, or were already in, a situation of debt distress. On the whole, the debt sustainability of HIPCs that have passed completion point remains highly vulnerable to shocks. A worrying trend for the countries that are beyond completion point is that short-term debt is expected to rise considerably faster than more stable medium- to long-term debt. This gives rise to greater vulnerability to rollover difficulties and increases the risk of sovereign default (Detragiache and Spilimbergo, 2004). Against the background of the credit crunch, rolling over of short-term external debt has become more difficult and may imply considerably higher refinancing costs. Prospects are even bleaker for the countries that have not yet reached decision point under the HIPC Initiative, many of which are conflict or post-conflict countries. Under these conditions, a temporary moratorium on debt repayments could help prevent the emergence of a new, generalized external debt problem in developing countries (see section D.5 and box 1.2).

In 2008, total net ODA from members of the OECD Development Assistance Committee (DAC) rose by 10 per cent in real terms, to reach $119 billion (OECD, 2009b). While this is the highest dollar figure recorded to date, it represents only 0.30 per cent of members' combined gross national income (GNI) – a far cry from the 0.7 per cent target. Moreover, there are indications that, owing to the financial and economic crisis, aid budgets may shrink considerably (Roodman, 2008). Over the past 30 years, when donor countries have experienced economic or banking crises ODA has shrunk with a cumulative reduction of 4 per cent in the second year following the crisis, and 30 per cent in the fifth year.

ODA prospects for 2009 are uncertain, because aid budgets are increasingly being subjected to tighter budgetary pressure as donor governments implement large stabilization programmes. On the other hand, since ODA makes up only a small percentage of donor countries' budgets, its continued delivery is primarily a matter of political will. The United States, although at the epicentre of the current crisis, intends to increase its development assistance by 9 per cent in 2010, and Japan has already substantially increased its ODA disbursements; other donor countries may follow. This would not only help maintain the momentum of poverty reduction efforts in the beneficiary countries, but also add to the overall fiscal demand stimulus for the world economy as a whole (see section D.5).

D. Short-term policy responses to the global crisis

1. A late awakening

Most policymakers took a while to recognize the true nature and magnitude of the financial and economic crisis. Soaring global imbalances had long been identified by many observers as posing a severe threat to global stability,[23] but when the first signs of problems emerged at the centre of the global financial system around August 2007, governments were caught off guard and were generally slow to respond. As late as mid-2008, several monetary authorities, including the European Central Bank (ECB), still considered inflationary pressures to be the main risk to the global economy, and consequently tightened their monetary stances.

In all aspects of the policy response to the crisis, the United States led the action. This was largely because the bursting of the real estate bubble, balance-sheet difficulties of financial institutions, as well as signs of an outright recession first emerged in that country. When other governments joined in efforts to combat the crisis, it was mostly in reaction to pressing problems rather than pre-emptive. In some cases, macroeconomic policies have even been procyclical, repeating the policy mistakes that aggravated crises in several Asian and Latin American countries in the late 1990s and early 2000s.

The initial policy response consisted of liquidity provision to banks in the major financial markets to deal with the direct symptoms of the financial crisis. In addition, central banks cut interest rates to lower the cost of credit for both financial and non-financial agents. However, it soon became clear that traditional monetary policy measures would not be sufficient to restore confidence in financial markets, and that unconventional measures would be required by central banks and fiscal authorities to contain the rapidly deteriorating asset positions of financial institutions. This led to unprecedented direct support by governments and efforts to rescue systemically important companies, primarily to strengthen the balance sheets of financial firms in the United States and several European countries.

The need for the United States authorities to provide State guarantees to large financial firms like Fannie Mae, Freddie Mac and Bear Stearns in the course of 2008, were early indications of the severity of the crisis. However, it was not until the collapse of a systemically important financial institution, the financial services firm Lehman Brothers, in September 2008 that the risk of a breakdown of the entire financial system was fully recognized. Subsequently, policymakers sought more systematic solutions for strengthening banks' balance sheets, and as the crisis spilled over into the real sector, governments of most developed countries reacted with fiscal stimulus packages.

Initial policy measures soon turned out to be insufficient and had to be broadened and deepened, leading to an unprecedented scale of government intervention in many developed countries. Governments in many developing and transition economies also embarked on expansionary monetary and fiscal policies, although their policy space for countercyclical action is often perceived as limited or has come to be circumscribed in the context of IMF-supported programmes. The following sections offer a review of the policy measures taken in various countries, along with international efforts to tackle the crisis.

2. Monetary policies

The pressing need for liquidity in the major financial markets was partly due to the high amounts of leveraged bank credit used by many operators in these markets in the build-up to the financial crisis. And it was also partly the result of new funding practices by most financial intermediaries. While traditional banking had relied on deposits for funding, in recent years investment banks, hedge funds, special investment vehicles and even commercial banks frequently issued short-term debt as a source of funding. As the institutions that provided them with liquidity (investment funds, insurance companies, pension funds, big firms and wealthy individuals) lost confidence in the quality of these assets, liquidity in money markets suddenly became scarce, and credit risk translated immediately into liquidity risk (Aglietta and Rigot, 2009). Governments responded to this liquidity crisis through gradual interest rate adjustments which are summarized in table 1.7.

In the United States, the Federal Reserve led the way to monetary easing with a first discount rate cut in mid-August 2007. The Bank of England started to ease its monetary policy stance in small steps only in December 2007. By that time, the ECB had already taken steps to boost liquidity in the banking system, as euro-area banks turned out to be heavily exposed to United States mortgage market risks. The ECB demonstrated much less flexibility than the Federal Reserve and the Bank of England in adjusting its interest rate to the changing macroeconomic situation. In July 2008 it actually raised the policy rate. One year after the outbreak of the market turmoil, and with the United States and the euro-area economies entering into recession, this move clearly reflected the ECB's lack of appreciation of the gravity of the situation. Had it grasped the true nature of the crisis, it would have eased monetary policy to help launch a quick recovery in member States and the world economy, rather than opting for monetary tightening to counter a wrongly perceived risk of inflation.

The sudden aggravation of the financial turmoil in September 2008 signalled to policymakers worldwide that policy action was urgently needed to prevent a financial meltdown and their economies from spiralling out of control. Major central banks around the world responded to the events of September by an unprecedented internationally coordinated policy easing in early October 2008 – a move that included the United States Federal Reserve, the ECB, the Bank of England, the Bank of Canada, and the central banks of Sweden and Switzerland. Many other central banks in both developed and emerging-market economies, including Australia, China, India, Japan and the Republic of Korea, embarked on easing their policy stance at about the same time. In other cases, though, the scope for immediate policy easing was more limited as a generalized "flight to quality" and carry trade unwinding exerted downward pressure on several emerging-market currencies.

Maintaining its momentum of monetary easing, the Federal Reserve reduced its Federal funds rate target to the historical low of 0.25 per cent by December 2008. It also undertook a number of "unconventional measures" to restore liquidity in the securitized money and credit markets. Given the predominance of markets and securitized instruments over banks in the United States financial system, these "credit easing" measures were seen as vital for reviving lending. In addition, the Federal Reserve has embarked on purchasing long-term Treasury and Agency securities with the aim of keeping longer term yields low, as short-term yields are near zero, a measure that would also seem appropriate in Europe.

The ECB was not only late but also relatively timid in easing its policy stance, as its key policy rate reached 1 per cent only in May 2009, down from 4.25 per cent in October 2008. In addition to extensive liquidity provisions to banks, which had begun in August 2007, the ECB announced in May 2009 that under its "enhanced credit support"[24] approach it would provide longer term refinancing than it did with its usual operations (three months). Accordingly, at the end of June 2009 it provided one-year financing of more than €440 billion to the euro-area banking system – the largest amount ever for a single ECB operation.

The Bank of Japan reduced its key policy rate from the already very low level of 0.5 per cent to 0.1 per cent in the fourth quarter of 2008, in addition to measures to facilitate corporate financing and outright purchases of longer term government securities.

Developing countries found themselves in very divergent situations regarding the scope for easing monetary policy, depending mainly on their initial

Table 1.7

INTEREST RATES IN SELECTED ECONOMIES, JULY 2007–MAY 2009

	Interest rates (Annualized in per cent)				*Change in basis points*		
	July 2007	*July 2008*	*December 2008*	*May 2009*	*July 2007–July 2008*	*July 2008–Dec. 2008*	*Dec. 2008–May 2009*
Argentina	9.34	8.98	11.12	10.82	-36	213	-30
Australia	6.25	7.25	4.25	3.00	100	-300	-125
Belarus	9.70	10.40	19.00	17.90	70	860	-110
Brazil	11.25	13.00	13.75	10.25	175	75	-350
Canada	4.50	3.00	1.50	0.25	-150	-150	-125
Chile	5.25	7.25	8.25	1.25	200	100	-700
China	3.33	4.14	2.79	2.79	81	-135	0
China, Hong Kong SAR	4.37	2.30	0.95	0.31	-207	-135	-64
Czech Republic	3.00	3.75	2.25	1.50	75	-150	-75
Euro area	4.00	4.25	2.50	1.00	25	-175	-150
Hungary	7.75	8.50	10.00	9.50	75	150	-50
Iceland	13.30	15.50	18.00	13.00	220	250	-500
India	6.00	6.00	5.00	3.25	0	-100	-175
Indonesia	8.25	8.75	9.25	7.25	50	50	-200
Japan	0.50	0.50	0.10	0.10	0	-40	0
Latvia	5.21	5.40	8.92	10.78	19	352	186
Malaysia	3.60	3.70	3.37	2.13	10	-33	-124
Mexico	7.25	8.00	8.25	5.25	75	25	-300
Norway	4.50	5.75	3.00	1.50	125	-275	-150
Pakistan	10.00	13.00	15.00	14.00	300	200	-100
Poland	4.50	6.00	5.00	3.75	150	-100	-125
Republic of Korea	4.75	5.00	3.00	2.00	25	-200	-100
Russian Federation	10.00	11.00	13.00	12.00	100	200	-100
Saudi Arabia	5.06	3.82	2.55	0.85	-124	-127	-170
Serbia	9.50	15.75	17.75	14.00	625	200	-375
Singapore	2.56	1.00	1.00	0.69	-156	0	-31
South Africa	9.50	12.00	11.50	7.50	250	-50	-400
Sweden	3.50	4.50	2.00	0.50	100	-250	-150
Switzerland	2.71	2.76	0.66	0.40	5	-210	-26
Thailand	3.25	3.50	2.75	1.25	25	-75	-150
Turkey	17.50	16.50	15.70	9.50	-100	-80	-620
Ukraine	9.00	15.90	14.80	17.20	690	-110	240
United Kingdom	5.75	5.00	2.00	0.50	-75	-300	-150
United States	5.25	2.00	0-0.25	0-0.25	-325	-175	0

Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; Bloomberg; and national sources.
Note: Data refer to key policy reference rates or target rates (end-of-period), except for Hong Kong (China), Latvia, Malaysia, Saudi Arabia, Singapore, Switzerland and Turkey (monthly average of 3-month interbank market rate); Argentina and Belarus (monthly average of 1-day interbank market rate); and Ukraine (weighted average rate of banks' refinancing of the National Bank of Ukraine).

current-account position and the degree of openness of their capital account. Some were even induced to temporarily tighten monetary policy as their currencies came under, sometimes intense, pressure. This was the case for Brazil, Chile, Mexico, Peru and the Russian Federation, where monetary policy was tightened in the third quarter of 2008, before initial steps for monetary easing were taken in the first months of 2009. Similarly, the South African Reserve Bank, confronted at the outset with a plunging rand and relatively high inflation, began easing its policy stance only in late 2008.

Asian economies in general moved earlier towards a more expansionary monetary policy. The People's Bank of China cut both its policy rates

and minimum reserve requirements in several steps from September 2008 onwards, with money and credit aggregates recording rapid growth in the first quarter of 2009. Similarly, the Reserve Bank of India swiftly cut its key policy rates and banks' reserve requirements after mid-September 2008 (Subbarao, 2009). The central banks of Hong Kong (China), Indonesia, Malaysia, the Philippines, Saudi Arabia, Singapore, Taiwan Province of China, Thailand and Turkey reduced their interest rates, in most cases from already relatively low levels. Although it faced a sharp depreciation of its currency in the last quarter of 2008, the central bank of the Republic of Korea cut its key policy rates significantly.[25] By contrast, in Pakistan, where monetary policy is being operated under a 23-month IMF stand-by arrangement, interest rates remained high, as fighting inflation with a restrictive monetary policy has taken priority over countercyclical demand stimulation.

3. Support for ailing financial institutions

In September 2008 it also became clear that bank losses were much higher than initial estimates of losses from subprime mortgages had suggested. In the United States, the continuing decline in property prices and the ensuing credit crunch set in motion a wave of bankruptcies or near-bankruptcies of leading financial institutions. This changed the perception of the dimension of the crisis. Monetary authorities in developed countries began to intervene to an extent that went far beyond their role as lenders of last resort. They made available enormous amounts of liquidity, rescued financial institutions that were deemed systemically important, and adopted direct measures aimed at cleaning the balance sheets of financial intermediaries and restoring the availability of credit.

The virtual insolvency of two major government-sponsored institutions that played a central role in the mortgage market, Fannie Mae and Freddie Mac, was a decisive test as to how far the United States Government would go in supporting the financial system. It confirmed that the crisis in the market for subprime mortgages was only the tip of the iceberg, and that there was a risk of a general breakdown of the financial system. In early September, the two institutions were de facto nationalized, as the Government injected $100 billion into the capital of each institution, took over their control and opened an unrestricted credit line to keep them afloat.[26] Their effective nationalization was a logical step because of their status as government-sponsored enterprises. In addition, the government provided guarantees in support of the takeover of the investment bank Bear Stearns by JPMorgan Chase, which was an acknowledgment of the systemic importance of that bank.[27] However, similar support was not extended to Lehman Brothers, which had to file for bankruptcy in September 2008. In the aftermath of this event, money and credit markets seized up completely. By contrast, when the insurance giant, American International Group (AIG), hovered on the brink of bankruptcy as a result of its exposure to credit default swaps, the Federal Reserve rushed to its rescue with the provision of a credit facility of more than $180 billion. In exchange, the Federal Reserve obtained 80 per cent of the Group's capital – another case of nationalization.[28]

After dealing with these large institutions on a case-by-case basis, the Treasury launched the Troubled Assets Relief Program (TARP) that was approved by Congress as a part of the Emergency Economic Stabilization Act in October 2008. The objective of TARP is to allow the Treasury to buy or insure "troubled" (or "toxic") assets held by different types of institutions, for an amount of up to $700 billion. Under the original plan, financial institutions could sell their toxic assets to the government through a reverse auction mechanism. The original plan was soon replaced by one to inject capital into troubled institutions (TARP phase II). TARP funds would thus be used to buy preferred (non-voting) stocks and warrants in several large banks, which had to accept limits on the compensation schemes they offered their senior executives. In March 2009, the new Administration announced that most of the remaining TARP funds would be used to establish a public-private investment programme to acquire "toxic" assets. Under this arrangement, also known as the Geithner Plan, private investors can establish a 50-per-cent partnership with the Government in investment vehicles aimed at buying assets whose current market value is uncertain but which carry a high risk of non-performance in the future. Up to 85 per cent of the amount paid for the toxic assets purchased by such investment vehicles can be financed with non-recourse loans from the Federal Deposit Insurance Company (FDIC), and this could reach a total of $1,000 billion.[29]

In February 2009, "stress tests" were undertaken for the 19 largest banks in the United States to determine their chances of survival in case of a further deterioration of the macroeconomic situation.[30] Following their results, 10 of these banks were urged to raise $75 billion of capital in the course of the year; otherwise they would have to accept an injection of public capital that would considerably dilute existing private shares. The other nine banks were declared to be in a solid position and were allowed to return the TARP funds they had received earlier.[31]

Transferring "toxic" bank assets to the central bank or another publicly sponsored institution is a way of "cleaning up" the balance sheets of financial institutions. The idea behind this approach is that the restoration of banks' capacity and willingness to lend requires more time than they can afford in a crisis situation, since it implies a lengthy process of writing down the value of doubtful assets and a recapitalization from current profits. However, policy intervention in favour of banks with large amounts of such assets is not without problems, as it may imply subsidizing shareholders and a form of insurance for banks without appropriate recompense by the beneficiaries (see box 1.1).

The Government of the United Kingdom took similar action aimed at rescuing the British banking system. Under this programme, the Government has the authority to inject up to £50 billion of capital in several large banks in exchange for preferred shares. This enables banks to write down parts of their toxic assets. Accordingly, two leading mortgage lenders were nationalized. Banks also obtained access to up to £200 billion of short-term loans from the Bank of England and up to £250 billion worth of government guarantees for interbank loans. Banks that participated in the scheme had to agree to limit levels of employee compensation and dividend payments. In January 2009, the Government announced a second rescue package, which includes an insurance programme (the Asset Protection Scheme) aimed at protecting banks against losses arising from mortgage-backed securities and other asset-backed securities. It also contains a credit guarantee scheme that allows banks to issue bonds with a government guarantee. In exchange for this support, banks have to increase their lending.[32]

At the beginning of July 2009, the German Government also introduced a scheme that allows the transfer of toxic bank assets to newly created "bad" banks. Under this scheme, both privately and publicly owned financial institutions can transfer toxic assets into a "special purpose vehicle" (SPV) at 90 per cent of their book value. In exchange, these financial institutions receive bonds issued by the SPV that are guaranteed by a fund created in October 2008 for the stabilization of the financial system (SOFFIN). When the SPV is eventually liquidated, any profit will be paid back to the banks that transferred the assets. However, if the SPV makes a loss, the institutions that transferred the assets will not be able to pay out any profit to their shareholders until they reimburse SOFFIN for the losses incurred on its guarantees.

In Switzerland, in order to help UBS, the largest Swiss bank, to clean its balance sheet of toxic assets, the Government bought 6 billion Swiss francs (CHF) worth of new shares, and the Swiss National Bank granted UBS a loan of CHF 54 billion. UBS then used these newly raised funds to capitalize and fund a new "bad" bank to which it transferred toxic assets amounting to CHF 60 billion. This operation led to a considerable dilution of shares, in addition to which UBS shareholders will have to shoulder the first CHF 6 billion worth of losses on toxic assets and the Swiss Government will absorb the remaining losses, if any. Australia, Canada, Norway and Spain have also set up mechanisms for dealing with toxic assets (Khatiwada, 2009).

The "unconventional" interventions of the Federal Reserve, including the direct financing of private non-financial agents, led to an increase in the total of its balance sheet from $890 billion in early September 2008 to $2,055 billion in mid-June 2009. The composition of the Federal Reserve's assets also changed dramatically: in June 2007, 93 per cent of its outstanding credits was in the form of Treasury bonds; this share fell to 21 per cent in December 2008 and it was 31 per cent in June 2009.[33] The weight of risky assets grew correspondingly, including mortgage-backed securities, term-auction credit, credit extended to AIG and asset-backed commercial papers. These changes illustrate the extent to which the Federal Reserve felt obliged to replace the private financial system for the direct financing of economic activity. Thus the principle of independence of the central bank came to be set aside, and the distinction between fiscal and monetary policy became blurred: the Federal Reserve helped the Treasury in managing the crisis without having to wait for Congressional

Box 1.1

"TOXIC" ASSETS AND "BAD" BANKS

The financial crisis has led to a situation in which many banks are holding assets that have a market value well below their original book value, making the banks insolvent on a mark-to-market basis. Left to themselves these banks could be tempted to take too much risk ("gamble for resurrection") or take no risk at all and, by refraining from lending, stifle economic activity. There is thus a strong rationale for policy intervention.

If the remaining value of the bad assets is known, the solution is fairly simple: a government agency temporarily takes over the bank, helps recapitalize it and then sells it. This is what is routinely done by agencies like the United States Federal Deposit Insurance Corporation (FDIC) when banks are put under conservatorship or receivership. The situation is more complicated when the remaining value is unknown; this is when assets are considered as "toxic".

For illustration, one may consider the case of a bank which has assets with a book value of $1 billion and liabilities worth $900 million, so that the book value of its capital amounts to $100 million. Half of the bank's assets are safe, but the remaining half are toxic and are traded at 50 per cent of their book value. The bank is thus insolvent on a mark-to-market basis. If the private sector is not willing to recapitalize the bank, the government essentially has five options (which it can choose alone or in combination):

1. Buy the toxic assets (at a price somewhere between the assumed market price and their book value), and then liquidate them over a long period of time.
2. Give a subsidy to private investors interested in buying the toxic assets, and induce them to pay a price that can return the bank to solvency.
3. Inject public capital into the bank, but abstain from interfering with the management of the bank.
4. Take over the bank and guarantee all of its liabilities, and then use the good assets to create a new "good" bank (with a capital large enough to cover the bank's old liabilities); the good bank could eventually be re-privatized, and the bad assets put in a "bad" bank which will be slowly liquidated.
5. Convert some of the bank's liabilities into equity capital by imposing a debt-for-equity swap on the bank's unsecured creditors (as is often done in bankruptcies of non-financial firms), and create a new bank with fewer assets and liabilities.

The main problem with option 1 is the determination of the price of the toxic assets. In the above example, the minimum would be $400 million (the amount required to ensure the solvency of the bank), but banks may ask for more. This approach is similar to that of the original Troubled Assets Relief Program (TARP). It implies a subsidy for both shareholders and bondholders, but, since the real value of the toxic assets is unknown, it lacks transparency regarding the potential subsidy, and thus leaves considerable scope for lobbying to extract the largest possible subsidy. Option 2, which corresponds to the Geithner Plan, has been criticized for involving subsidies (again, for shareholders and bondholders) that are even more opaque (and possibly larger) than those involved in the original TARP, and even for inviting fraud (Johnson and Kwak, 2009; Krugman, 2009; Sachs, 2009; Young, 2009).[a] In option 3, which is similar to phase II of TARP, there is still a subsidy for unsecured debt holders and shareholders. This approach also appears to be problematic because the government supplies all the capital necessary to make the bank solvent without having any say in the bank's management. Bank nationalization, as in option 4, is similar to the approach Sweden adopted in response to the banking crisis that hit many Nordic countries in the early 1990s. It still generates a subsidy for the unsecured bondholders but does not subsidize shareholders.[b] The main complication with this approach is that the government or a government agency will need to manage the bank for a certain period of time. Option 5, similar to the practice with corporate bankruptcies, takes into account both the liability and asset side of the bank's balance sheet and assigns different rights to different types of liabilities.

A scheme suggested by Bulow and Klemperer (2009) is to create a "good" bank which holds the clean assets and the secured liabilities (including deposits), and a "bad" bank that holds the toxic assets and the unsecured debt and owns the equity of the good bank. From the taxpayer's point of view, this appears

Box 1.1 (concluded)

to be the cheapest and the fairest means to resolving the current situation because it does not imply any subsidy.[c] The main disadvantage of this approach is that the process of sorting out good and bad liabilities may end up being time-consuming and entail a substantial amount of litigation. Moreover, if the pool of unsecured creditors includes systemically important firms, the plan may amplify the crisis by imposing losses on them.

According to many observers, the last two options have the advantage of minimizing moral hazard and the fiscal cost of crisis resolution. They are variants of the approach which the IMF, with support of the United States, usually imposes on developing countries that are hit by a banking crisis. They are also similar to what the United States pressured Japan to do in the early 1990s. By contrast, as the current crisis is at home, the United States Administration considers the last two options as being too complex, given the large number of banks involved, and has adopted variants of the first, second and third options. This is somewhat surprising since the United States bureaucracy might have been expected to follow Sweden's example. Its choices may have been influenced by the desire to avoid what some observers might view as "excessive" intervention, and also by strong lobbying by the financial industry. Even conservative observers like James Baker, Lindsey Graham and Alan Greenspan have argued that temporary nationalization is preferable to the policies adopted by the current and previous Administrations.[d]

The presumption that the desire to protect the interests of Wall Street played a role in the management of the current crisis is consistent with the observation that, rather than giving banks a plain and visible – but politically unacceptable – subsidy, the subsidy was hidden and made as opaque as possible. Cynical observers argue that considerable effort was made to protect shareholders and limit the potential gains for public finances by adopting complex and opaque policies, probably on the assumption that policies that are both bad and complex tend to receive less opposition and scrutiny than policies that are both simple and bad (Snower, 2009). Financial markets reacted positively to the Government's support programme: bank shares initially dropped dramatically following the announcement of the stress-test programme in early February 2009, but they started to recover in early March, and by mid-June they had increased by 100 per cent from the trough and by 40 per cent compared with early February.

Those who are opposed to even a temporary nationalization of insolvent banks appear to forget that banks always have a public component, because the State is the ultimate guarantor of their liabilities. Several banks have positive equity value only because they enjoy implicit and explicit government guarantees. Seen in this light, the recent decision to allow banks that passed the stress test to return TARP funds (and thus no longer be subject to limits on executive compensation and dividend payments) seem paradoxical for at least two reasons. First, these banks received large subsidies when the government removed the enormous counterparty risk associated with credit default swaps issued by American International Group (AIG). Second, while market participants are fully aware that the adverse scenario used in the stress test was not as bad as what realistically should have been assumed, they remain confident that if a real adverse scenario were to happen, the Government would do whatever is necessary to save troubled financial institutions. In other words, all financial institutions have a call option on government resources. By allowing some institutions to return TARP funds and avoid tighter regulation, the Government is giving them this option without any charge.

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[a] For defence of the plan by an academic economist, see DeLong (2009).

[b] In the Swedish case, insolvent banks were first asked to seek capital injections from their shareholders. The incentives for raising such capital were provided by the fact that if shareholders were not able (or willing) to provide new capital, the Government would force them to surrender control before providing public support (Jonung, 2009).

[c] The bank will require new funds only if the secured liabilities (such as insured deposits) are greater than the assets. However, this is not a subsidy, but an insurance payment. Hall and Woodward (2009) describe how this was applied to Citigroup in the United States, and Buiter (2009) describes how it was applied to the Royal Bank of Scotland in the United Kingdom.

[d] "How Washington can prevent 'zombie banks'" James Baker, *Financial Times*, 1 March 2009; "Greenspan backs bank nationalization" by Krishna Guha and Edward Luce, *Financial Times*, 18 February 2009; "Sen. Graham: Consider nationalizing banks", Charlotteobserver.com, 16 February 2009.

Table 1.8

FISCAL STIMULUS AND SUPPORT TO THE FINANCIAL SYSTEM IN SELECTED ECONOMIES

(Per cent of GDP)

	Fiscal stimulus[a]	Support for the financial sector[b]	Years to spend fiscal stimulus
Developed economies[c]	**3.7**	**48.5**	.
Australia	5.4	9.5	3
Austria	1.2	35.4	2
Belgium	1.4	31.0	2
Canada	4.1	24.8	3
France	1.5	19.1	2
Germany	3.6	22.2	2
Greece	0.8	11.6	1
Hungary	-7.7	9.1	2
Iceland	-7.3	263.0	2
Ireland	-8.3	266.4	3
Italy	0.3	3.3	2
Japan	4.7	22.3	3
Netherlands	2.5	46.5	2
Norway	1.2	17.8	1
Poland	1.2	3.2	2
Portugal	0.8	14.4	1
Spain	3.9	22.9	3
Sweden	3.3	70.2	2
Switzerland	0.5	12.0	2
United Kingdom	1.9	81.7	3
United States	5.5	81.1	3
Developing economies[c]	**4.7**	**2.9**	.
Argentina	6.4	0.9	1
Brazil	5.6	1.5	1
Chile	2.8	0.0	1
China	6.2	0.5	2
China, Hong Kong SAR	2.4	0.0	1
China, Taiwan Province of	2.1	0.0	1
India	1.8	6.4	3
Indonesia	2.0	0.1	2
Malaysia	2.8	6.3	2
Mexico	1.6	0.0	1
Peru	3.2	0.0	2
Philippines	3.1	0.0	1
Republic of Korea	6.2	20.5	3
Saudi Arabia	9.2	9.4	3
Singapore	8.0	0.0	1
South Africa	7.4	0.0	3
Thailand	3.4	0.0	1
Turkey	1.1	0.5	2
Transition economies[c]	**5.8**	**7.4**	.
Kazakhstan	11.1	0.0	2
Russian Federation	5.4	8.0	2
Total[c]	**4.0**	**36.1**	.

Source: UNCTAD secretariat calculations, based on UN/DESA, 2009b; IMF, 2009b and c; OECD, 2009a; Council of the European Union, 2009; ECLAC, 2009b; *UNCTAD Handbook of Statistics* database; and national sources.

a Corresponds to discretionary measures on public spending or revenues in response to the financial crisis, excluding the "automatic stabilizers".

b Comprises capital injection, purchases of assets, lending by government treasuries, central bank support provided with treasury backing, liquidity provision by central banks and guarantees, excluding deposit insurance provided by deposit insurance agencies. Liquidity provision by central banks only includes the new special facilities established to address the present crisis and excludes the operations of the regular liquidity facilities.

c Country grouping weights based on current dollars.

approval to commit funds (Aglietta and Rigot 2009, OECD, 2009a). Moreover, the Federal Reserve relies on the Treasury for guarantees to acquire massive amounts of risky assets, while the Treasury relies on Federal Reserve intervention to buy its long-term debt and prevent interest rates from soaring.

The sizeable bail-out operations and the provision of large amounts of liquidity by several central banks and governments (see also table 1.8) prevented a breakdown of the financial system. But these measures, even combined with sharp interest rate reductions, were not sufficient to return the financial system back to normal functioning and to fully restore credit availability to the non-financial sector. Similarly, while expansionary monetary policy is essential for keeping the financial and economic crisis under control, it is not sufficient on its own to bring about a recovery. Even with very low interest rates and healthy banks, credit will not recover as long as rising unemployment and falling incomes restrain demand, and faltering demand discourages investment. In order to stimulate demand, countercyclical fiscal policy measures that have a direct effect on aggregate demand are therefore indispensable.

4. Fiscal policies

As the financial crisis spilled over into the real sector, a wide consensus emerged that the effects of automatic stabilizers would not be sufficient to stop the downturn in aggregate demand. Consequently, governments in many developed and emerging-market economies reacted with discretionary fiscal stimulus and support measures, such as debt-financed increases in public spending and tax cuts, to counter the increasingly dramatic downturn in final demand, output and employment (table 1.8).

The United States Administration began introducing fiscal stimuli in early 2008, but adopted a more aggressive stance after the slowdown in that country had turned into an outright recession in the third quarter of that year. At the G-20 meeting in Washington in November 2008, the Managing Director of the IMF stated that a global fiscal stimulus in the order of 2 per cent of world GDP was essential to restore global growth (Strauss-Kahn, 2008). At their subsequent London Summit in April 2009, the

G-20 leaders reaffirmed their commitment "to deliver the scale of sustained fiscal effort necessary to restore growth".[34] Some months later, the IMF's First Deputy Managing Director, praised the fiscal stimulus for recent economic improvements and urged governments to spend the committed funds fully and in a timely manner, and to increase them if needed.[35] However, the spirit of these statements is not reflected in the conditions attached to the financial support that the IMF has been providing to several emerging-market economies. In most cases, procyclical fiscal tightening remains part of those conditions.

Indeed, ever since financial and macroeconomic crises affected developing or transition economies, the role of fiscal policy during crisis situations has been highly controversial (*TDR 2006*, chap. IV). In one view, an expansionary fiscal policy is necessary to support aggregate demand and help exit a crisis. In the opposite view, fiscal tightening[36] is indispensable to restore the confidence of financial markets, attract new capital inflows and "crowd in" private investment. This second view guided much of the conditionality set by the IMF in all the crises since the mid-1990s, but was criticized not only by various economists, but also by the IMF's Independent Evaluation Office (IMF-IEO, 2003). The criticism was directed at the procyclical nature of these policies and their unnecessary aggravation of the crises. It was also pointed out that contractionary fiscal policies cannot be effective in achieving their primary goal (i.e. the reduction of the fiscal deficits) because they push the affected economies deeper into recession and narrow the tax base.

This time, as the crisis has evolved, international support for a strong and active fiscal stimulus has increased, at least in developed countries, and even among institutions and actors that have traditionally been wary of State intervention. However, national fiscal policy responses and initial fiscal stabilization programmes, like the tax cut in the United States in early 2008, were a case of too little, too late. In the context of a major crisis with strong deleveraging pressures, tax reductions tend to be ineffective for reviving private consumption and investment, especially if they benefit mainly high-income segments of the population that have a relatively low marginal propensity to consume. Therefore, much stronger measures were needed after the collapse of Lehman Brothers in September 2008. Governments were compelled to increase public spending to compensate for falling private demand, or to subsidize certain types of private consumption and investment, assuming the role of what could be called "borrower and spender of last resort". Governments may also have found it difficult to resist pressures for demand stimulation after huge amounts of public money had been mobilized at an earlier stage for the rescue of banks and other financial institutions that were responsible for the crisis.

In the United States, the new Administration responded to the deepening recession in February 2009 with a fiscal stimulus package (American Recovery and Reinvestment Act) amounting to $787 billion to be used through 2009 and 2010. The increased Federal budget expenditures proposed by the Act included transfers to low-income workers and the unemployed, higher spending for health care and education, and investment in infrastructure, including renewable energy.[37] However, it is not clear how much *net* stimulus will remain after the contractionary effects of budget cuts at the local and state government levels are taken into account. Canada also launched a sizeable fiscal package that combines tax cuts and higher spending, including for infrastructure and housing investment, and transfers to vulnerable groups.

In November 2008, the European Commission had already launched the European Economic Recovery Plan which called for an immediate and coordinated effort by EU member States to boost demand. It suggests that member countries should provide a fiscal stimulus equivalent to 1.5 per cent of GDP, in addition to the stimulus resulting from automatic stabilizers and the support provided to the financial system (EC, 2009). National governments in the EU had varying priorities in the design of their respective policy responses. In the United Kingdom, a fiscal stimulus programme of 1.5 per cent of GDP was agreed for 2009, consisting mainly of a temporary cut in the value-added tax rate. In France, where the Government had already reduced taxes on high incomes in the course of 2007, a further stimulus was provided in the form of additional expenditure for major infrastructure projects and support to industries in difficulty and low-income households. In Germany, the main ingredients of the stimulus were tax abatements, subsidies on new car purchases and energy-saving home renovations, as well as additional infrastructure investments. In Spain, most of the stimulus takes the form of greater spending on public works and transfers to households and firms,

in particular the automobile industry. The fiscal stimulus packages in Europe are generally smaller than the one being implemented in the United States. Policymakers have justified this on the grounds that Europe has relatively higher automatic stabilizers embedded in its welfare and tax regimes.

Japan was relatively late with a fiscal policy response to the crisis, but, including a recently announced new stimulus package, discretionary measures over the 2008–2010 period now amount to over 4 per cent of GDP. This package consists mainly of higher public spending for infrastructure investments in support of climate change mitigation, but also includes transfers to households, businesses and local communities. In China a fiscal stimulus package equivalent to more than 13 per cent of GDP was announced in late 2008. How much of this amount consists of new measures, not previously planned, is debatable. Nevertheless, even if one accepts the IMF's lower estimate of 6.2 per cent of GDP, it remains one of the largest fiscal stimulus packages in the world. Additional investment in transport and energy infrastructure, as well as in environmental protection, rural development, low-cost housing, education and healthcare, has already proved very effective in boosting domestic demand.

Like China, the Republic of Korea is implementing a fiscal stimulus programme that exceeds 6 per cent of GDP, but over a period of three years compared to two years in China. The largest fiscal package in Asia is probably that of Singapore, which amounts to 8 per cent of GDP, to be spent in a single year. Other Asian economies, such as Hong Kong (China), India, Indonesia, Malaysia, the Philippines, Saudi Arabia, Taiwan Province of China and Thailand, are also benefiting from sizeable fiscal packages, with particular emphasis on direct spending for infrastructure projects, but also including assistance to specific industries (Khatiwada, 2009). The fiscal stimulus is also significant in oil-exporting transition economies, such as Kazakhstan and the Russian Federation, where it is being financed with funds accumulated during the oil boom.

In Latin America and the Caribbean, the authorities of most countries have granted tax reductions and additional subsidies and/or expanded expenditure. In some countries, such as Argentina, Brazil, Chile, Mexico and Peru, public investment programmes are being accelerated or expanded substantially. Several years of running fiscal primary surpluses has given these countries considerable room for manoeuvre. In addition, Chile and Peru will use resources accumulated in their stabilization funds, while Argentina has mobilized supplementary resources from the nationalization of its social security system. Other countries that were not able or willing to expand public expenditure sought to change its composition by shifting its uses to those activities that are more likely to have a strong impact on production and employment.

Several countries have also strengthened their social programmes with the aim of mitigating the social impact of the crisis, preserving employment and sustaining domestic demand. Governments in the countries mentioned above and in some other economies of the region, including Barbados, Belize, the Bolivarian Republic of Venezuela, Bolivia, Colombia, Costa Rica, El Salvador, Guatemala, Honduras and Jamaica, have taken measures to protect vulnerable groups of the population, such as raising minimum wages and pensions, and providing incentives to private firms to keep jobs or create new ones. These measures are also expected to stimulate private demand (ECLAC, 2009b).

The value of the fiscal packages aimed at stimulating demand in the countries for which data were available amounts to 3.7 per cent of GDP, on average, in the developed countries, 4.7 per cent in developing countries and 5.8 per cent in the transition economies (table 1.8). Direct comparisons between countries are difficult because the fiscal packages vary in terms of their time horizon: they extend over a period of between one and three years. However, Iceland and Ireland, and to lesser extent Hungary, are clearly distinct from all the other countries in the sample, as they have committed huge financial resources to rescue their financial sectors while at the same time adopting an extremely restrictive fiscal policy stance, including tax increases and cuts in public expenditure of more than 7 per cent of their GDP.

Developed countries, especially those that were directly hit by the bursting of speculative bubbles – Iceland, Ireland, the United Kingdom and the United States – are providing massive support to their financial systems. However, this support is of a different nature than current fiscal measures for demand stimulation. It represents contingent liabilities that may not involve actual fiscal expenditure. In the

case of financial bail-outs and "bad bank" schemes, the final amount of subsidies will depend on many factors, including the revenues governments can obtain when they eventually sell the troubled assets or the restructured banks. In the case of fiscal stimuli, the fiscal burden as a result of lower tax revenues or higher expenditures should be assessed against the increase in government revenues that will result from the greater economic activity that would not have occurred in the absence of such stimuli.

Given the magnitude of the crisis, a substantial increase in budget deficits in most countries seems both unavoidable and justified. But the effectiveness of deficit spending and its medium-term impact on the public finances also depends on how the deficit is generated. Varying levels and composition of revenues and expenditures and different rates of GDP growth can yield similar levels of fiscal deficit. Moreover, not all fiscal deficits are expansionary. Higher public expenditure may provide an economic stimulus when it increases investment, consumption and employment, but not when it is used for the financing of a bank bail-out. Lower fiscal revenue, on the other hand, may encourage private spending resulting from tax reductions for low- and middle-income groups, but not when it results from reduced export earnings. Consequently, fiscal policies should not focus primarily or exclusively on fiscal balances, but rather on the level and composition of spending and revenues, in order to maximize their impact on the economy and contribute to long-term development objectives.

5. The international policy dimension

The unfolding of the global crisis did not receive attention in international decision-making bodies until October 2008, which was when central banks of major economies engaged in coordinated monetary easing.[38] A novelty was that also in October 2008, the United States Federal Reserve, for the first time since the end of the Bretton Woods system, provided four emerging-market economies (Brazil, Mexico, the Republic of Korea and Singapore) with a bilateral swap of $30 billion to help them defend their currencies.

Since November 2008 the G-20 has taken the lead in launching and coordinating international action[39] to address the financial and economic crisis, although its legitimacy has been called into question because the vast majority of developing countries are not represented.[40] At its London Summit in April 2009, the G-20 presented a Global Plan for Recovery and Reform that would "constitute the largest fiscal and monetary stimulus and the most comprehensive support programme for the financial sector in modern times".[41] It includes an increase in IMF resources by $500 billion (to $750 billion), a new allocation of $250 billion for Special Drawing Rights (SDRs), additional lending by multilateral development banks of $100 billion, and support for trade finance of $250 billion. However, a closer look at the programme (Giles, 2009) reveals that these figures relate in part to decisions that had already been taken long before the summit; others were more a reflection of intentions than concrete pledges. Only half of the additional resources for the IMF were made available immediately by some member States, while the financing of the other half remained unclear. Moreover, only part of the new SDR allocation will directly benefit those countries that are most in need of international liquidity: since the additional SDRs will be allocated to IMF members according to their quotas, only $80 billion will go to low- and middle-income developing countries.

Clearly, improving the potential for multilateral financial support in the current crisis can, in principle, help developing and transition economies counter the impact of the adverse external environment on their national economies. However, such support could have been made considerably more effective if it had been linked to a reform of the IMF itself, including a review of the principles that have guided the policy conditions attached to its lending. It was observed in past crises that those conditions mostly led the borrowing countries into even deeper crisis.

IMF lending has surged since the outbreak of the current crisis, extending to nearly 50 countries by the end of May 2009. The bulk of loans are in the form of either stand-by arrangements under the General Resources Account (SDR 48 billion) or the newly created lending facility – the Flexible Credit Line (SDR 52 billion) – which is available to countries with strong fundamentals, policies and track records of policy implementation. Close to 30 poorer developing countries receive support under either the Poverty Reduction and Growth Facility (SDR 1.7 billion) or the Exogenous Shocks Facility (SDR 0.4 billion)

(IMF, 2009d). Policy conditions attached to these IMF loans are fairly similar to those of the past, including a requirement that recipient countries reduce public spending and increase interest rates.

This is at odds with recent declarations by the IMF in which coordinated countercyclical policies and large fiscal stimulus packages have been recognized as the most effective means to compensate for the fall in aggregate demand induced by the debt deflation that followed the bursting of speculative bubbles in a number of financial markets.[42] This new position has not been applied to countries that are in real need of crisis lending; instead, the traditional stabilization and adjustment policy reforms are attached as binding loan conditions. Pakistan, for example, had to tighten both its fiscal and monetary policy, including drastically reducing its fiscal deficit from 7.4 per cent of GDP in 2008 to 4.2 per cent of GDP in 2009. In the stand-by agreement with Ukraine, approved in November 2008, the initial objective was to achieve a balanced budget, even though GDP was projected to fall by more than 10 per cent in 2009 and gross public debt was very low. However, in May 2009, the IMF was obliged to accept a loosening of fiscal policy and allow a fiscal deficit of 4 per cent of GDP in light of the continued weakening of economic activity, which could have been expected at the outset.[43] Belarus, Georgia, Hungary, Latvia and Serbia have all signed IMF agreements that require very restrictive fiscal policies, which could exacerbate these countries' economic downturns. Several studies that have examined fiscal and monetary targets in recent IMF loan programmes find that the Fund has also continued to impose procyclical macroeconomic tightening in almost all recent lending arrangements with developing countries (ActionAid and Bank Information Center, 2008; CEPR, 2009; TWN, 2009). For example, in the IMF programmes for Sao Tome and Principe, and Senegal the target is to bring fiscal deficits down to below 3 per cent of GDP, to be achieved through spending cuts where necessary. In Côte d'Ivoire and Ethiopia, the targets for 2009 are even more stringent, below 2 per cent of GDP. In Côte d'Ivoire, Malawi and the Congo, the IMF programmes aim to reduce inflation to below 5 per cent in the midst of the current crisis (Molina-Gallart, 2009).

Only Colombia, Mexico and Poland, the three countries that have been granted access to the IMF's new Flexible Credit Line (FCL), have been allowed to ease their monetary and fiscal policies. But in these countries the need for foreign financing is less severe than in others. Inflation and interest rates have been lower there than in some other crisis-stricken countries, so that they have attracted far fewer speculative inflows that could cause currency overvaluation, and which would undermine their international competitiveness.

The G-20 has not yet managed to lead the way for better international coordination of macroeconomic policies so far. Such coordination is important for three reasons. Firstly, economies with current-account surpluses (that had benefited from strong growth impulses from the deficit countries in recent years) would be able to make a greater contribution to global stabilization than countries that entered the crisis with large current-account deficits. At the same time, the distribution of global demand growth should be such as to reduce global imbalances rather than exacerbating them. If other countries, through their expansionary efforts, were to systematically fall behind the United States, there would be a strong likelihood of a resurgence of global imbalances. The slower the recovery and the wider the new imbalances, the greater will be the risk of increased protectionism.

Secondly, in order to make deficit spending viable in all countries, it would be essential to ensure that no country benefits unduly from unidirectional demand spillovers emanating from deficit-spending programmes of other countries without itself making a commensurate contribution to the global demand stimulus. Thirdly, low-income countries require additional support in the form of aid in order to help them in their ongoing efforts to achieve the Millennium Development Goals (MDGs). Such additional support can best be mobilized through a concerted multilateral effort. If a countercyclical increase in bilateral aid flows were to be integrated into fiscal stimulus packages in an internationally coordinated manner, it would also have an expansionary effect on demand in donor countries similar to a fiscal stimulus at home. By the same token, since it is highly likely that many indebted low-income countries hurt by the global crisis will encounter problems in maintaining external debt sustainability, a temporary moratorium on their debt repayments would be in the spirit of the countercyclical policies undertaken in most developed and emerging-market economies (box 1.2). It would not only be an important element in efforts to attenuate the impact of the global crisis on growth, poverty alleviation and investment in the

Box 1.2

A TEMPORARY MORATORIUM ON OFFICIAL DEBT

In 2005, countries devastated by the *tsunami* in the Indian Ocean were promptly offered a temporary debt moratorium by the creditors of the Paris Club. Though this was less visible than other emergency aid, the speedy and direct response of the creditors allowed those countries to allocate much of their financial resources to meeting their humanitarian and reconstruction needs. The current global economic crisis has all the characteristics of an economic tsunami.

Developing countries are innocent bystanders, yet most of them, including the poorest, are being hit by falling export earnings and workers' remittances. The collateral damage from the current crisis could well take the form of a debt crisis for some vulnerable economies. The debt sustainability of several low-income countries, including some of those that have reached the completion point for debt relief under the HIPC Initiative, is already seriously at risk. In this situation, timely crisis prevention is preferable to crisis management at a later date, because it avoids large costs in terms of lost output and human suffering. Debt service payments for the 49 low-income countries are estimated to total about $26 billion for 2009 and 2010, a small figure compared to the size of the fiscal stimulus packages launched in the countries that are also the main creditors to the low-income countries. The form of assistance could be similar to the ones provided after Hurricane Mitch in 1998 and the tsunami in 2005. For these two natural disasters, Paris Club creditors agreed not to expect any debt payments on eligible sovereign claims from the countries affected by these disasters for up to three years. The deferred amounts could be repaid over a period of several years in the future.

In the present situation, a temporary debt moratorium on all official debts could be offered to all low-income countries (with no discrimination), without imposing any conditionality or performance criteria, as a measure to counter the fallout of the global crisis. The temporary moratorium should automatically come to an end once the world economy is well on the road to recovery. At that point the situation and possible needs for further assistance of individual debtor countries could then be assessed on a case-by-case basis within the existing institutional framework. A debt moratorium could be implemented expeditiously, whereas a scaling up of ODA from bilateral or multilateral sources would require considerably more time and more complex decision-making and implementation processes.

Compared with the size of the stimulus packages for developed countries, the total amount of such a temporary debt moratorium would be minuscule. However, for the debtor countries, in particular for the low-income countries that rely on external financing from official sources, it would provide an important fiscal breathing space and compensate for shortfalls in foreign exchange earnings and fiscal revenue. It would function as a countercyclical measure which could contribute to the macroeconomic stability in these economies. This in turn will benefit the global economy as a whole. Indeed, in a deep recession like the present one, it is also in the interests of creditor countries to stabilize their exports to low-income countries, even though these exports represent only a small share of their total exports. Stabilizing any element of global demand is more conducive to recovery than maintaining high flows of official debt service.

debtor countries; it would also contribute to stabilizing global demand.

Another major shortcoming of the G-20 process, so far, has been that it has not launched serious reforms of the international monetary and financial system, including the design of new multilaterally agreed rules for exchange-rate management, cross-border financial flows and sovereign debt workouts, in addition to the creation of a new international reserve to replace the dollar. These issues are discussed in greater detail in chapter IV of this *Report*.

6. Outlook

Production, employment and income growth in the world economy in general, and in most economies individually, are unlikely to recover until banks are recapitalized, their balance sheets cleaned up of toxic assets and other major actors in financial markets have become more solid. In order to halt the contraction of GDP, it will be necessary to maintain or even further strengthen the expansionary stance of monetary and fiscal policies. Developing and transition economies remain highly vulnerable to depressed export markets. Since only a small number of them can replace falling external demand with faster domestic demand growth, they depend on recovery in the world's leading economies.

In many countries, Governments and central banks have set new precedents for supporting ailing financial institutions. This indicates that, beyond the crisis, the relationship between the State and the private sector, in particular private financial institutions, could be revised fundamentally in the interests of greater stability and reliability of the financial system. This would be the logical consequence of the various efforts to rescue individual financial institutions that ended up in trouble on account of mismanagement. The need for such rescue operations has revealed that the huge profits and incomes earned from the financial activities of some market participants and managers over the past few years have been disproportional to the macroeconomic and social usefulness of the financial sector. Thus it is clear that large segments of the financial sector cannot be left to function like a giant casino without doing great damage to the real sector of the economy. The recent heavy involvement of governments and central banks should therefore lead to a review of the existing modes of functioning of the financial sector. Such a review should not only look at the need for strengthening financial regulation and supervision (a topic discussed in greater depth in chapter III of this *Report*), but also at a redefinition of the role of central banks and public financial institutions in the economy.

The immediate objective of deficit spending is to avoid a further contraction in an economy, and possibly to foster a recovery of the productive sector. However, tax reductions or expenditure increase may also have longer term implications. For instance, they could influence income distribution in favour of social groups whose real disposable incomes have stagnated or fallen in recent years; or they could influence the pace of structural change, for example towards more climate-friendly modes of production and consumption (as discussed in chapter V of this *Report*). Well-conceived policies to overcome the crisis may therefore also help accelerate progress towards other strategic objectives.

Growing budget deficits as a consequence of fiscal stimulus packages have prompted concerns that governments will have to raise tax rates in order to be able to service the increasing public debt. Such concerns are unjustified, since, in a growing economy, government revenue will normally rise sufficiently at constant tax rates. By the same token, if governments were to remain passive in a situation of severe crisis, relying exclusively on automatic stabilizers, the fiscal balance will deteriorate as a result of lower tax revenues. Adjusting public spending to falling tax revenue might not lead to a lower fiscal deficit either, because the tax base will narrow further and more financial rescue operations might become necessary. By contrast, a discretionary increase in public spending, especially when it expands investment, enhances production capacity and job creation, and leads to higher GDP. This in turn enlarges the future tax base and thereby raises public revenues at given tax rates. This does not mean that the size of the domestic public debt is completely irrelevant; it may have undesirable effects on income distribution, and an increasing share of interest payments in the budget may compromise budget flexibility in the future. This is why, in order to be truly countercyclical, an expansionary fiscal policy in a recession needs to be combined with more restrictive fiscal policies when recovery has set in and output growth accelerates.

There are also widespread concerns that the huge injections of central bank money and the sharply rising budget deficits in many countries will sooner or later lead to inflation, and eventually to accelerating inflation if governments and central banks do not react early to contain this danger. This fear is based on the monetarist view that inflation is always a monetary phenomenon because it cannot be financed without additional money, and that "too much money chasing too few goods" will inevitably create inflation (Greenspan, 2009; Feldstein, 2009).

However, "too much money" needs a channel through which to inject the virus of inflation into an

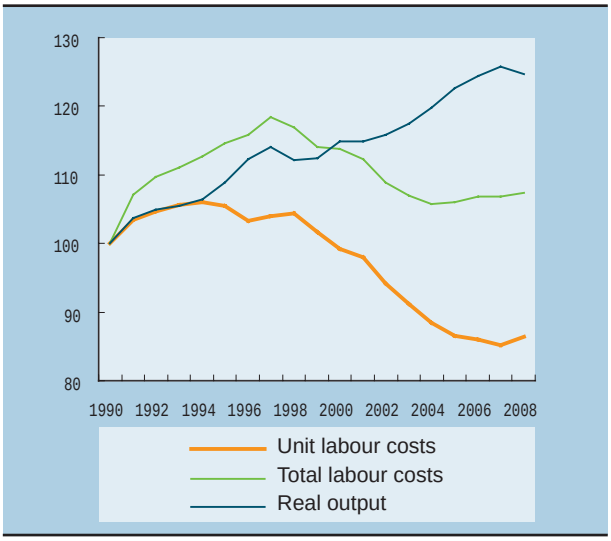
economy. There are only two channels for this to happen: if demand growth exceeds potential supply growth ("demand-pull inflation"), or if cost increases, particularly labour costs, exceed productivity growth ("cost-push inflation"). In the present situation, with capacity utilization at historic lows and unemployment rising with dramatic speed, neither overheating nor wage inflation is a realistic prospect for several years to come. It is a matter of years, not months, before economies that are now in deep crisis can be restored to a level of capacity utilization where supply cannot keep up with demand or to a level of employment that could trigger demand for higher wages. This will allow central banks to withdraw excess liquidity by selling revalued assets and absorbing excess money supply. Thus fears that "too much money" or rising government deficits could reignite inflation are unjustified in the current depressed state of the global economy.

Indeed, deflation – not inflation – is the real danger. Japan in the 1990s, following the bursting of the big bubble, provides an example of deflationary stagnation, which occurred despite huge injections of money and several attempts to reignite (albeit half-heartedly) a depressed economy (chart 1.9). The main problem is that with sharply rising unemployment the downward pressure on wages mounts. Wage deflation is the imminent and most dangerous threat in many countries today, because governments are finding it difficult to stabilize a tumbling economy when there is a large-scale fall in wages and consumption. However, deflation will not cure itself. Therefore, the most important task is to break the spiral of falling wages, prices and demand as early as possible, and to revive the financial sector's ability to provide credit for productive investment to stimulate real economic growth. Governments and central banks need to take rapid and strong proactive measures to boost demand before the virus of deflation infects their economies.

Chart 1.9

UNIT LABOUR COSTS IN JAPAN, 1990–2008

(Index numbers, 1990 = 100)



Source: OECD, *Main Economic Indicators* database.

Notes

1 For a recent comprehensive outlook for the world economy, see UN/DESA (2009b).

2 As a group, metals and minerals registered their lowest price level in February 2009, and agricultural raw materials in March 2009.

3 For instance, the International Rubber Study Group reports that between September and December 2008, the year-on-year natural rubber consumption growth rate plunged from 2.1 to -3.4 per cent. This period registered a more abrupt fall in rubber consumption than that of the 2001–2002 global economic slowdown (IRSG, 2009). Cotton consumption declined by 13 per cent in 2008 (ICAC, 2009). The United States Department of Agriculture (USDA, 2008) considered this the worst global consumption contraction in 65 years.

4 This is the case not only for minerals and metals but also for other commodities. For instance, the rebuilding of cotton product pipeline inventories that shrank significantly during the economic downturn is also expected to provide a boost to consumption, with China accounting for more than half of this increase in 2009 (USDA, 2009a).

5 Oil price developments are also linked to those of other commodities through the mechanism of commodity index investment (see chapter II).

6 Data refer to the average of Dubai, Brent and Texas.

7 Chinese oil imports reached a 12-month high in March 2009 as a result of strategic stockpiling by the Government and rising demand from refiners (Ulrich, 2009).

8 For cotton, see USDA, 2009a; for coffee, ICO, 2009a and b; for tea, EIU, 2009; and for sugar, USDA, 2009b. There are some indications that cocoa consumption may have been relatively more affected by the crisis (ICCO, 2009). In addition, shortages in cocoa supply are also related to structural problems in Côte d'Ivoire and a high incidence of plant disease.

9 UNCTAD secretariat calculations based on the IEA Oil Market Report (various issues), IMF International Financial Statistics and UNCTAD Commodity Prices online.

10 A survey by Fraser Institute (2009) indicates that the sector expects a dramatic fall in investment and exploration during the current economic downturn, with at least 30 per cent of exploration companies going out of business. Time magazine (2009) cites Merrill Lynch in estimating that mining investment will be 40 per cent lower in 2009–2010, and investment in the oil sector will be 30 per cent lower in 2009 and 40 per cent lower in 2010 than expected before the crisis.

11 For instance, copper capacity utilization fell to around 78 per cent in the first two months of 2009, compared with an average of 87 per cent over the past five years (ICSG, 2009).

12 There is wide agreement throughout the energy sector on the possibility of a future energy supply crunch due to lower investment resulting from the global recession (see, for instance, CERA, 2008; and *The Economist*, 2009).

13 USDA (2009c) expects a 5 per cent reduction in wheat acreage and a 4 per cent reduction in cotton acreage in the United States. The planting area for corn will increase by 1 per cent from last year but this will still be 7 per cent lower than in 2007. The total area for principal crops is expected to shrink by approximately 1.2 per cent.

14 See, for instance, *TDRs 2006, 2007* and *2008*; WESP 2006, 2007 and 2008.

15 Some economic authorities dismissed the very existence of a problem, believing that external imbalances could continue indefinitely, provided that the corresponding capital flows found productive uses (Economic Report of the President, 2006: 146). With respect to growing domestic indebtedness, there was added confidence that, since credit was essentially delivered to private agents, no crisis could occur, as the private sector would always be aware of the need to honour its debts. Such an idea was popularized at the end of the 1980s in Great Britain by then Chancellor of the Exchequer Nigel Lawson, and has been dubbed "Lawson's Law"; it ended in the pound sterling crisis of 1992 and severance from the European Exchange Rate Mechanism (O'Connell, 2006).

16 In the United States, delinquency rates in commercial banks climbed from 1.51 per cent of total loans in the first quarter of 2006 to 5.6 per cent in the first quarter of 2009. For real estate loans, delinquency rates were 1.36 per cent and 7.13 per cent in those periods (Federal Reserve, 2009a).

17 Gross private investment in the United States plunged by 23 per cent in the last quarter of 2008 and by 51.8 per cent in the first quarter of 2009 (at annual rates, seasonally adjusted); personal consumption of durable goods contracted by 14.8 and 22.1 per cent in the third and fourth quarters of 2008 respectively (also at annual rates, seasonally adjusted) (Bureau of Economic Analysis, 2009).

18 Actual figures are from Eurostat (epp.eurostat.ec.europa.eu) and the United States Bureau of Labor Statistics (www.bls.gov/news.release/empsit.toc.htm). The OECD forecasts that unemployment will rise in 2010 to 10.1 per cent in the United States and to 12.0 in the euro area (OECD, 2009a).

19 Between the third quarter of 2007 and the fourth quarter of 2008, outstanding financial assets of households and non-profit organizations decreased by almost 20 per cent, from $50.5 trillion to $40.8 trillion. Most of the losses were concentrated in corporate equities, mutual fund shares and pension fund reserves. In the same period, households' real estate value declined from $21.1 to $18.3 trillion (Federal Reserve, 2009b).

20 Price variations correspond to the first quarter of 2009 compared to the same period in 2008 (see *Monthly Digest of Statistics*, No. 761, May 2009 for the United Kingdom; *INSEE Conjoncture Informations Rapides* No. 147, 28 May 2009 for France; and *INE, Boletín Mensual de Estadística*, April 2009 for Spain).

21 A long-lasting stock market downturn will negatively affect future pension payments in countries where the majority of pension schemes are funded by private capital. In Chile, for example, retirement accounts lost almost one third of their value between December 2007 and December 2008 and in Argentina pension forecasts were so low that parliament voted a return to the previous public pay-as-you-go system (AIOS 2008).

22 In the case of Mexico, while UNWTO data for January and February 2009 still post positive growth of 13 per cent, this was before the outbreak of the A(H1N1) influenza virus. National data for January to April 2009 show a year-on-year decline in international arrivals of 5.9 per cent (SIIMT, 2009).

23 See for example, various issues of the *TDR* since 2005.

24 See "Supporting the financial system and the economy: key ECB policy actions in the crisis", speech by Jean-Claude Trichet, President of the ECB at a Conference organized by the Nueva Economía Fórum, and *The Wall Street Journal Europe*, Madrid, 22 June 2009; and "ECB looks to stimulus by stealth", *Financial Times* online, 24 June 2009, at: http://www.ft.com/cms/s/0/970be020-60f3-11de-aa12-00144feabdc0,dwp_uuid=70662e7c-3027-11da-ba9f-00000e2511c8.html?ftcamp=rss.

25 The Bank of Korea's (2009) response to the crisis also included a one-off interest payment on banks' required reserve deposits to support their recapitalization.

26 See *The Economist* online, 8 September 2008, at: http://www.economist.com/businessfinance/displayStory.cfm?story_id=12078933.

27 See "JPMorgan Chase and Bear Stearns Announce Amended Merger Agreement", JPMorgan Chase & Co, Press Releases, 24 March 2008, at: http://investor.shareholder.com/jpmorganchase/press/releasedetail.cfm?ReleaseID=301224&ReleaseType=Current.

28 See "US to take control of AIG", *Financial Times* online, at: http://www.ft.com/cms/s/0/271257f2-83f1-11dd-bf00-000077b07658.html.

29 For investment vehicles, for the purchase of toxic assets for a total of $100 billion, both the private investor and the Government will need to contribute a minimum capital of $7.5 billion, and the FDIC will extend a non-recourse loan of $85 billion.

30 The adverse scenario of the stress test assumed an output contraction of 3.3 per cent in 2009 and no growth in 2010, a 22 per cent further decrease in home prices, and an unemployment rate of 10.3 per cent in 2010. Several observers have argued that the tests were designed to allow almost everybody to pass. Rather than setting extreme conditions, the assumptions of the "adverse" scenario were not too far from the expectations of private forecasters.

31 Banks requiring capital injection included Citigroup, Bank of America, Wells Fargo and GMAC. Banks that were allowed to return TARP funds included JPMorgan Chase, Goldman Sachs and Morgan Stanley.

32 See "BOE to make more capital available", *Financial Times*, 9 June 2009.

33 United States Treasury securities held by the Federal Reserve increased from $476 billion on 31 December 2008 to $633 billion on 17 June 2009, as it purchased long-term T-bonds as a way of maintaining long-term interest rates at relatively low levels.

34 G-20, The Global Plan for Recovery and Reform, 2 April 2009, at: http://www.g20.org/Documents/final-communique.pdf.

35 According to Lipsky (2009), "The spending measures already announced must be implemented if they are to support the incipient recovery. Moreover, if the signs of recovery turn out to be a false dawn, consideration may need to be given to providing additional stimulus". See also Freeman et al., 2009.

36 Required fiscal tightening concerns spending and revenue measures that affect global demand, but generally exclude the support of a troubled financial sector, even if it involves large fiscal costs.

37 The Congressional Budget Office provided a detailed breakdown of measures and a year-by-year estimate of the economic effects of the American Recovery and Reinvestment Act of 2009 in a letter to the Honorable Charles E. Grassley, a ranking member of the Committee on Finance of the United States Senate, available at: http://www.cbo.gov/ftpdocs/100xx/doc10008/03-02-Macro_Effects_of_ARRA.pdf.

38 On the same occasion, the Federal Reserve also authorized temporary bilateral swap lines to provide dollar liquidity to overseas markets through foreign central banks, with the ECB and the Swiss National Bank and later also with the central banks of Australia, Brazil, Canada, Denmark, Japan, Mexico, New Zealand, Norway, the Republic of Korea, Singapore, Sweden and the United Kingdom. In order to be able to offer liquidity in foreign currency to financial institutions in the United States, the Federal Reserve obtained swap lines with the Bank of England, the ECB, the Bank of Japan and the Swiss National Bank.

39 In November 2008, G-20 leaders declared a determination to "enhance our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems" (G-20 Declaration from the Summit on Financial Markets and the World Economy, 15 November 2008, available at: http://www.fazenda.gov.br/portugues/documentos/2008/novembro/G20-SUMMIT-LEADERS-DECLARATION-2008-11-15.pdf).

40 See, for example, Hell (2008), as well as TWN Info Service on Finance and Development, "General Assembly thematic dialogue on economic crisis begins", Third World Network, 1 April 2009; and Archibugi D, "The G20 ought to be increased to 6 billion", at: http://www.opendemocracy.net/article/email/the-g20-ought-to-be-increased-to-6-billion.

41 G-20, Declaration on Delivering Resources Through the International Financial Institutions, London, 2 April 2009, available at: http://www.g20.org/Documents/Fin_Deps_IFI_Annex_Draft_02_04_09_-__1615_Clean.pdf.

42 For example, the IMF noted that "countercyclical monetary policy can help shorten recessions, but its effectiveness is limited in financial crises. By contrast, expansionary fiscal policy seems particularly effective in shortening recessions associated with financial crises and boosting recoveries" (IMF, 2009e).

43 For an explanation of the revision of the IMF stand-by agreement with Ukraine, see IMF Press Release 09/156, "IMF completes first review under stand-by arrangement with Ukraine and approves US$2.8 billion disbursement", Washington, DC, 8 May 2009.

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Annex to chapter I

THE GLOBAL RECESSION COMPOUNDS THE FOOD CRISIS

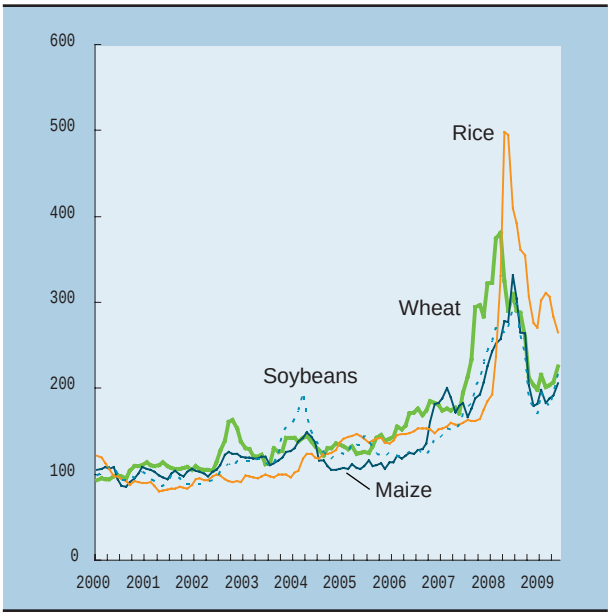
As is well known, the sharp increase in the prices of food commodities between April 2007 and May 2008 (chart 1.A1) had dramatic consequences for many developing countries. The greatest impact was on low-income countries, where poor households spend a large proportion of their income on food, and which are strongly dependent on food imports.[1] The prices of wheat, maize, rice and soybeans all peaked between March and July 2008, but then fell steeply until the end of the year. In early 2009, wheat and maize prices stabilized at their 2007 levels and rice prices at their early 2008 level. Food prices are still well above their longer term average. The factors that have caused the ongoing food crisis were discussed at greater length in *TDR 2008 (*chap. II, section C). All these factors continue to influence the global markets for food commodities (Mittal, 2009). The features that have distinguished the current food crisis from previous episodes of rapidly increasing food prices include increasing demand for commodities for biofuel production and commodity speculation in financial markets (Peters, Langley and Westcot, 2009). Thus, apart from reflecting a major failure of development strategy (UNCTAD, 2008), the recent food crisis is closely linked to other global challenges, such as the financial and economic crisis, the energy crisis and efforts to address the problem of climate change.

According to estimates of the Food and Agriculture Organization of the United Nations (FAO), the combination of the high food prices and the global economic crisis has caused the number of hungry people in the world to soar by 100 million, resulting in more than one billion hungry people this year (FAO, 2009a). In 2009, food emergencies persist in 31 countries (FAO, 2009b), and between 109 million and 126 million people may have fallen below the poverty line since 2006 due to higher food prices.

Chart 1.A1

FOOD COMMODITY PRICES, JANUARY 2000–MAY 2009

(Index numbers, 2000 = 100)



Source: UNCTAD, *Commodity Price Statistics Online*.

Sub-Saharan Africa and South Asia are identified as the most vulnerable regions (Purcell, 2009).

Following the surge in food prices, low-income food-deficit countries saw their food import bill double between 2005 and 2008. In 2009, it is expected to fall by 23 per cent as a result of lower prices, but it should remain much higher than the average of the past decade. For cereals, which are the most critical item for food security, the import bill in low-income food-deficit countries increased by 62 per cent in 2007/08. While lower prices are expected to knock down the size of that bill by 27 per cent in 2008/09, this is still 54 per cent higher than the average of the four previous seasons between 2003 and 2007 (FAO, 2009b and c).

The significant fall in international food prices in the second half of 2008 did not translate into substantially lower prices in developing countries. According to FAO (2009c), domestic prices have remained generally very high, and in some cases at record highs. It appears that while the pass-through between prices on international commodity markets and consumer prices was high in the phase of increasing prices, the reverse was not evident during the subsequent months of falling prices (Ghosh, 2009).

Lower food prices were the result of bumper harvests in 2008, mainly of cereals, due to increased plantings and favourable weather conditions. Cereal production rose by 13.2 per cent in developed countries, but by only 2.8 per cent in developing countries (FAO, 2009c). Producers in developed countries were generally better able to cope with the rising costs of inputs. On the demand side, the global recession may have affected demand for biofuels because of the lower oil prices, and the demand for feedstock because of reduced meat consumption. However, the relatively lower elasticity of demand for food implies that it is less affected by a slowdown in global economic activity than demand for other commodities. Total cereal utilization increased by 3.8 per cent in 2008/09, and is expected to rise again by 1.3 per cent in 2009/10 (FAO, 2009c). Moreover, non-market fundamental factors, such as the unwinding of speculative positions in food commodities and the appreciation of the dollar, may have contributed significantly to the sharp decline in international food prices.

Increasing production and somewhat slower demand growth eased market conditions and allowed some replenishing of inventories, which had fallen to historically low levels in 2008.[2] In 2009, the stock-to-utilization ratio of grains and oilseeds is significantly higher than in 2008, but it is still about 16 per cent below the average for the decade 1996–2006, before prices surged.[3] Moreover, the situation seems to be reversing again in 2009. As a result of the lower prices, the prevailing high input prices, and the credit crunch, some farmers have been cutting back planting area (IRRI, 2008). Yields are also being affected by lower fertilizer use in order to reduce costs.

In addition, adverse weather conditions in different parts of the world are affecting crop prospects. World cereal production is forecast by FAO (2009b and c) to drop by 3 per cent in 2009/10 from the 2008/09 level, and to fall slightly short of use, so that stocks will partly be eroded. In the case of oilseeds (mainly soybeans), declining production in major producing countries, together with increasing demand, notably from China, may again reduce inventories to critically low levels in 2009. All this, together with the rebound in oil prices and the return of financial investors to commodity markets, is reflected in upward pressure on prices.

Thus, while the market balance has somewhat improved, any shock to food markets could exacerbate the food security situation. In addition, forecasts by specialized agencies expect food prices to remain high in the longer run, mainly as a result of continuously rising biofuel demand and structural factors related to population and income growth (OECD-FAO, 2009; FAPRI, 2009; USDA, 2009).[4]

The global recession has also had a negative impact on the food situation, notably in the poorest countries, where lower incomes resulting from declining employment and wages and falling remittances are limiting the capacity of poor households to buy food. In many countries, falling export revenues due to the low prices of their commodity exports and difficulties in obtaining trade finance have reduced import capacity and lower fiscal revenues have limited the scope for government action to address the symptoms of the food crisis. Moreover, in low-income food-deficit countries whose currencies depreciated since mid-2008 the fall in international food prices was not fully translated into lower domestic prices. The effects of the crisis are dramatically reflected in country case studies by the World Food Programme (WFP, 2009) for Armenia, Bangladesh,

Ghana, Nicaragua and Zambia, which confirm that poor households are eating fewer and less nutritious meals. Many are also cutting back on health care and children's schooling.[5]

The food crisis remains a vital concern; it requires a combination of short- and long-term actions. Short-term measures already being applied include increased emergency food assistance, cash transfers and improved safety nets to meet urgent food needs. A number of developing countries have also resorted to price controls and subsidies, and to various trade policy measures to protect their populations.[6] However, the latter have exacerbated the problem in world markets. Moreover, although these measures have sheltered consumers from exploding food prices, in some countries they have reduced incentives for farmers to increase production (Gandure, 2008). Some of these measures were relaxed with the easing of markets, which also may have contributed to lowering prices, but many of them remain in place. Moreover, several countries have acquired land overseas, particularly in Africa, with a view to securing food supplies. Such investments may bring some opportunities, but they also pose risks for the poor if their access to land is impaired. These investments should therefore be adequately regulated to ensure fair benefit-sharing (FAO, IFAD and IIED, 2009).[7]

Over the long term, food security will require more investment in agriculture to raise productivity. More remunerative prices for farmers would provide them with a greater incentive to boost production. Due to the lack of data, a systematic comparison of world market prices and farm-gate prices is not possible, but there are indications that many small farmers in developing countries, especially in low-income countries, have benefited only partially, if at all, from rising world market prices for their products. On the other hand, they have been affected by the higher world market prices for their inputs (Oxfam, 2008; Dawe, 2008).

The capacity to respond to price incentives would also require a more supportive institutional and financial framework. At the national level, this implies greater government support for agricultural research, development and infrastructure, purchase of inputs, provision of credit and extension services. Such support was significantly reduced or even entirely abolished under structural adjustment programmes sponsored by the international financial institutions. At the international level, the removal of distortions in international agricultural markets, especially by dismantling agricultural support and protection in developed countries, could help increase agricultural incomes and production in developing countries. While the immediate effect might be an increase in food prices, in the medium term the benefits of the elimination of agricultural support in developed countries are likely to outweigh the adjustment costs of such a policy reform for developing countries, including net food importers (Herrmann, 2007).

Annual additional investments to ensure food and nutrition security, estimated at $25 billion to $40 billion (UN/DESA, 2008), are small compared to the fiscal stimulus and financial support packages that are now being implemented in developed countries in response to the financial and economic crisis. Official development assistance (ODA) for African agriculture would need to increase from the current $1–2 billion to some $8 billion by 2010 (MDG Africa Steering Group, 2008). The international response to the global food crisis has been rapid, notably with the establishment of the Comprehensive Framework for Action,[8] and has led to additional aid pledges for food and agricultural development. But so far, resources available to solve the food crisis have not increased sufficiently to meet all the priority needs, and disbursement of funds has been slow (FAO, 2009e; EC, 2009; Oxfam, 2009). Moreover, aid flows are threatened by the global recession (UNCTAD, 2009); the World Food Programme has already been obliged to scale down its food aid operations (*Financial Times*, 12 June 2009). Due to the continuing food emergency situation in many of the poorest countries, the international community should fulfil the pledges made to fight the global food crisis. Adequate compensatory financing should also be provided to developing countries to help them address balance-of-payments problems resulting from higher food prices. One such scheme is the Exogenous Shock Facility of the International Monetary Fund (IMF), which was modified in September 2008 in order to make it more effective. Since then it has provided financing to eight developing countries and one transition economy for a total of SDR 767 million (IMF, 2009).[9]

Notes

1 For a detailed discussion on the state of food insecurity in the world in connection with the high food prices, see FAO, 2008.

2 The stock-to-use ratio for aggregate global grains and oilseeds in 2008 reached its lowest level since 1970 (Trostle, 2008).

3 UNCTAD secretariat calculations based on USDA, *Production, Supply and Distribution* database.

4 According to FAO, to keep up with population and income growth, global food production needs to increase from average 2005–2007 levels by more than 40 per cent by 2030 and 70 per cent by 2050 (OECD-FAO, 2009).

5 Similar conclusions are also reached in a study by the Institute of Development Studies (IDS, 2009) for Bangladesh, Indonesia, Jamaica, Kenya and Zambia.

6 For a review of domestic policy responses to high food prices, see FAO, 2009d.

7 Similarly, the United Nations Special Rapporteur on the Right to Food has recently recommended some principles and measures, based on human rights, to discipline "land grabbing" (de Schutter, 2009).

8 The Comprehensive Framework for Action was established in 2008 by the United Nations Secretary-General's High-Level Task Force on the Global Food Security Crisis (see background information on the Task Force at http://www.un.org/issues/food/taskforce/). Other initiatives include the Initiative on Soaring Food Prices by FAO, the World Bank Global Food Response Programme, regional responses such as the African Food Crisis Response by the African Development Bank, the EU Food Facility and individual donors' aid pledges. In addition, there was a High-Level Conference on World Food Security: the Challenges of Climate Change and Bioenergy in Rome in June 2008, and a High-Level Meeting on Food Security for All in Madrid in January 2009. There has also been a proposal for the establishment of a Global Partnership for Agriculture and Food Security to include all agents involved: governments, the private sector, civil society, donors and international institutions. For more details on responses to the food crisis, see EC, 2009, and information on the food price crisis and the global food security challenge from the Global Donor Platform for Rural Development at: http://www.donorplatform.org/content/view/185/172.

9 See IMF Factsheet on the Exogenous Shock Facility at: http://www.imf.org/external/np/exr/facts/esf.htm.

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