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# TRADE AND DEVELOPMENT REPORT, 2010

## *Chapter I*

### AFTER THE GLOBAL CRISIS: AN UNEVEN AND FRAGILE RECOVERY



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## AFTER THE GLOBAL CRISIS: AN UNEVEN AND FRAGILE RECOVERY

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### A. Recent trends in the world economy

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#### 1. Global growth and international trade

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The world economy appears to be recovering from its worst crisis since the Second World War. After a marked slowdown in 2008 and a real contraction of almost 2 per cent in 2009, global GDP is expected to expand by about 3.5 per cent in 2010 (table 1.1). This would mean a return to pre-crisis growth rates in most regions, with the exception of the European Union (EU) and some transition economies where a resurgence of growth is proving to be much slower. However, these prospects are no reason for complacency: the exit from recession may seem to have been rapid but it is unlikely to be either strong or durable if it continues to be based on temporary factors, such as inventory cycles and exceptional fiscal stimulus programmes, and if the underlying causes of the crisis are still in place, such as unregulated financial systems, income inequality and global imbalances.

The global crisis in 2008–2009 was exceptional in several respects: it was the first time in the post-war period that global GDP contracted, almost all regions in the world were affected, and the time lapse between the financial shock and its impacts on the real economy was remarkably short. No region was spared by the crisis. Developed economies – where the financial

crisis originated – and transition economies were the worst affected, but developing economies also suffered GDP contractions, or at least a significant deceleration. In fact, most developed and emerging economies posted strongly negative growth rates in the last quarter of 2008 and the first quarter of 2009, including several emerging economies that had been growing at a fast pace in the first half of 2008. Even those emerging economies that avoided an outright recession (including China, India and Indonesia) could not escape a significant slowdown of economic growth at that time (see *TDR 2009*, chap. I).

As remarkable as the rapid spread of the crisis in late 2008 and early 2009, is the rapid recovery in numerous countries, particularly in developing regions. However, their relatively high growth rates in 2010 are partly due to the fact that they rebounded from low levels in 2009, a statistical effect that is set to wane in the near future. And unless new sources of dynamism can be found, growth rates will probably decline in most countries in 2011.

In developed economies, the rescue packages initiated by governments in 2008 and 2009 prevented the collapse of financial markets, while supportive fiscal and monetary policies partially compensated for sluggish private demand. With some exceptions

Table 1.1

WORLD OUTPUT GROWTH, 1991–2010								
<i>(Annual percentage change)</i>								
<i>Region/country</i>	<i>1991– 2003<sup>a</sup></i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009<sup>b</sup></i>	<i>2010<sup>b</sup></i>
<b>World</b>	<b>2.8</b>	<b>4.1</b>	<b>3.5</b>	<b>3.9</b>	<b>3.9</b>	<b>1.7</b>	<b>-1.9</b>	<b>3.5</b>
<b>Developed countries</b>	<b>2.5</b>	<b>3.1</b>	<b>2.5</b>	<b>2.8</b>	<b>2.5</b>	<b>0.3</b>	<b>-3.4</b>	<b>2.2</b>
<i>of which:</i>								
Japan	1.0	2.7	1.9	2.0	2.4	-1.2	-5.2	2.5
United States	3.3	3.6	3.1	2.7	2.1	0.4	-2.4	2.9
European Union (EU-27)	2.3	2.5	2.0	3.1	2.8	0.7	-4.2	1.1
<i>of which:</i>								
Euro area	2.1	2.2	1.7	2.9	2.7	0.6	-4.1	0.9
France	2.0	2.5	1.9	2.2	2.4	0.2	-2.6	1.2
Germany	1.7	1.2	0.8	3.0	2.5	1.3	-4.9	1.5
Italy	1.6	1.5	0.7	2.0	1.4	-1.3	-5.1	0.8
United Kingdom	2.9	3.0	2.1	2.8	2.6	0.5	-4.9	1.1
European Union (EU-12) <sup>c</sup>	2.7	5.6	4.7	6.5	6.1	3.9	-3.3	2.0
<b>South-East Europe and CIS</b>	<b>..</b>	<b>7.7</b>	<b>6.6</b>	<b>8.1</b>	<b>8.5</b>	<b>5.4</b>	<b>-6.3</b>	<b>4.1</b>
South-East Europe <sup>d</sup>	..	5.5	4.7	5.1	6.1	4.2	-3.6	1.2
Commonwealth of Independent States (CIS)	..	8.0	6.8	8.4	8.7	5.5	-6.5	4.4
<i>of which:</i>								
Russian Federation	..	7.2	6.4	7.7	8.1	5.6	-7.9	4.3
<b>Developing countries</b>	<b>4.6</b>	<b>7.3</b>	<b>6.7</b>	<b>7.4</b>	<b>7.8</b>	<b>5.4</b>	<b>2.4</b>	<b>6.9</b>
Africa	3.0	5.9	5.6	5.9	6.0	4.9	2.5	4.8
North Africa, excl. Sudan	3.4	4.8	5.2	5.7	5.2	5.2	3.3	4.7
Sub-Saharan Africa, excl. South Africa	3.0	7.6	6.5	6.3	7.2	5.3	3.8	5.9
South Africa	2.4	4.9	5.0	5.3	5.5	3.7	-1.8	3.0
Latin America and the Caribbean	2.7	6.1	5.0	5.7	5.9	4.3	-1.8	5.2
Caribbean	2.4	3.9	7.6	9.4	6.1	3.3	0.2	2.2
Central America, excl. Mexico	4.1	4.3	4.8	6.5	7.1	4.5	-0.6	3.0
Mexico	3.0	4.0	3.2	4.8	3.2	1.5	-6.6	4.1
South America	2.5	7.2	5.6	5.8	7.0	5.5	-0.2	5.9
<i>of which:</i>								
Brazil	2.5	5.7	3.2	4.0	6.1	5.1	-0.2	7.6
Asia	5.9	8.0	7.6	8.2	8.8	5.8	4.0	7.8
East Asia	7.5	8.3	8.1	9.2	10.2	6.8	5.3	8.9
<i>of which:</i>								
China	10.0	10.1	10.4	11.6	13.0	9.6	8.7	10.0
South Asia	5.1	7.5	8.1	8.4	8.7	5.0	5.5	6.6
<i>of which:</i>								
India	5.8	8.3	9.3	9.4	9.6	5.1	6.6	7.9
South-East Asia	4.6	6.6	5.9	6.2	6.6	4.0	0.8	7.0
West Asia	3.5	8.9	7.1	6.0	5.0	4.6	-0.8	5.2

**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) 2010: Mid-Year Update*; ECLAC, 2010; OECD, 2010; and national sources.

**Note:** Calculations for country aggregates are based on GDP at constant 2000 dollars.

**a** Average.

**b** Preliminary estimates for 2009 and forecasts for 2010.

**c** New EU member States after 2004.

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

(e.g. Finland, Greece, Iceland, Ireland, Italy, Spain and the Baltic countries), developed economies returned to positive growth rates between the second and the fourth quarter of 2009. It is estimated that in 2010, growth rates will be close to 3 per cent in Australia, Canada, Japan and the United States, but it is unlikely that developed countries as a whole will return to rapid and sustainable growth rates in the near future. The main reason is that, in general, final domestic demand remains weak owing to continued high unemployment and low private consumption. Households tend to increase savings partly for precautionary reasons, but also because of declining real income and the scarcity of bank credit. Investment remains discouraged by idle productive capacities, uncertain future demand and more difficult access to credit. Indeed, it is likely that balance-sheet adjustments in financial and non-financial private sectors will continue to dampen domestic demand.

On the positive side, the inventory cycle entered an upside phase in mid-2009 as firms began to rebuild their inventories. For instance, in the United States, the main factor contributing to GDP growth since then has been the reversal from destocking to restocking, followed by private consumption; on the other hand, fixed investment, public expenditure and net exports have made little or no contribution. In Germany, the replenishing of inventories is expected to be the sole positive contribution to growth based on domestic demand in 2010. However, the contribution of restocking is by its very nature only temporary.

Several developed countries seem to be promoting net exports as a possible driver of growth. Very dynamic regional growth in Asia, and the resultant strong demand, contributed most to the significant export-led recovery of Japan – one of the developed countries severely affected by the crisis. In Western Europe, too, policies have aimed at increasing net exports, and the growth rate, albeit more modest, has also been lifted primarily by external demand. The United States, on the other hand, will find it difficult to follow an export-led growth strategy following the appreciation of the dollar. More generally, if too many big players begin to rely on net exports, they cannot all be successful, and this could lead to trade tensions among them. Moreover, there is a high risk that a withdrawal of fiscal stimulus before the return of strong domestic consumption and investment will jeopardize economic recovery.

The depth of the economic recession and the vigour of the subsequent recovery vary widely among developing and transition economies. In particular, the financial shock seriously affected those emerging-market economies that had been running current-account deficits and depended heavily on capital inflows. Such countries (many of them in Central and Eastern Europe and the Commonwealth of Independent States (CIS)) were forced to apply restrictive macroeconomic policy responses, in some cases under IMF-led programmes. By contrast, the financial turmoil had little effect on low-income countries that are largely excluded from international financial markets (such as South Asian and sub-Saharan African countries) and on emerging-market economies that had avoided large external deficits and accumulated significant international reserves in the years prior to the crisis. This not only gave their governments enough policy space to conduct countercyclical macroeconomic policies, but also their previously accumulated reserves provided a buffer against the financial shockwaves and helped them to pre-empt exchange-rate and banking crises.

As a result, most Asian and Latin American emerging-market economies were able to contain a rise in unemployment and achieve rapid recovery of domestic demand, which appear to be the main drivers of their growth in 2010. Improvements in commodity prices since mid-2009 and in the volume of exports (especially in East and South-East Asia and in some Latin American countries such as Argentina, Brazil and Mexico) have also contributed significantly to GDP growth. Latin American GDP is forecast to expand by some 5 per cent in 2010, with growth in the four MERCOSUR countries<sup>1</sup> and Peru at close to 7 per cent. Recovery is likely to be more moderate in Mexico, Central America and the Caribbean, with growth rates generally between 2 and 4 per cent. These countries were strongly affected in 2009 by the collapse of foreign trade, a reduction in international tourist arrivals and falling remittances. At present, their merchandise exports appear to be the main contributor to their economic upturn, as domestic demand remains weak.

Most South-East Asian economies started 2010 with very rapid growth rates, sustained by both buoyant exports and strong domestic demand. Even if some deceleration is likely in the second half of 2010 and into 2011, the subregion's GDP should expand by some 7 per cent in 2010. South and East

Asia only suffered a deceleration of their rapid pace of growth in early 2009, and most of them are on track to return to their pre-crisis growth rates in 2010. Policies aimed at boosting domestic demand in China and India, in particular, must be credited to a large extent for that outcome. Fiscal support and credit availability strengthened domestic demand, leading to both higher consumption and investment expenditure. In China, some reorientation of public expenditure is under way, which would increase the share of social expenditure and reduce that of investment in infrastructure. This, together with sustained increases in real wages, may help rebalance the composition of domestic demand and make its expansion more sustainable in the long run by increasing the share of household consumption and reducing that of investment from its very high current level. Remittances sent to South Asia continued to grow in 2009 (unlike recipient countries in Latin America, Europe, North Africa and the CIS), which added to the resilience of domestic demand. Trade flows have rebounded since mid-2009, providing a dynamic condition for these regions' economies, and contributing to the upturn in commodity prices from their lows of the first quarter of 2009.

Higher commodity prices have been playing an important role in Africa, West Asia and the CIS: they helped increase national income, generated additional fiscal revenue and relaxed foreign-exchange constraints. In oil-exporting countries in North Africa and West Asia, higher public spending in 2009 and 2010 for important investment projects was also made possible by previously accumulated funds. In several African countries, economic performance partly relies on activities such as agriculture, which are largely unaffected by short-term international trends and face generally positive prospects. In addition, investment projects related to infrastructure development, telecommunications and/or extractive industries helped maintain positive per capita income growth in 2009 and will continue to support even faster growth in 2010. In South Africa, the country in the region that was the worst affected by the international crisis, the manufacturing and mining sectors should benefit from improved foreign demand, and there is also expected to be an increase in tourism. The projected growth rate for the region as a whole is 5 per cent, and closer to 6 per cent for sub-Saharan countries (excluding South Africa). Finally, in most countries of Central and Eastern Europe and the CIS, recovery is likely to be moderate, with domestic demand

weighed down by unemployment and constraints on government spending. The highest growth for these groups in 2010 will probably occur in some oil or gas exporters (e.g. Azerbaijan and Turkmenistan). The Russian Federation and Ukraine are set to grow by more than 4 per cent, and although this will not be sufficient to restore their GDP to its pre-crisis level, it will provide some relief to other CIS countries, for which the Russian Federation is a major market and the main source of workers' remittances.

International trade, which contracted sharply in both volume and value, was the main channel through which the crisis spread globally. The volume of world trade plunged by more than 13 per cent in 2009 (table 1.2). Given the overall fall in unit prices of trade (close to 11 per cent), the decline in the value of trade in current dollars was even more pronounced, reaching 23 per cent for the year.

Although the crisis-induced squeeze on trade credit played a role in reducing trade worldwide, the decline in domestic demand, amplified by the globally synchronized nature of the downturn since 2008, was the main cause of the slowdown in world trade in 2009. The sharp falls in wealth and expectations prompted households and firms to reduce or postpone spending, especially on consumer durables and investment goods, which constitute an important share of world trade. Expanded global supply chains – a dominant feature of transnational corporations in world trade today – also played an important, though unquantifiable, role in the 2009 slump in world trade. In addition, lower production of manufactures translated into lower demand for energy and industrial raw materials. As a result, all countries and regions registered significant declines in their exports of goods, with larger declines in volume in developed and transition countries than in developing countries. Since the crisis first affected the demand for durable and capital goods, it is no wonder that the impact was greatest on countries like Germany and Japan. However, in terms of the value of exports, the worst hit countries were exporters of oil and mining products, for which not only the volume, but more importantly the unit value of exports fell sharply.

In all regions, both exports and imports declined. In some cases, this was partly due to the high import component of exported manufactures, so that those countries that faced lower demand for their exports automatically reduced their demand for imports.

Table 1.2

Region/country	Volume of exports				Volume of imports			
	2006	2007	2008	2009	2006	2007	2008	2009
	<b>World</b>	<b>9.2</b>	<b>5.8</b>	<b>3.0</b>	<b>-13.7</b>	<b>8.5</b>	<b>6.6</b>	<b>2.2</b>
<b>Developed countries</b>	<b>8.5</b>	<b>3.9</b>	<b>2.8</b>	<b>-14.8</b>	<b>7.2</b>	<b>3.7</b>	<b>0.0</b>	<b>-14.2</b>
<i>of which:</i>								
Japan	11.8	6.8	4.9	-25.3	4.3	0.8	-0.9	-12.8
United States	10.5	6.8	5.5	-14.9	5.4	1.1	-3.7	-16.5
European Union	8.9	3.2	2.5	-13.7	8.9	4.8	1.1	-13.7
<b>South-East Europe and CIS</b>	<b>6.0</b>	<b>8.6</b>	<b>0.8</b>	<b>-15.5</b>	<b>21.4</b>	<b>26.1</b>	<b>16.0</b>	<b>-28.2</b>
South-East Europe	16.1	17.9	-13.3	-20.1	10.5	23.7	-9.5	-19.5
CIS	5.5	8.1	1.6	-15.2	23.6	26.5	18.9	-29.2
<b>Developing countries</b>	<b>10.8</b>	<b>8.7</b>	<b>4.2</b>	<b>-11.7</b>	<b>10.2</b>	<b>10.6</b>	<b>5.3</b>	<b>-9.5</b>
Africa	1.3	4.8	-2.8	-10.0	9.9	11.2	11.6	-2.4
Sub-Saharan Africa	1.1	4.7	-1.4	-10.3	12.6	8.8	3.7	-5.6
Latin America and the Caribbean	5.6	2.4	-0.6	-9.7	13.2	11.6	8.6	-17.1
East Asia	18.3	15.6	7.3	-10.2	10.6	10.2	0.6	-4.6
<i>of which:</i>								
China	25.4	21.8	10.5	-13.0	13.3	14.1	2.4	-0.2
South Asia	10.9	6.3	14.9	-18.9	9.9	10.9	7.2	-6.9
<i>of which:</i>								
India	11.3	15.2	10.7	-7.9	9.9	16.9	10.4	-7.5
South-East Asia	10.3	6.9	2.1	-9.7	7.3	6.7	8.0	-15.9
West Asia	3.8	2.0	7.4	-14.4	9.4	16.7	8.4	-12.8

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

More generally, concurrent movements in exports and imports in all the regions show the synchronized character of economic retraction, or slowdown, and contrasts with previous episodes of localized crises. In such episodes, the economies hit by recession considerably reduced their imports but not their exports, and consequently found some economic stimulus through their foreign trade. In the present crisis, the best performers were countries that could rely on their domestic or regional markets. Thus, even though both imports and exports fell worldwide, the degree of the fall varied in different regions. In South America, the CIS and most countries exporting oil and mining products, import volumes declined more than export volumes due to terms-of-trade losses. In

other countries, imports by volume declined more moderately than exports, either because a significant proportion of imports are normally funded through non-export revenues, such as public grants or private remittances (as seems to be the case in sub-Saharan Africa and South Asia), or because the countries were running large trade surpluses and/or had abundant foreign exchange reserves when the crisis erupted. In China, for example, lower exports reduced the trade surplus but only marginally affected the volume of imports.

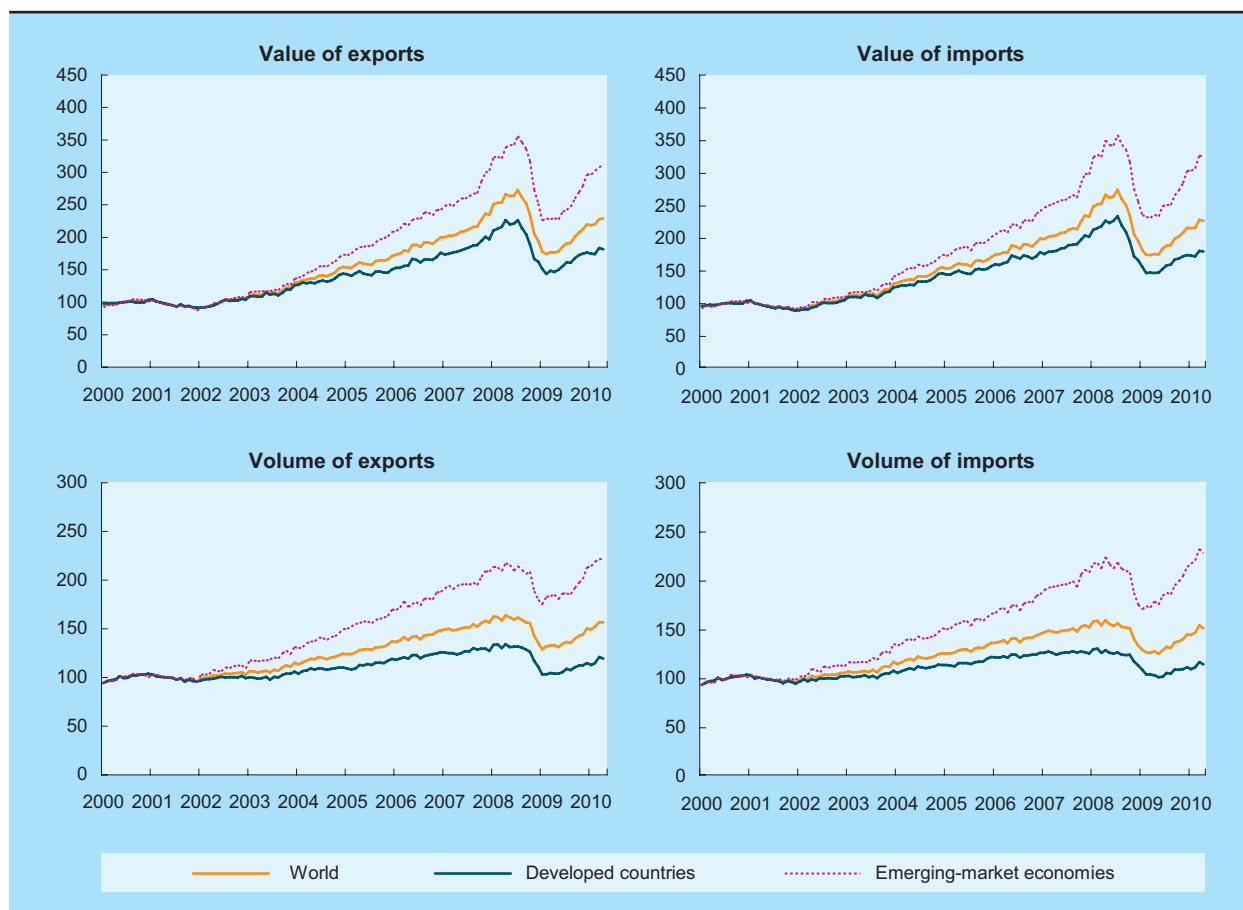
The feared surge in protectionism has not materialized so far. New import-restricting measures imposed by G-20 countries from November 2009



Chart 1.1

### WORLD TRADE BY VALUE AND VOLUME, JANUARY 2000–APRIL 2010

(Index numbers, 2000 = 100)



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

to May 2010 have affected at most only 0.7 per cent of these countries' imports and 0.4 per cent of world imports of goods, which represents about half the increase of the previous six months (UNCTAD, WTO, OECD, 2010; WTO, 2010). But uncertainties linked to export markets and high unemployment rates could still potentially trigger protectionist policies in the not too distant future.

Since the sharp contraction of trade in 2009 was strongly demand-driven, as demand recovers, so too should trade. In fact, trade volume started to recover from the second half of the year, led by strong demand from developing countries and relatively weaker demand from developed countries. Indeed, trade between developing countries is increasing significantly in 2010. By April 2010, the external

trade (by volume) of emerging-market economies had already bounced back to its previous peak of April 2008. External trade in developed countries has also been growing since mid-2009, although at a slower pace (chart 1.1). Overall, world trade in goods could expand in volume by more than 10 per cent in 2010, which would allow it to return to its pre-crisis levels. However, measured in current dollars, the recovery will take more time, as unit values in international trade remain, on average, clearly lower than their 2008 peaks.

Trade in services has by and large followed the same trends as that of goods. Regarding travel services, the year 2009 is viewed as "one of the most challenging periods in tourism's history" (World Tourism Organization, 2010a). The number of international



tourist arrivals fell by 4.3 per cent that year, compared to 2008 which was a record year. Among world regions, international arrivals shrank above average in Europe (-5.6 per cent), partly aggravated by the then still strong euro, in West Asia (-5.4 per cent) and in the Americas, which suffered an additional blow to tourism due to the influenza A(H1N1) virus (swine flu). Worldwide tourist receipts were down by 5.8 per cent in value, which shows that tourists also cut their average expenditure at destination (World Tourism Organization, 2010b). The decline in international arrivals was the most pronounced in the first three quarters of 2009, coinciding with the period when the financial crisis reached the real economy, as reflected in rising unemployment and falling consumer confidence. The fourth quarter of 2009 saw a revival in international arrivals, although it was uneven and weak. This again corresponded to the overall economic recovery that started during that period.

International transport services also have a direct relationship with the overall performance of the global economy and total merchandise trade. Seaborne trade (which carries 80 per cent of all traded goods) declined in volume by 4.5 per cent in 2009.<sup>2</sup> The sharpest reduction was in containerized trade at the end of 2008 and into 2009. The bulk sector was less affected owing to large imports by China, which took advantage of low prices of commodities and freight to increase its stocks of raw materials. Prices of maritime freight plummeted by the end of 2008, when the Baltic Exchange Dry Index fell by 90 per cent from its record high in May of that year. By mid-2009 there was a partial recovery, with freight rates at around 40 per cent of their 2008 peak (UNCTAD, 2010). The world merchant fleet capacity grew by 6.7 per cent in 2008 and by another 7 per cent in 2009. Given the scheduled ship deliveries, that capacity will grow further during 2010. As a result, it is unlikely that the recovery of trade in goods will lead to a new surge in freight tariffs in the short run.

## **2. Recent trends in primary commodity markets**

After the collapse in demand for and prices of commodities in the second half of 2008 as a result of the global financial and economic crisis, most commodity prices rebounded in 2009. This upward

trend continued partially into 2010, although the behaviour of prices in the first months of the year was fairly erratic, exhibiting some downward corrections in January–February and May 2010 (chart 1.2). The prices of a large number of commodities increased significantly between the beginning and end of 2009, but they were lower than their average of 2008 (table 1.3) – an average that was very high owing to soaring prices in the first half of 2008. Overall, in spite of their sharp decline in the second half of 2008, prices for all commodity groups during 2009 and early 2010 have remained well above their average of the 2000s.

The most significant price increases in 2009 and the first half of 2010 were in metals and minerals, and energy products, particularly crude petroleum. These were also the commodities that had witnessed the sharpest slump in prices in the second half of 2008. By April 2010, the price of crude petroleum had more than doubled in comparison with the trough of early 2009, while the price index for metals and minerals had increased by 83 per cent, reaching close to its peak levels of early 2008. The prices of agricultural commodities grew more moderately, although those of agricultural raw materials rose by more than 55 per cent from their trough (chart 1.2). Thus the commodities which experienced the largest variations in prices were those that are more closely linked to the evolution of the global industrial production cycle.

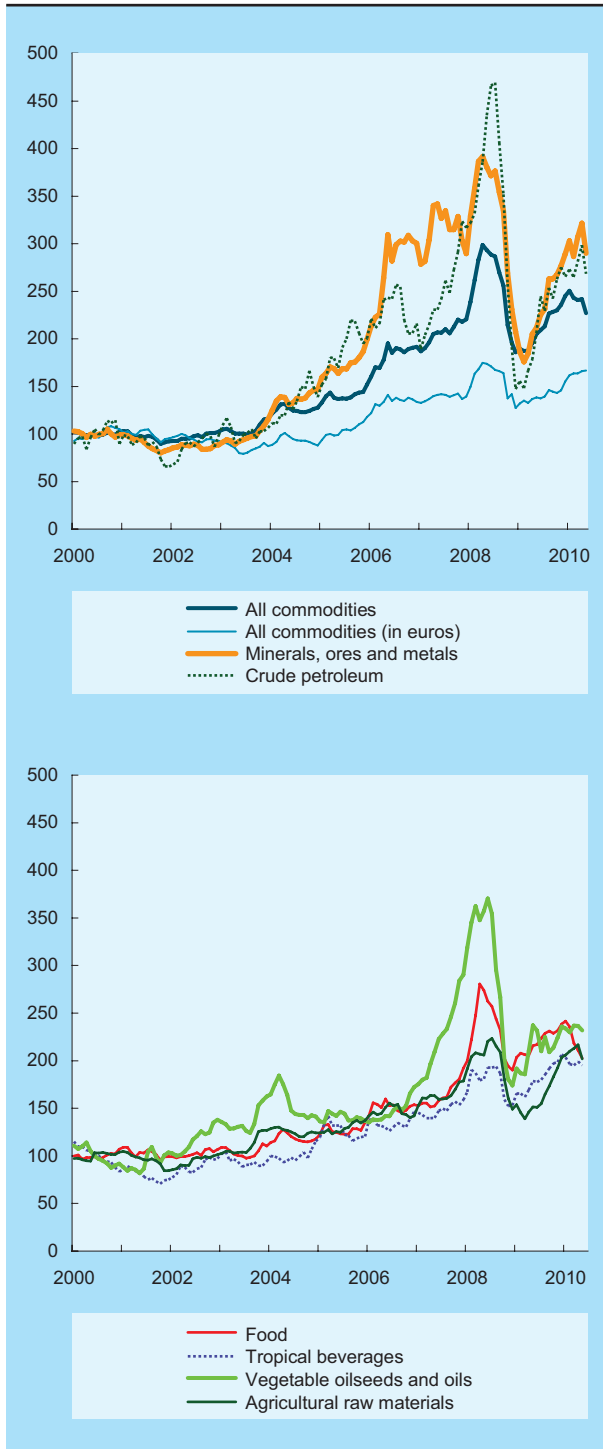
Robust demand from rapidly growing developing countries, mainly China, has been the key driver of the recovery of commodity prices, particularly metals and minerals, and crude petroleum, and partly also agricultural raw materials. China's strong demand growth for minerals and metals, and energy was largely due to the success of its fiscal stimulus package and monetary policy easing in response to the crisis, as well as to its policy of building up its commodity inventories. Chinese authorities took advantage of the lower prices to increase their strategic reserves for the future, while private companies sought to replenish their inventories. As an illustration, in 2009, Chinese demand for the main base metals (aluminium, copper, lead, nickel, tin and zinc) increased by 23 per cent, whereas this demand fell by 13.5 per cent in the rest of the world (World Bank, 2010).

The monthly average of crude petroleum prices, which usually lead developments in other commodity markets, had fallen sharply to around \$40 per barrel

Chart 1.2

### MONTHLY COMMODITY PRICE INDICES BY COMMODITY GROUP, JAN. 2000–MAY 2010

(Index numbers, 2000 = 100)



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

**Note:** Crude petroleum price is the average of Dubai/Brent/West Texas, equally weighted. Prices are in current dollars, unless otherwise specified.

in December 2008–February 2009, after having reached over \$130 in July 2008. By April 2010, the monthly average of Brent, Dubai and West Texas Intermediate prices was \$84 per barrel. To some extent, the rebound in oil prices in 2009 was driven by the cuts in supply by members of the Organization of the Petroleum Exporting Countries (OPEC), which observed a high degree of compliance with production quotas as a reaction to the global drop in demand. Overall, in 2009 global oil demand was 1.4 per cent lower than in the previous year, mainly as a result of the 4.4 per cent decline in demand by the members of the Organisation for Economic Co-operation and Development (OECD). By contrast, oil demand in non-OECD countries rose by 2.3 per cent, with oil consumption growth in China at 7.6 per cent (IEA, 2010).

Global demand for oil has recovered since the third quarter of 2009, primarily on account of consumption growth in non-OECD countries, while oil consumption in OECD countries has remained subdued. As a result, oil prices have generally remained at around the range of \$70–\$80 per barrel since then. This range is widely considered among producers as high enough to provide incentives for investment in new production capacity, but at the same time low enough not to jeopardize global economic recovery, because a slow recovery would have a negative impact on demand. By the end of 2009 and early 2010 the degree of compliance with production quotas among OPEC members had declined as a result of the higher prices. In addition, production in non-OPEC countries has been increasing. Oil consumption has continued to rise in 2010, but the demand pressure on prices is being absorbed by large inventories and spare capacity. The IEA (2010) forecasts world oil demand to increase by 1.9 per cent in 2010.

While the evolution of demand fundamentals in emerging-market economies certainly will have contributed to the upturn in the prices of a large number of commodities, it does not explain the magnitude of the price increases, which seems to have been excessive given the fragility of the recovery of the world economy during 2009. An additional major factor that may have boosted commodity prices beyond market fundamentals was the strong presence of financial investors in these markets. After fleeing from commodity markets in the second half of 2008, financial investors returned in 2009, driven by their growing appetite for risk in response to indications

Table 1.3

<b>WORLD PRIMARY COMMODITY PRICES, 2004–2010</b>								<i>Jan.–Dec.</i>
<i>(Percentage change over previous year, unless otherwise indicated)</i>								<i>2009<sup>b</sup></i>
<i>Commodity group</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>	<i>2010<sup>a</sup></i>	<i>2009<sup>b</sup></i>
<b>All commodities<sup>c</sup></b>	<b>20.0</b>	<b>11.6</b>	<b>30.2</b>	<b>13.0</b>	<b>24.0</b>	<b>-16.8</b>	<b>13.0</b>	<b>29.4</b>
<b>All commodities (in SDRs)<sup>c</sup></b>	<b>13.5</b>	<b>12.0</b>	<b>30.5</b>	<b>8.6</b>	<b>19.5</b>	<b>-14.6</b>	<b>14.7</b>	<b>23.6</b>
<b>All food</b>	<b>13.2</b>	<b>6.3</b>	<b>16.3</b>	<b>13.3</b>	<b>39.2</b>	<b>-8.5</b>	<b>2.5</b>	<b>18.3</b>
<b>Food and tropical beverages</b>	<b>13.2</b>	<b>8.8</b>	<b>17.8</b>	<b>8.6</b>	<b>40.4</b>	<b>-5.4</b>	<b>1.6</b>	<b>17.7</b>
<i>Tropical beverages</i>	6.4	25.5	6.7	10.4	20.2	1.9	9.1	24.9
Coffee	19.8	43.8	7.1	12.5	15.4	-6.9	9.0	15.3
Cocoa	-11.8	-0.7	3.5	22.6	32.2	11.9	12.8	33.2
Tea	2.1	9.1	11.7	-12.3	27.2	16.5	-1.5	42.7
<i>Food</i>	13.9	7.2	19.0	8.5	42.5	-6.0	0.9	17.0
Sugar	1.1	37.9	49.4	-31.7	26.9	41.8	12.6	86.9
Beef	17.8	4.1	-2.4	1.9	2.6	-1.2	25.5	11.4
Maize	5.0	-12.0	24.4	38.2	34.0	-24.4	-2.8	1.4
Wheat	6.8	-1.4	26.6	34.3	27.5	-31.4	-13.7	-14.2
Rice	23.1	17.1	5.5	9.5	110.7	-15.8	-8.3	-1.5
Bananas	39.9	9.9	18.5	-0.9	24.6	0.7	-3.2	-1.6
<b>Vegetable oilseeds and oils</b>	<b>13.2</b>	<b>-9.5</b>	<b>5.0</b>	<b>52.9</b>	<b>31.9</b>	<b>-28.4</b>	<b>9.6</b>	<b>23.0</b>
Soybeans	16.1	-10.4	-2.2	43.0	36.1	-16.6	-5.2	8.9
<b>Agricultural raw materials</b>	<b>13.4</b>	<b>3.2</b>	<b>13.3</b>	<b>12.0</b>	<b>20.5</b>	<b>-17.5</b>	<b>28.3</b>	<b>32.2</b>
Hides and skins	-1.7	-2.1	5.1	4.5	-11.3	-30.0	54.3	65.6
Cotton	-3.3	-11.6	5.9	10.2	12.8	-12.2	34.4	31.7
Tobacco	3.6	1.8	6.4	11.6	8.3	18.1	-2.2	16.4
Rubber	19.2	16.7	40.6	9.5	16.9	-27.0	79.0	88.3
Tropical logs	19.2	0.3	-4.7	19.5	39.3	-20.6	1.0	-5.5
<b>Minerals, ores and metals</b>	<b>40.7</b>	<b>26.2</b>	<b>60.3</b>	<b>12.8</b>	<b>6.2</b>	<b>-30.2</b>	<b>30.0</b>	<b>55.3</b>
Aluminium	19.8	10.6	35.4	2.7	-2.5	-35.3	30.3	54.3
Phosphate rock	7.8	2.5	5.3	60.5	387.2	-64.8	-8.5	-66.0
Iron ore	17.4	71.5	19.0	9.5	65.0	-28.2	26.1	0.0
Tin	73.8	-13.2	18.9	65.6	27.3	-26.7	29.5	36.8
Copper	61.0	28.4	82.7	5.9	-2.3	-26.3	41.5	116.8
Nickel	43.6	6.6	64.5	53.5	-43.3	-30.6	47.3	51.0
Tungsten ore	22.9	120.7	36.2	-0.6	-0.3	-8.9	0.0	0.0
Lead	72.0	10.2	32.0	100.2	-19.0	-17.7	25.8	104.9
Zinc	26.5	31.9	137.0	-1.0	-42.2	-11.7	35.3	100.0
Gold	12.6	8.7	35.9	15.3	25.1	11.6	17.4	32.2
<b>Crude petroleum</b>	<b>30.7</b>	<b>41.3</b>	<b>20.4</b>	<b>10.7</b>	<b>36.4</b>	<b>-36.3</b>	<b>26.6</b>	<b>70.6</b>
<b>Memo item:</b>								
<b>Manufactures<sup>d</sup></b>	<b>8.3</b>	<b>2.5</b>	<b>3.4</b>	<b>7.5</b>	<b>4.9</b>	<b>-5.6</b>	..	..

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

**Note:** In current dollars, unless otherwise specified.

**a** Percentage change between the average of January to May 2010 and the average for 2009.

**b** Percentage change between January and December 2009.

**c** Excluding crude petroleum.

**d** Unit value of exports of manufactured goods of developed countries.

of better prospects for global economic activity. The increasing attractiveness of commodities as an asset class has also been reinforced by ample liquidity and low interest rates.

The volume of derivatives trading in non-precious metals increased by 132.8 per cent in 2009, while it rose by 12.9 per cent for energy products and by 3.7 per cent for agricultural products. Commodity derivatives trading is growing particularly fast in China, where the Shanghai Futures Exchange, trading mostly in futures in industrial metals, tripled its volume in 2009 (Burghardt and Acworth, 2010). Furthermore, according to Barclays Capital (2010), in 2009 commodity assets under management rose to an all-time high year-end value of \$257 billion – representing the largest annual increase on record – with inflows of \$68 billion. This has contributed to a 42-fold increase in commodity assets under management over the past decade. The rising trend in commodity investments is expected to continue through the next decade. Another indicator of the effect of financial investment in these markets is that in 2009, commodity inventories, particularly for metals and minerals, rose alongside prices.

Therefore, movements in commodity prices continue to be strongly influenced by financial investors' sentiment about the evolution of the markets. In January–February and in May 2010 price corrections occurred following commodity sell-offs due to concerns about falling demand associated with the European sovereign debt crisis. A tightening of monetary policy in China to prevent an overheating of the economy, particularly in the property sector, was also a factor in the retreat of investors from commodity markets, which contributed to the fall in prices.<sup>3</sup> At the same time, gold has been benefiting from the uncertainties about the global economic recovery: increasingly attracting investors in search of a safe haven, its price has been hitting record levels in nominal terms.

An additional factor affecting changes in commodity prices has been the evolution of the exchange rate of the dollar, in which commodity prices are usually denominated. Thus the price increases in 2009 were associated with a depreciating dollar, just as in 2010 the price declines have been occurring concurrently with a stronger dollar, particularly as the euro was weakening due to the crisis in Greece. Changes in commodity prices in euro terms are less

extreme than those in dollar terms. In fact, in the first months of 2010, while the aggregate price index for all commodities in dollar terms declined, it continued to increase in euro terms (chart 1.2).

Prices of agricultural commodities, particularly food and tropical beverages, which are normally less affected by the evolution of macroeconomic variables, have been strongly influenced by supply conditions, notably the weather. Food prices, which were a major cause of the food crisis of 2008, have not recovered much since their collapse in the second half of that year. This has been mainly due to bumper harvests in cereals and in vegetable oilseeds and oils. In addition, the lower price of oil associated with the global crisis contributed to lowering the pressure on cereal and oilseed production for biofuels. Downward pressure on oilseed prices has been more modest due to strong demand, particularly for soybeans in China. Overall, the situation in food markets has been easing as inventories have been replenished to more comfortable levels. Moreover, forecasts suggest good harvests in 2010 (FAO, 2010). While this provides some relief to the global food crisis in the short term, food security is still a pressing problem in many developing countries. It is therefore critical to continue with efforts to overcome the structural causes of the food crisis (*TDR 2008*, chap. II).

Markets for tropical beverages have been tight as a result of poor harvests and rising demand. In the case of cocoa, production has been affected by recurrent underinvestment, domestic disruptions and problems of governance in Côte d'Ivoire, which accounts for about 35 per cent of global supply. Sugar prices increased sharply in 2009 and reached a 30-year high in January 2010. In 2009, bad weather seriously affected sugar production in leading sugar cane producing countries such as Brazil and India, but expectations for good crops in 2010 have led to a strong turnaround in prices (FAO, 2010). By contrast, supply conditions have not been so important in influencing agricultural raw material prices, which had fallen sharply in late 2008 and early 2009 due to the decline in global demand caused by the global recession. Natural rubber prices have increased in 2010 owing to a recovery in car production and demand in China, as well as to the increase in oil prices, which made synthetic rubber more expensive. Likewise, cotton prices have been rising as consumption has outpaced production, mainly because of the recovery of the Chinese textile sector.

In general, commodity prices have remained highly volatile, and their future evolution is extremely uncertain. As long as excessive speculation on commodity markets is not properly contained, the strong presence of financial investors will continue to add instability to these markets, as investors tend to react quickly to any financial and economic news, even if unrelated to commodity market fundamentals.<sup>4</sup> In the short term, developments in commodity markets will fundamentally depend on the pace of recovery of global economic activity. Given the ample inventories of most commodities at present, any increases in demand should be reasonably easy to meet, so that there is unlikely to be significant upward pressure on prices.

In the longer term, however, demand from fast growing China and other developing countries is expected to remain healthy on account of the continuing industrialization and urbanization process, and the corresponding needs for infrastructure development. On the other hand, once inventories and spare capacity begin to shrink in response to this demand, supply constraints, which contributed to the commodity

price boom of 2003–2008 and have not been appropriately addressed due to the global economic crisis in 2008–2009, risk re-emerging. In fact, the crisis has most likely aggravated supply constraints in the medium term, particularly in the extractive industries. Falling demand and prices and the credit crunch led to the cancellation or postponement of a number of projects in this sector. In 2009 there was a 42 per cent drop in worldwide non-ferrous exploration budgets from their 2008 high (Metals Economics Group, 2010). As a result, although there is a revival of investment with the renewed increase in prices, due to a lag in the supply response to the increasing demand, prices are expected to remain high over the medium to long term.<sup>5</sup> Sustained economic and population growth in emerging-market economies as well as continued expansion of biofuel output in response to higher energy prices (and depending on government mandates) are also expected to add upward pressure on prices of food commodities during the second decade of this century. Accordingly, the risk of another food crisis cannot be ruled out (OECD-FAO, 2010).

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## **B. Global recovery and rebalancing: current situation and prospects**

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When huge disruptions in global financial markets first emerged in mid-2007, policymakers were generally slow to recognize the true nature and magnitude of the unfolding calamity. Many observers had feared that the massive global imbalances posed a severe threat to global stability, but the full force of the market turmoil in August 2007 caught most policymakers off-guard. Some of them even continued to be preoccupied with perceived inflation risks, and, with few exceptions, they were only shaken out of their complacency and reluctance to act when the global economy took a nosedive in the final quarter of 2008. Coordinated policy easing by

leading central banks was both a highly warranted first step and an important sign of global solidarity in what was by then finally recognized as a global crisis of potentially catastrophic proportions.

At the G-20 summit meetings in November 2008 in Washington and in April 2009 in London, Heads of State and Government committed to employing large macroeconomic stimulus packages and comprehensive support programmes for their respective financial sectors. The types and magnitudes of policy measures implemented varied significantly across countries and regions, and not always in proportion to



the severity of the local downturn (*TDR 2009*). In the event, the aggregate policy impact of these measures proved sufficient to prevent the global economy from succumbing to forces that had the potential to cause another Great Depression (Aiginger, 2009).

In mid-2009, the global economy appeared to have bottomed out (see table 1.1), and has since shown some promising signs of recovery, albeit to varying degrees in different regions and countries. As a preliminary assessment, it would be fair to say that the implementation of powerful countercyclical macroeconomic policies won global policymakers an important first round in battling the crisis. However, remaining stresses and re-emerging imbalances as well as renewed fears and instabilities in global financial markets since the first quarter of 2010 indicate that the war against a global depression has not yet been won.

Despite this, calls for an “early exit” from the demand-stimulating macroeconomic policy stance have been growing louder. Such calls have been particularly prominent among European policymakers, most of whom had agreed only belatedly, and with great reluctance, to contribute to the global effort of countering the crisis in the first place. Indeed, already in 2009 some European countries embarked on retrenchment rather than stimulus programmes, and in the first half of 2010 new austerity measures aimed at balancing government budgets sooner rather than later were being announced. From a global perspective this is a risky undertaking, because it is precisely in Europe that recovery appears to be the most fragile. In fact, in mid-2010 it is becoming increasingly clear that the centre of the global crisis that originated in the United States in 2008 has shifted to Europe, creating a new hotspot of instability.

It is therefore important to stress that at this juncture any withdrawal of a stimulus policy seems rather premature, since in many countries private demand remains fragile, having only partially recovered from its trough so far, and with no sign of even approaching its pre-crisis levels. It therefore risks undermining the incipient global recovery and raises the spectre of a double-dip recession that could push the global economy into a vicious circle of debt deflation. Another risk is that countries or regions that make a premature exit from a domestic-demand-supporting policy stance could become overdependent on exports for their growth. This could result in the emergence of new

divergences and renewed tensions at the regional and/or global levels, prompting retaliatory measures in the form of protectionism, which, if practiced widely, could magnify any contractionary effects and stall the recovery. Today, an increasing number of countries are under pressure from financial markets to adopt policies that would only weaken their economies further. This would simply add to the stimulus burden of the remaining countries at the regional or global level. Currently, the strongest recovery trends are apparent in developing countries.

### **1. Developing countries at the vanguard of a potential recovery**

The global crisis spread to a large number of developing countries in the third quarter of 2008 and the ensuing free fall of growth in GDP, especially in manufacturing output, continued into 2009 in most countries and regions. World trade is estimated to have fallen by more than 13 per cent in volume in 2009 (see table 1.2). The global contagion hit some countries harder than others. Especially hard hit were several transition economies in Eastern Europe and Central Asia that had generated large current-account deficits and accumulated sizeable stocks of external debt before the crisis.<sup>6</sup>

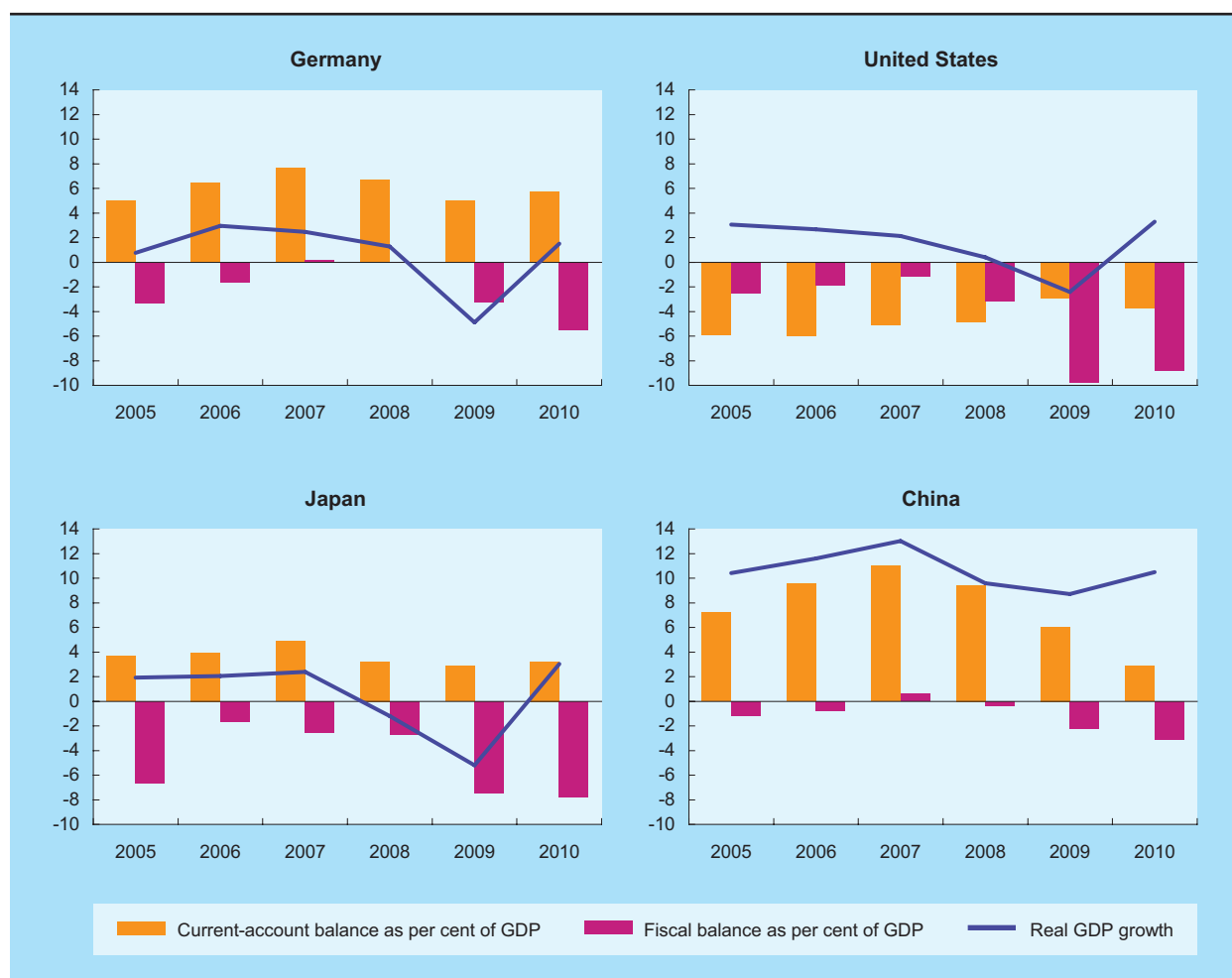
Gripped by fear and panic, global finance proved quite indiscriminate in fleeing out of what were suddenly perceived as excessively risky assets and into what are conventionally considered “safe haven” assets. “Sudden stops” (or reversals) in private capital flows drove currencies down against the dollar, with only a few exceptions. China’s direct exposure to “toxic assets” was limited due to prudent capital account management and tight regulation of its financial system. The latter, in conjunction with large foreign exchange reserves, provided the necessary policy space for China to maintain a stable exchange rate vis-à-vis the dollar throughout the crisis, and also to implement a massive macroeconomic stimulus programme. This helped China’s recovery as early as the second quarter of 2009.

In general, the strength of the recovery varied across countries according to the aggressiveness of their respective stimulus measures (chart 1.3). China, which was severely hit by the slump in its

Chart 1.3

### CURRENT-ACCOUNT BALANCE, FISCAL BALANCE AND REAL GDP GROWTH IN SELECTED COUNTRIES, 2005–2010

(Per cent)



**Source:** UNCTAD secretariat calculations, based on table 1.1; OECD, 2010; IMF, *World Economic Outlook* database, April 2010; and Economist Intelligence Unit, *EIU CountryData* database.

key developed-country export markets, adopted the most decisive approach to boosting domestic demand through stimulus measures.<sup>7</sup> China's GDP growth further accelerated after mid-2009, and has since spread throughout East and South-East Asia. As some large developed economies continue to struggle with problems in their financial sector and with sluggish domestic demand due to half-hearted stimulus measures, China – and to a lesser extent India – have again achieved GDP growth rates high enough to make them global leaders in the recovery. Their GDP growth resumed quicker than elsewhere,

based on an expansion of domestic demand, and is even expected to grow faster in 2010, once again boosting employment and expansion in production capacities. In China stimulus measures fully offset the negative impact of lower net exports on GDP growth and, similar to the United States, recovery is being driven mainly or almost entirely by domestic demand, in contrast to Germany and Japan (chart 1.4).<sup>8</sup>

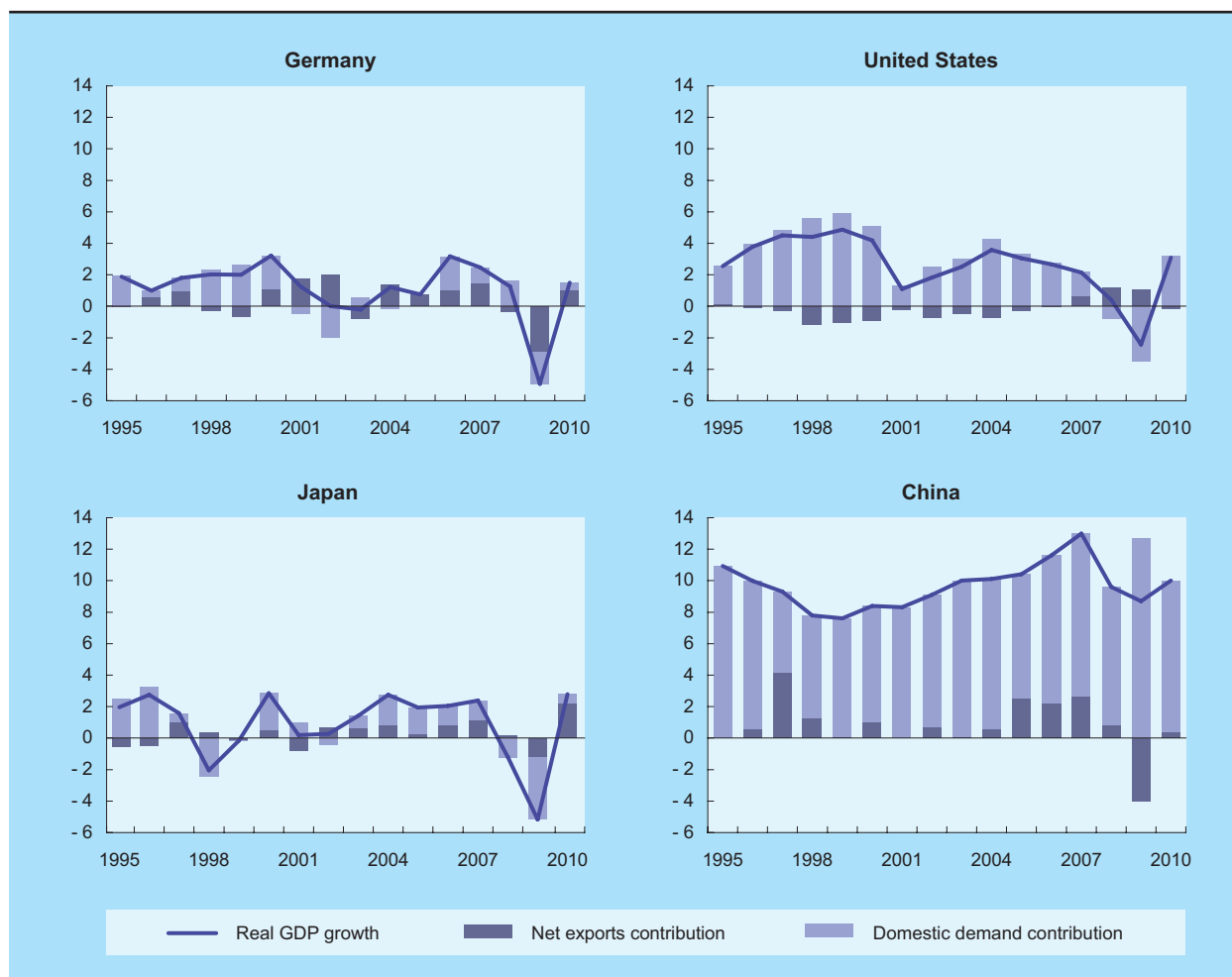
As already mentioned in section A, growth has picked up in all developing regions. In the first quarter of 2010, it approached or reached two-digit rates in



Chart 1.4

### REAL GDP GROWTH AND CONTRIBUTIONS OF NET EXPORTS AND DOMESTIC DEMAND IN SELECTED COUNTRIES, 1995–2010

(Per cent)



**Source:** UNCTAD secretariat calculations, based on table 1.1; European Commission, *Annual macro-economic database (AMECO)*; OECD, *OECD Stat* database; National Bureau of Statistics of China, *Statistical Yearbook 2009*; and World Bank, *China Quarterly Update*, June 2010.

several economies, including Brazil, China, India, Malaysia, Singapore, Taiwan Province of China, Thailand and Turkey. Even though their performance has resulted partly from a low comparison base, this may lead to the removal, at least partially, of the domestic demand stimulus. Monetary policies may turn to a more restrictive (or less expansionary) stance, for example in Brazil, China, India, Malaysia and Peru,

and in some cases, fiscal stimulus measures may be scaled down. However, this is not mainly because of concerns about fiscal balance, but rather because of fears of possible overheating. In fact, the costs of the fiscal stimulus measures in terms of fiscal balance remain moderate, as those measures have accelerated economic activity and, accordingly, increased government revenues.

## 2. Coping with the vagaries of unfettered global finance

From March 2009 net private flows to emerging markets turned positive following their sudden stop – or in many cases even reversal – since mid-2008. The rebound was driven mainly by portfolio equity investment flows turning from net outflows in 2008 into net inflows again in 2009. A further increase in net private capital flows is expected for 2010 (IIF, 2010). Risk aversion gradually gave way to the return of “risk appetite” combined with the usual herding behaviour of investors. This once again led to an extremely high correlation of price movements across very different markets (chart 1.5, see also *TDR 2009*, chap. I, section C). The reduction of policy interest rates to zero or near-zero in the United States, the euro area, Japan, Switzerland and the United Kingdom, together with the gradual unfreezing of credit markets at the centre of global finance created the conditions for investors’ return to risky asset markets and for the resumption of private capital flows to emerging markets.

At the peak of the crisis, pressures on their exchange rates and sharply curtailed foreign credit generally constrained the ability of emerging-market economies to promptly ease their monetary policy stance. With the improvement in international financial conditions during the course of 2009, the policy space for these economies gradually opened up, enabling them to reduce their policy interest rates to record lows. Given the generally healthier financial sector and macroeconomic conditions in these economies, and their more favourable growth outlooks compared with those for developed countries, along with positive, in some cases widening, interest rate differentials vis-à-vis developed countries, emerging-market economies again began to attract financial investors.

By the first quarter of 2010, the resurgence of net private capital inflows from their 2009 trough, although still well below their 2007 peak levels, proved sufficiently strong to pose risks and limit the policy options available to the recipient countries.<sup>9</sup> With sharply reduced local interest rates and plenty of domestic liquidity, many emerging-market economies do not need private capital inflows as a source of finance. Instead, “hot money” inflows act as an unruly contributory factor in pushing up asset prices, including the exchange rate.

Having been hurt by fickle capital flows in the 1990s, which provoked numerous crises, many emerging-market economies, when confronted with another surge in capital inflows after 2002, chose to intervene in currency markets. The purpose of such intervention was to prevent currency appreciation due to current-account surpluses and/or net private capital inflows and to contain the risks associated with a flood of liquidity. This strategy, often referred to as self-insurance, involved the accumulation of large amounts of foreign exchange reserves. In countries with current-account surplus positions, private capital inflows do not provide any additional finance that could be used for the purpose of increasing imports. Moreover, when their central banks intervene in the foreign exchange markets to prevent a currency appreciation, the private inflows are offset by official capital outflows as the reserves are held in foreign assets, mostly United States treasury bonds.

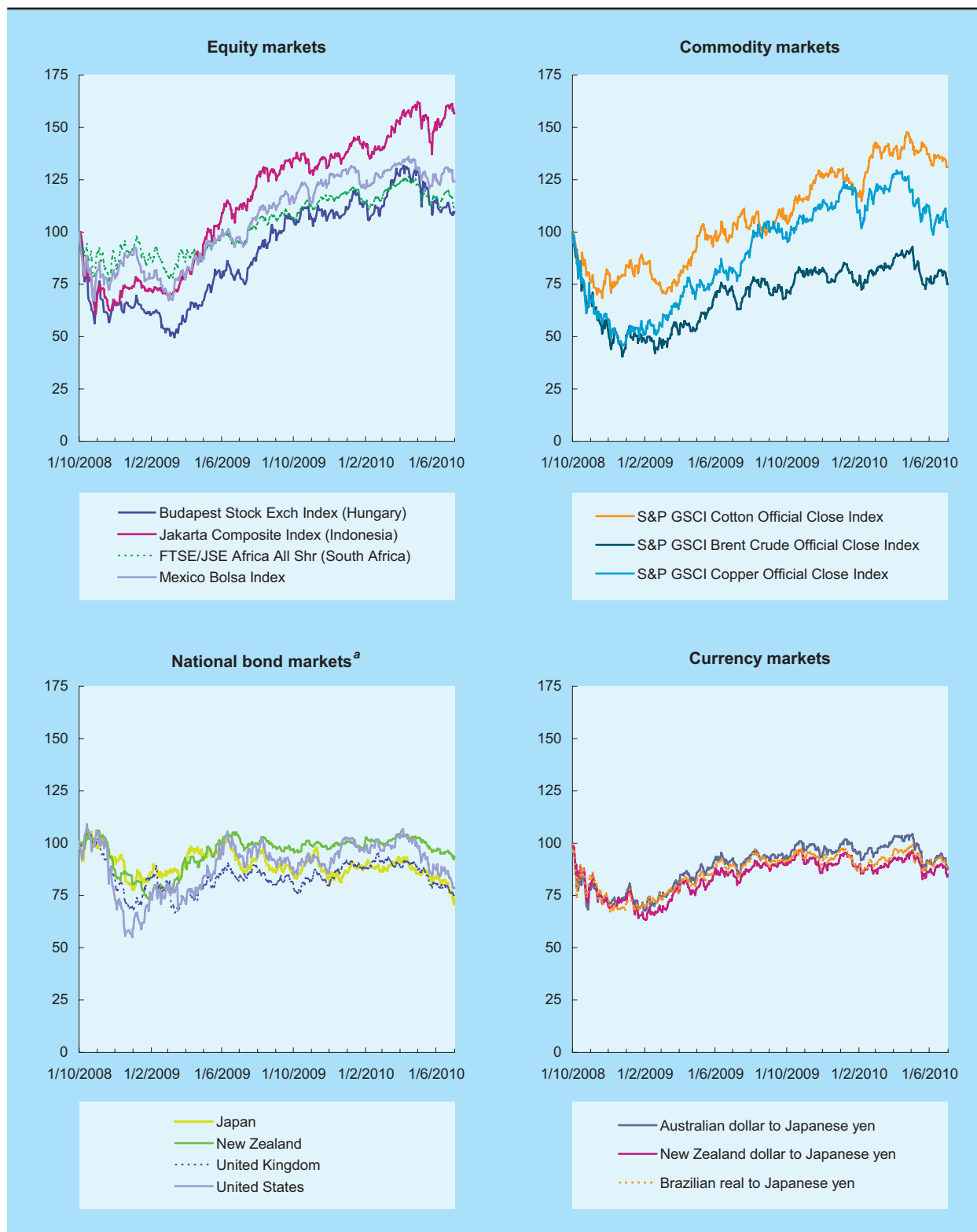
The effects of the global crisis are likely to reinforce the tendency among developing countries to seek such self-insurance. This may be criticized as blocking an even greater contribution of emerging-market economies with current-account surpluses to the much-needed rebalancing of global demand. But such criticism misses the point. First, resorting to self-insurance strategies is a response to systemic deficiencies in the existing global currency and financial set-up. The right way to address this issue is not to blame the countries that are the most vulnerable to these systemic flaws for their defensive responses, but to reform the global architecture in such a way as to make self-insurance strategies unnecessary. Second, these strategies reduced the vulnerability of emerging-market economies and helped them to recover from a global crisis that originated in a number of leading developed economies which are also largely responsible for the current global imbalances.

As central banks in many developed countries cut policy rates to zero or near-zero, arbitrage capital flows to emerging-market economies picked up, putting pressure on their exchange rates and reducing their room for manoeuvre in macroeconomic policy-making. At the same time, there was little pressure for adjustments in the developed economies, among which large imbalances still persist. Protracted weakness of domestic demand and a heavy reliance on exports are the most pronounced in Germany and Japan (see chart 1.4). Also, it is worth noting that Switzerland, while somewhat more successful in

Chart 1.5

## EVOLUTION OF PRICES IN SELECTED MARKETS AND COUNTRIES, OCTOBER 2008–JUNE 2010

(Index numbers, 1 October 2008 = 100)



Source: UNCTAD secretariat calculations, based on Bloomberg.

<sup>a</sup> Yields on 10-year bonds.

reviving domestic demand, intervened extensively in currency markets to contain an appreciation of the Swiss franc. As a result, its reserves quadrupled since the beginning of the crisis until mid-June 2010 (Garnham, 2010). Germany benefited considerably from the depreciation of the euro, which occurred as a result of the self-inflicted internal divergences in the euro area and its related debt problems. This is just the opposite of what is needed for a global rebalancing.

While developing countries have no responsibility for the global crisis, they can nevertheless play an important role in the recovery. But they cannot on their own generate the necessary stimulus for global demand and achieve global rebalancing; other countries, particularly the industrialized surplus countries, need to contribute as well (see also chapter II of this *TDR*).

In a repeat of global pre-crisis patterns, among the developed countries the United States has been experiencing a stronger recovery in domestic demand than the leading developed surplus countries (see chart 1.4). But in moving forward, the United States is likely to face strong headwinds.

### **3. United States: former global growth engine facing headwinds**

Following a sharp contraction in domestic demand in the second half of 2008, the United States economy began to recover after mid-2009. This recovery has been driven by monetary and fiscal stimulus measures, with automatic fiscal stabilizers operating freely only at the federal level. Since the final quarter of 2009, gradual inventory restocking has been a major contributor to GDP growth. This is likely to be completed by the third quarter of 2010. By that time the fiscal stimulus too will have run its course and fiscal adjustment may once again start to drag down the economy in 2011. The crucial question, therefore, is whether private demand will be ready to take over as the driving force behind continued recovery.

The United States was among those countries that chose to counter the global crisis with a substantial fiscal stimulus programme through the American Recovery and Reinvestment Act (ARRA). Since the onset of the crisis, United States public finances have

deteriorated very sharply, largely as a direct consequence of the workings of so-called automatic fiscal stabilizers (Bilmes, 2010). As an economy goes into recession, tax revenues fall and spending on social safety nets rises without any changes in tax rates or spending parameters. In addition, discretionary measures contained in the fiscal stimulus package amounted to 5.5 per cent of GDP, spread over 2009 and 2010 (*TDR 2009*). However, public finances may have deteriorated even more if the stimulus had been smaller, or, worse still, if ill-guided austerity measures had been attempted. Failure to properly counter the crisis would have left an even larger impact on government revenues and spending commitments.

It has also been suggested that the net positive effect of the fiscal stimulus of the ARRA may have been overstated, since what appears to have been an expansionary effect at the federal level forestalled austerity measures that would have been needed at the state and local levels had the ARRA not been introduced (Aizenman and Pasricha, 2010). This is because public borrowing at the state and local levels in all states of the United States except Vermont is constitutionally constrained by balanced budget rules that require operating revenues to cover operating costs. Today, more and more states and municipalities are forced to implement fiscal austerity measures, which take the form of spending cuts and tax hikes that are bound to weaken their economies.<sup>10</sup> Built-in stabilizers only operate freely at the federal level through the federal income tax system, and through federal social safety nets in particular.

Also operating only at the federal level is the fiscal stimulus programme, since the balanced budget rule does not apply to the United States Federal Government. The stimulus programme includes federal grants to the states that are designed to obviate the need for state-level austerity. Unless new measures are agreed and adopted, the stimulus programme will by and large stop providing support to the recovery towards the end of 2010. Thus, state-level austerity, which is likely to increase in 2011 (McNichol and Johnson, 2010; Leachman, Williams and Johnson, 2010), could only be alleviated thereafter by federal-level automatic or built-in stabilizers.

Headwinds are also likely to arise from a number of other sources. Developments in the property market remain critical. While temporary first-buyer tax incentives, Federal Reserve purchases of mortgage-

backed securities and mortgage modifications have provided some provisional support, adjustment in the housing market remains unfinished and threatens to linger on. Large stocks of unsold houses and the potential for new foreclosure waves will keep prices under pressure. And as long as house prices keep falling and foreclosures rising, lenders' and borrowers' balance sheets will continue to weaken, feeding the downward spiral that has been central to the crisis in the United States. Commercial property markets pose an additional risk.

Weakness in the labour market is likely to persist for years to come. While data indicating employment growth were a hopeful sign in March and April 2010, after more than 8 million jobs lost since the beginning of the crisis, the continued frailty of the labour market will keep growth of wages and disposable income in check. At the same time, credit growth remains feeble. It seems decidedly unlikely that the financial system, still in the process of recovery, will again augment household spending power through liberal credit creation, as it did in the pre-crisis era. In short, the former engine of global growth seems in poor shape to regain its pre-crisis strength any time soon (see also chapter II of this *Report*).

It is mainly for this reason that the United States authorities are pinning their hopes for recovery on strong growth in exports. A weaker dollar would support this strategy, which would also be in line with the needed global rebalancing. But Europe, which is the main market for United States exports and was late in joining the global boom of 2002–2007, is now also the outstanding laggard in the current global recovery.<sup>11</sup> This limits the scope for faster export growth in the United States. Moreover, the sharp depreciation of the euro against the dollar in the first half of 2010 will certainly not contribute to any benign global rebalancing.

#### **4. Europe: instability and divergence**

From mid-2009 a very moderate recovery began in Europe, mainly as a result of a revival of global trade, and in mid-2010 the euro area in particular remains highly dependent on exports for its meagre GDP growth. While the inventory cycle is providing a temporary boost to activity, final domestic demand

growth continues to be weak. Automatic fiscal stabilizers, which are having a relatively strong impact in most Western European countries, have been the main cause of the deterioration of public finances since the start of the crisis. In Europe proactive stabilization policies are generally frowned upon, especially by the euro area authorities. Accordingly, temporary fiscal stimulus measures were applied reluctantly and unevenly across the euro area in response to the crisis. Some of the new EU member countries in Central and Eastern Europe that were particularly hard hit by the crisis responded to it by adopting contractionary policies. Among the older EU members in Western Europe, Greece, Ireland, Portugal and Spain shifted towards fiscal retrenchment in the first half of 2010. Only some core European countries opted for a mildly stimulatory fiscal policy for 2010, but this is set to be reversed, which will result in continent-wide fiscal austerity in 2011.

Instability in the euro area is largely a home-grown problem. The subprime mortgage crisis in the United States merely acted as the trigger for a series of events that led to the European debt crisis of 2010.<sup>12</sup> While subprime-related write-downs have certainly added to pressures for the deleveraging that is under way within European banking systems, the root cause of the European crisis can be traced to serious intraregional divergences and to the related build-up of regional imbalances that had long been negligently ignored by market participants and policymakers alike.

Upon joining the European currency union, its member countries relinquished national control over monetary policy as well as the possibility of nominal exchange rate realignments to restore trade balances. Instead, the ECB defined its primary price stability mandate as one of holding the area-wide annual harmonized consumer price inflation rate at "below but close to" 2 per cent. Maintaining a balance in intraregional competitiveness positions and trade would have required that wage trends in member countries align national nominal unit labour cost increases with the area's targeted 2 per cent inflation trend (Flassbeck, 2007).

In actual fact, national wage trends have persistently diverged from this implicit stability norm since the euro was launched in 1999. This has been the most conspicuous in Germany, where real wages have barely grown since 1999, and nominal unit labour costs have stayed virtually flat (see also chapter III,



box 3.1). While trends in nominal wages and unit labour costs complied with the implicit stability norm in France, other countries such as Greece, Ireland, Italy, Portugal and Spain deviated from that norm in an upward direction, although to a much lesser extent than Germany's deviation in the opposite direction. As a result, over time, internal competitiveness positions gradually drifted out of kilter and trade imbalances in the euro area soared, with large surpluses in Germany and the Netherlands and large deficits in their Southern European intraregional counterparts.

Trade imbalances imply corresponding intraregional financial flows from the surplus to the deficit countries. These have been mainly in the form of debt flows smoothly intermediated by Europe's integrated financial system. At least this was the case until severe stress struck at the core of the leading international financial centres, which also affected Western Europe's large and globally active universal banks that engage in both traditional banking and investment activities. Triggered by the subprime mortgage crisis in the United States, regional imbalances in Europe started to unravel as credit flows in Europe dried up. Outside the euro area, in those EU countries with large current-account deficits, exchange rates were affected by a sudden stop of capital flows. Inside the euro area, financial markets concentrated on public debt markets instead. The first target of market speculators was Ireland in February 2009, which triggered ruthless fiscal retrenchment there. This was followed by speculative attacks in early 2010 on the sovereign debt of euro area member countries with large budget and current-account deficits, with Greece as their primary target.

In many ways the situation in Greece in the latest global crisis resembles the experiences of a number of emerging-market economies in earlier crises. It highlights the adjustment challenges faced by a country when its macroeconomic policy space is tightly constrained (box 1.1).

It is noteworthy that apart from Greece, other countries under attack had budget deficits below 3 per

cent of GDP prior to the crisis; Ireland and Spain even had budget surpluses. In the event, the relevant European authorities responded with considerable delay to what were initially local instabilities, and then only when policymakers worldwide realized that there was a serious threat of regional contagion as well as fresh global financial stresses. First a €110 billion financial support package for Greece was agreed, conditional on its Government undertaking a ruthless fiscal retrenchment. Then a €750 billion temporary European Financial Stability Facility at the euro area level was agreed in May 2010, which includes a sizeable IMF contribution as well as small and sterilized sovereign bond purchases by the ECB in secondary markets (Reuters, 2010).

By mid-2010 the measures agreed in Europe had still failed to restore calm in global financial markets and the euro's real effective exchange rate continued to depreciate. Doubts remain as to a possible sovereign default of Greece (see also box 1.1) and whether the underlying real intraregional disequilibria will be addressed. Questions are also being raised as to the effectiveness of the draconian fiscal retrenchments in achieving fiscal sustainability when countries are pushed into deep recession, particularly as retrenchment in those countries with current-account deficits is not being offset by simultaneous expansion in surplus countries in the region. Following Germany's lead in committing to fiscal consolidation to regain market confidence, fiscal austerity is set to spread across the continent in 2011. With the prospect of a premature end to stimulus policies in Europe, there is growing fear of a possible European, or even global, double-dip recession occurring.

The crisis in Europe suggests that the euro area's current policy regime may well be unsustainable, and that member countries' uncoordinated national policies are on a collision course. It is mainly for these reasons that Europe is today's global hotspot of instability and divergence. Originating in the United States, the global crisis is now centred on Europe, and the region is slowing down global recovery, given its importance in world trade.

**Box 1.1****RESOLVING THE GREEK CRISIS: POLICY CONSTRAINTS AND SYSTEMIC DEFICIENCIES**

As a member of the euro area, Greece has effectively surrendered all macroeconomic policy instruments that could potentially help it tackle its current crisis. First, due to restrictions imposed by EU treaties and the Stability and Growth Pact, as well as mounting pressures from its European partners and financial markets, the Greek Government implemented draconian fiscal retrenchment – the very opposite of what was warranted, namely a countercyclical fiscal policy. Second, while legally prohibited from rendering any monetary support to the Greek treasury, the country’s central bank is also in no position to support the economy or the banking system. Third, it is no longer possible to restore the country’s competitiveness by devaluing the nominal exchange rate.

This last constraint puts Greece in an even worse position than developing and emerging-market economies that have faced financial crises. In their cases, currency depreciation typically acted as a catalyst for turning their countries’ fortunes around by restoring competitiveness and boosting net exports. In the case of Greece, the only avenue available for restoring competitiveness within the euro area is through nominal wage adjustments that would reduce Greek unit labour costs relative to its European partners. With nominal wage growth essentially flat in the region’s largest economy, Germany, this form of adjustment would translate into outright wage-price deflation.

Not only is a drawn-out process of wage-price deflation far more painful than a one-off currency devaluation; an additional problem arises from the fact that while prices and current incomes fall in that process, the value of the debt, which is fixed in some nominal currency unit, remains unchanged, so that the real burden of the debt rises. As debtors attempt to maintain their debt service by distress selling in product and/or asset markets, the debt situation worsens further and a self-sustained process of “debt deflation” (Fisher, 1933: 337–357) is set in motion, with bankruptcies spreading among interconnected economic units and potential repercussions in other countries.

By mid-2010, the measures agreed in Europe to support the Greek economy had still failed to restore calm in global financial markets, so that a default by Greece and other EU periphery countries still seems a real possibility. Default arises when an entity can no longer meet all its obligations to make payments to other entities, including servicing its debts. Defaults by firms or households occur when current and prospective income plus assets available as collateral or for resale fail to convince potential creditors that solvency is assured for the time to maturity of the outstanding debt. But for a government the situation is quite different.

In sovereign defaults a distinction should be made between debts denominated in national currency and those denominated in foreign currencies. Sovereign default in developing countries typically arises when payment obligations in foreign currency cannot be met. Causes of difficulties that can lead to *external* default include sudden declines in export revenues, remittances or net foreign capital inflows, as well as sudden increases in foreign interest rates. As revenues denominated in foreign currency dry up or fail to keep pace with foreign currency outlays, the ability of the sovereign government to boost tax revenues in domestic currency, or issue domestic currency, is of little help in closing the foreign currency gap. With regard to sovereign debt in domestic currency, it could be argued that default is somewhat of a contradiction in terms: since national sovereignty includes the power to tax and issue a sovereign currency, it is difficult to see why a sovereign government should ever default. The position of a sovereign government is different from that of a private debtor, since, at least theoretically, it can either increase its revenues through taxes or issue more currency. However, in a democratic society, the extent to which the sovereign can make use of this prerogative is a question of political feasibility.

The Eurosystem provides a very special kind of governance with regard to the sovereignty and policy space of its member States: these States have to surrender their national sovereignty over *monetary* matters while sharing supranational monetary sovereignty over the euro. This arrangement also severely circumscribes their *fiscal* sovereignty at the national level, but at the same time it does not provide for sharing fiscal sovereignty at the supranational level. As a result, member States no longer have access to loans from their respective central banks, yet the ECB, too, is prohibited from direct lending or directly purchasing securities issued by member State governments. In addition, budget deficits and public debt outstanding of member States are subject to limits, and there is a “no bailout clause”, which means that no member State shall be responsible for public debts issued by other members.

In practice, there has been a limited, indirect bailout, as the ECB has been buying a considerable amount of Greek bonds on the secondary market. Nevertheless, it is clear from the unfolding European crisis that the arrangements for macroeconomic policies and government financing need to be reviewed.



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## C. The need for global coordination and caution in withdrawing macroeconomic stimulus

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In a globally integrated economy, international coordination of economic policies is essential. *TDR 2009* already observed that “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” (*TDR 2009*, chap.I, section D). This remains a challenge in 2010 and beyond as the world community begins to reap the initial benefits of a policy-sponsored recovery.

At the current juncture, in the eagerness to embark on uncoordinated consolidation, there is a tendency to forget that a double-dip recession which could result from a premature abandoning of expansionary policies poses by far the greatest threat to public finances. Coordination does not mean that all countries should withdraw their stimulus programmes simultaneously; it primarily concerns the free-rider problem. As a rule, governments should withdraw stimulus in line with the recovery of private domestic demand in their country. Ending stimulus to domestic demand before that point means having to rely on exports for recovery, thereby shifting the burden of sponsoring demand stimulus onto others. Ideally, the timing of a stimulus withdrawal should contribute towards rebalancing global demand. From this perspective, current discussions on exit not only reveal conflicting policy visions, but also suggest that there is a lack of focus on the actual threats.

### 1. Fears of inflation, risks of deflation

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At the peak of the crisis, policymakers mostly agreed that deflation presented the greatest threat. With the rebound of commodity prices, headline consumer price inflation has also generally returned. Yet in many economies, high levels of unemployment and depressed capacity utilization rates mean that a trend of declining wages and unit labour costs may continue to exert a downward pressure on core inflation, which is already very low. In Japan, deflation remains firmly entrenched, resulting in huge economic costs to that country for over a decade, an experience that policymakers in the United States and Europe may need to bear in mind when evaluating macroeconomic risks in the current situation. This is especially important in the euro area, where, during the period 2005–2007, rising headline inflation due to international commodity price hikes was seen as signalling inflation risks even though core inflation pressures were well contained. This led to an excessive tightening of the monetary policy stance and subdued growth of domestic demand.

A related issue concerns government bond purchases by central banks, which are sometimes viewed as posing inflation risks or as crowding out banks' bond financing needs and corporate investment plans (Barber, 2010; ECB, 2010a; Posen, 2010). In general, threats of inflation may arise when an economy is on the verge of overheating and encounters supply

bottlenecks, or when important cost components or profit aspirations are out of line with productivity growth. Central banks' provision of emergency liquidity to disorderly financial markets or support for government financing on reasonable terms do not pose an inflation risk per se, if there are large spare capacities.

On the other hand, inflation risks are growing in some developing countries that have strong growth dynamics. In some of these countries, rising energy and food prices are also having a relatively strong impact on headline inflation. However, a tightening of monetary policy would be ineffective in stabilizing prices in the face of cost-push inflation pressures, while rising interest rates would provide an even greater attraction for capital inflows and threaten to destabilize their economies. In order to anchor core inflation at a low level, an incomes policy might be considered as an alternative option (see chapter V).

## 2. Does the G-20 process work?

The G-20 was originally created in response to the financial crises of the late 1990s. Thereafter, its role as a forum for international cooperation was strengthened in the context of the global crisis of 2008, and since then it has held regular meetings under rotating chairmanships. At their Pittsburgh Summit in September 2009 the G-20 Leaders designated the Group as the premier forum for international economic cooperation, replacing the G-8 in this role to better reflect the changed realities in the world economy. In their statement they claimed: "our forceful response helped stop the dangerous, sharp decline in global activity and stabilize financial markets" (G-20, 2009a) and they announced an agreement to launch a new Framework for Strong, Sustainable and Balanced Growth. The purpose of the framework is to commit members to "work together to assess how [our] policies fit together, to evaluate whether they are collectively consistent with more sustainable and balanced growth, and to act as necessary to meet our common objectives."<sup>13</sup>

In preparing the economic agenda for the Leaders Summit in Toronto in late June 2010, the G-20 Ministerial Meeting in Busan (Republic of Korea) earlier that month indicated a clear shift in emphasis

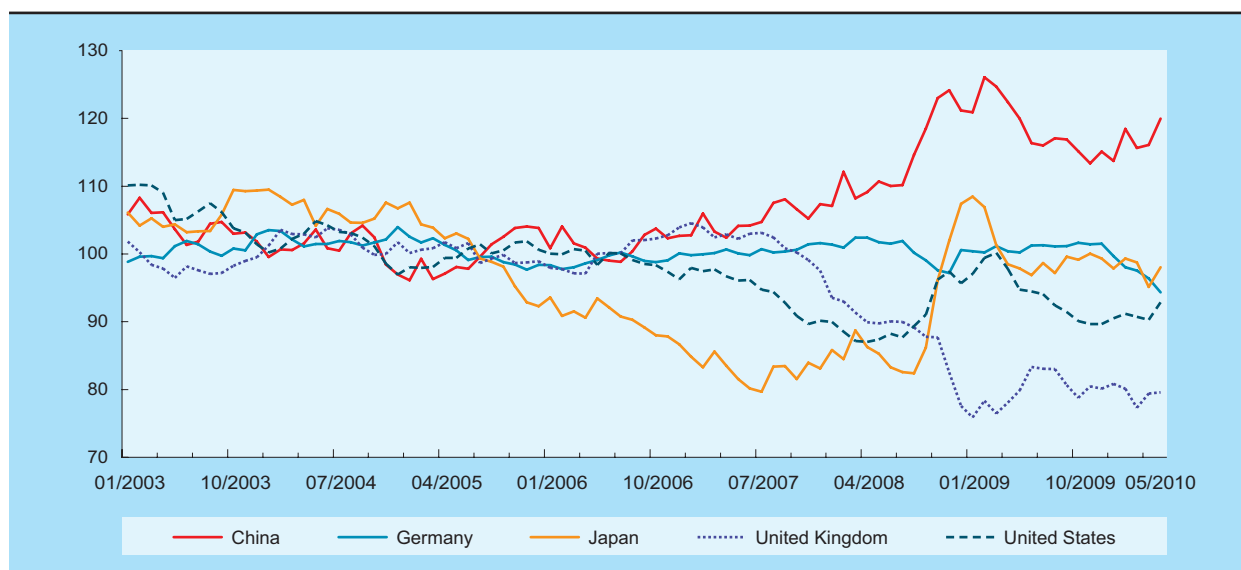
in the way the G-20 is handling the crisis and on the issue of withdrawing stimulus. Media reports surrounding that meeting revealed contrasting policy views among members. The communiqué effectively denounced the previous position, that fiscal stimulus should be maintained until recovery was assured, and replaced it with fiscal consolidation as the new policy priority. According to that communiqué, "The recent events highlight the importance of sustainable public finances and the need for our countries to put in place credible, growth-friendly measures, to deliver fiscal sustainability, differentiated for and tailored to national circumstances. Those countries with serious fiscal challenges need to accelerate the pace of consolidation" (G-20, 2010).

Europe is leading the rush to the exit: immediately following the G-20 Busan Meeting, Germany passed an austerity plan, set to start in 2011, and invited its European partners to follow suit. The shift towards unconditional austerity would seem to conflict with what was agreed in the progress report prepared at the St. Andrews Summit in November 2009, namely, "to cooperate and coordinate, taking into account any spillovers caused by our strategies ..." (G-20, 2009b). Europe-wide austerity is bound to cause spillovers beyond this continent, but agreement on this issue no longer seems possible.

At the peak of the global crisis, G-20 members managed to see eye to eye on the need for coordinated measures to generate a strong demand stimulus, as the sheer severity of the events discounted any alternative. That moment seems to have passed: developments in mid-2010 have been reminiscent of the process of Multilateral Consultation on Global Imbalances that was launched in 2006, which entrusted the IMF to facilitate discussion and cooperation between China, the euro area, Japan, Saudi Arabia and the United States. Those consultations proved unsuccessful at the time: these systemically important countries failed to arrive at any "shared views on global imbalances" and hence agreed on strategies for their respective countries that did not represent any departure from the policies that had led to the global imbalances in the first place.

Today, there is a strong belief among policymakers in the euro area that fiscal austerity will not harm, but rather support, growth by boosting confidence. In contrast, policymakers in the United States fear that continued domestic demand stagnation in

Chart 1.6

**REAL EFFECTIVE EXCHANGE RATE, SELECTED COUNTRIES, JANUARY 2003–MAY 2010***(CPI based; index numbers, 2005 = 100)*

**Source:** Bank for International Settlements statistical database.

Europe will undermine any recovery of United States exports.<sup>14</sup> Failure to coordinate policies at the G-20 level raises the prospect of global imbalances re-emerging, especially among developed countries.

### 3. Are global imbalances set to widen again?

Global imbalances started to emerge in the early 1990s as domestic demand growth in the United States became associated with protracted weakness of domestic demand in Japan and much of Western Europe (IMF, 2001 and 2002). All along, the United States offset the deflationary forces originating in much of the rest of the world by encouraging borrowing and spending, particularly by private households. The resulting internal imbalances in the United States household and financial sectors began to implode as the property bubble burst in 2006.

Developing countries, on the other hand, staged a significant policy shift in the aftermath of the Asian financial crisis. Many of them embarked on a strategy of avoiding current-account deficits by favouring

competitive exchange rates and accumulating foreign exchange reserves. After 2002, China's current-account surplus surged, and in subsequent years the oil price boom inflated oil-producing countries' surplus positions.

The immediate policy responses to the unfolding global crisis led to a sharp shrinking of global current-account imbalances (chart 1.3). However, if the global economic forces that gave rise to imbalances prior to the crisis resurface, those imbalances will again widen in due course. In principle, robust domestic demand growth in developing countries led by China, together with strengthening currencies, help global rebalancing. However, their experience with the global crisis may well convince developing countries that it would not be in their best interest to revert to tolerating sizeable current-account deficits, as they did prior to the Asian crisis. This could revive the forces that contributed to the global imbalances. At the same time imbalances among developed countries risk becoming bigger and the continued weakness of the euro also militates against global rebalancing. While China's real effective exchange rate was rising in the first half of 2010, Germany's was declining (chart 1.6).

Contrary to the pre-crisis situation, United States authorities have limited scope for recourse to expansionary monetary policy, so that sustained recovery in the United States under adverse global conditions will require greater and longer fiscal policy support, with budget deficits and public debt replacing earlier private deficit spending and private debts (Bibow, 2009). If history is any guide, the United States authorities find recession-induced high unemployment levels much less tolerable than their European counterparts. Alternatively, if the United States authorities,

too, were to succumb to the sort of fiscal orthodoxy that has quickly regained the upper hand in leading European economies, either global deflation or trade protectionism would be the likely result.

A re-emergence of global imbalances would be contrary to the declared G-20 objectives and reflect a failure of the G-20 process of international cooperation. So far that process has fallen short of launching serious reforms of the international monetary and financial system.

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## D. The task ahead: reforming the global monetary and financial system

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### 1. *The exchange rate problem*

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A major concern is that unfettered markets cannot be trusted to determine exchange rates that reflect fundamentals and allow balanced trade. Apart from generating excessive short-term volatility, currency markets systematically overshoot or undershoot, thereby causing serious trade imbalances and related instabilities. However, government policy responses to this threat may result in excessive stability of nominal exchange rates, which may have similar economic consequences. Unilateral exchange-rate management may also lead to political tensions, since it conflicts with the multilateral character of exchange rates.

Therefore, a multilaterally agreed arrangement for exchange-rate management could introduce greater stability into the world economy as well as a higher degree of coherence between the multilateral trading system and international financial governance. As discussed at greater length in previous *TDRs*, this could be achieved through a system of managed flexible exchange rates which aims for a rate that is consistent with a sustainable current-account position. Implicitly featuring the purchasing power

parity condition as the key guiding rule, nominal exchange rates would be periodically adjusted to compensate for inflation differentials. Other factors such as terms-of-trade shocks and the state of countries' development would also need to be taken into account to assure a system-wide effort to achieve balanced trade.

An internationally agreed exchange-rate system aimed at ensuring stable and sustainable real exchange rates (RERs) for all countries would go a long way towards reducing the scope for speculative capital flows. As nominal exchange rates would follow inflation differentials, containing those differentials would go even further in limiting interest rate differentials, which are the main inducement for destabilizing carry trade strategies. In addition, symmetric intervention obligations under the "stable RER" rule would greatly reduce the need for emerging-market economies to hold international reserves as a means of self-insurance against currency crises.

The current monetary non-order causes developing countries to adopt defensive strategies against fickle markets, and it allows developed countries to engage in beggar-thy-neighbour strategies, with a

reliance on exports serving to offset their failure to manage domestic demand. The stable RER rule could provide a basis for the needed multilateral framework that would address both these issues.

## 2. Stabilizing the financial system

Closely related to exchange-rate instability and misalignment is the problem of destabilizing capital flows. Opening up to global finance implies a de facto loss of national policy autonomy for developing countries (*TDR 2006*, chap. II, section F; Akyüz, 2007; Mayer, 2008). External financial conditions, mainly influenced by monetary policies and financial players in the leading global financial market centres, largely determine the scope for domestic macroeconomic policies. Financial conditions as set in international markets are not only likely to be out of line with local requirements; they are also prone to fickleness, with floods of capital inflows and sudden reversals causing different sets of challenges.

Possible measures to deal with this problem include taxes on international financial transactions as well as various capital-account management techniques that may target both the level and the composition of inflows. In many cases, instruments directly targeting private capital flows may also be appropriately combined with, and complemented by, prudential domestic financial regulations. For instance, the Republic of Korea has recently introduced a series of measures designed to limit banks' currency exposures through forward transactions (Song Jung-a, 2010).

The global crisis has shown all too clearly that it is in the legitimate interest of countries to contain uncontrollable risks taken on by their private sectors in unfettered global financial markets. The so-called Stiglitz Commission emphasized that the host-country principle should guide countries' approach to financial regulation and supervision (UNPGA, 2009). Blindly relying on the proper conduct of foreign players that are regulated and supervised only by their home countries can prove very risky, especially since there has been limited progress in making the financial systems in the leading developed countries any safer.

One important aspect of reform of financial regulations and supervision should be to ensure the

system's functional (or social) efficiency in contributing to growth and stability in the real economy. At the same time, it should eliminate products that provide no real service other than the ability to gamble and increase leverage, which is often the case with financial derivatives (see also *TDR 2009*, chap. II). For instance, credit default swaps (CDSs) are supposed to provide hedging services. But when the issuance of CDSs reaches 10 times the risk to be hedged, it becomes clear that 90 per cent of those CDSs are not providing any hedging (or insurance) service; rather, they are being used for what amounts to gambling purposes. This is why there is a need for regulations that limit the issuance of CDSs to the amount of the underlying risk, and prohibit other types of financial instruments that are conducive to gambling (see annex to this chapter).

So far, reform of financial regulations and supervision has been pursued only at the national level, without due consideration to the need for a global architecture that would guarantee a certain degree of coherence. At this juncture, financial reform in the United States is more advanced than in Europe (see box 1.2). Furthermore, United States banks have also succeeded better than those in Europe in restoring their balance sheets and capital.

Financial globalization requires proper global governance, and, officially, the G-20 members remain committed to coordinating their policies with the aim of creating a safer global financial system through the Financial Stability Board (FSB) as their coordinating platform.<sup>15</sup> But progress in certain areas is proving to be slow, and the mere fact that national financial reform is proceeding at different speeds and along different routes would seem to indicate that in this area too conflicting policy views and/or interests impede proper coordination by the FSB. Furthermore, it would be important to have a fundamental inquiry into why the main international institutions charged with identifying risks to global financial stability may have failed to flag early warning signs in the build-up to the global financial crisis.

Against this background, emerging-market economies and other developing countries may be obliged to erect higher protection barriers against unfettered global finance, preferably through policies other than increased self-insurance, as the latter gives rise to pressures on the key reserve currency issuer that can create systemic risks of its own.



**Box 1.2****AFTER THE BAILOUT: UNITED STATES FINANCIAL REFORM**

The latest financial and economic crisis forced the United States Government to commit its own credit to the survival of the financial system. The \$700-billion Troubled Asset Relief Program (TARP) was only one, though very important, support measure for preventing a financial meltdown. With huge redistributive impacts, to the detriment of tax payers, the financial costs of the bailout are today shrinking with the recovery of the economy and of asset prices, as capital injections to banks are repaid at a profit to the Treasury. The true real costs of the crisis are the foregone output in its aftermath and, in particular, high levels of unemployment. These costs will continue to pile up as long as the economy fails to return to its potential growth trajectory with full employment. Apart from immediate emergency measures that successfully pre-empted a meltdown, the crisis also triggered a financial reform process that aimed at putting the system on a more solid footing to better prevent future financial crises and their impact on tax payers. The Restoring American Financial Stability Act of 2010 enacted in July stands on five pillars:

1. *Improving consumer protection* through the creation of a Consumer Financial Protection Bureau targeting the household sector, with the ability to design and enforce regulation of financial products, such as mortgages and credit cards.
2. *Addressing the “too big to fail” problem* by allowing regulators to impose capital ratios that increase with bank size, and by creating a Resolution Authority enabling the take-over, and orderly liquidation by the Government of any troubled large financial institutions which, were they to fail, could cause damages to the overall financial sector. The new legislation also imposes limits on proprietary trading by deposit-taking institutions, and limits bank ownership of hedge funds and private equity funds to 3 per cent of their tier-one capital.
3. *Regulating financial derivatives* by requiring that trading of standardized derivative products take place in organized exchanges. Banks are still allowed to trade simple derivative instruments (such as interest rate and foreign exchange swaps), but are required to move trading of more complex derivative instruments to specialized affiliates.
4. *Avoiding regulatory arbitrage and establishing an early warning system aimed at monitoring risks in the financial system as a whole* by creating a new Financial Oversight Council, and streamlining and coordinating responsibilities among existing regulators. The Council is composed of existing regulators (the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Controller of the Currency, but not the Office of Thrift Supervision which was eliminated in the process) and chaired by the Secretary of the Treasury.
5. *Addressing incentive problems in the financial industry* by setting standards to limit excessive compensation, and by giving shareholders the right to express non-binding opinions on executive pay. Investors would be allowed to sue rating agencies for “knowing or reckless” failures in their credit assessments.

Essentially, the Act re-regulates the current system without fundamentally changing its structure (Reich, 2010). It gives regulators substantial new powers, with hardly any requirement for them to implement tougher rules. This approach has the advantage of increasing the system’s flexibility, but the disadvantage of weakening regulators by not providing sufficient political backing. As a result, the ideological stance of regulators and of the administration appointing them will influence the quality of regulation. Only some of the fundamental problems of modern finance responsible for its hazardous fragility (*TDR 2009*) have been addressed; legislators were too timid to shut down the casino components of the financial system, or at least shield the banking system from its hazards.<sup>a</sup>

<sup>a</sup> The leniency of the Act was reflected in the market rally in bank equity prices.

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## E. Outlook

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The global economy is at a critical juncture. Through their coordinated response to the economic and financial crisis, policymakers have won an important battle in preventing the great recession from turning into another Great Depression. However, the ongoing recovery remains highly uneven and fragile. The global industrial inventory cycle may give a misleading impression, leading to a belief in the briskness and sustainability of the turnaround. In fact, it should be a warning that businesses remain wary of the strength and durability of the rebound. It therefore behoves the world's policymakers to remain vigilant and well prepared to initiate further support measures should such a need arise.

Global growth is vital to employment creation, especially in developing countries, where the task is not only to prevent unemployment rates from rising, but also to continue the fight against poverty by absorbing a continuously growing labour force, especially in manufacturing and modern services. A faltering global recovery would mean rising unemployment and underemployment, increasing poverty, and – almost certainly – failure to meet the Millennium Development Goals.

Policy-driven recovery in the United States, fairly strong up to mid-2010, is likely to slow down in the second half of the year and faces strong headwinds ahead. In Europe, most precariously, domestic demand continues to stagnate and continent-wide

fiscal austerity starting in 2011 might stall recovery in the region even before it has started. As a result, global recovery remains extremely unbalanced and fragile.

Continued policy stimulus is needed to maintain the momentum, and global macroeconomic policy coordination in this context is critical. Policies should focus on strengthening the recovery and rebalancing global aggregate demand. A process of self-sustaining growth in private spending and employment is not yet assured, while the forces that caused global imbalances in the past seem to be resurfacing. With emerging-market economies in Asia, led by China, experiencing a strong rebound from the crisis, the demand stimulus they provide to the global economy will be crucial but insufficient to restore the world economy to its pre-crisis growth path, even if the large primary-commodity-exporting countries are able to amplify the expansion in Asia. Developing countries should carefully consider all their options to prevent their development strategies from being unravelled by instabilities arising in the leading developed countries once again. In particular, developing countries with export-oriented development strategies need to prepare for the possibility of continued weakness of demand in developed-country markets. To this end, it would be advisable for them to strengthen domestic and regional demand for achieving their growth and employment objectives, an issue that is examined in greater detail in chapter III. ■



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## Notes

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- 1 Argentina, Brazil, Paraguay and Uruguay.
- 2 Seaborne trade volumes are measured in tons. This measure differs from the “volume of trade” presented elsewhere in this chapter, which corresponds to the value of imports or exports deflated by their corresponding unit prices.
- 3 Data from JP Morgan (2010) show that as growth in Chinese fixed investment, particularly in real terms, has eased significantly in 2010, growth in the volume of commodity imports has eased as well.
- 4 For a detailed discussion on the effects of financialization of commodity markets, see *TDR 2009*, chap. II.
- 5 In the medium term, offshore oil production prospects could be affected by the sinking of the Deepwater Horizon drilling rig in the Gulf of Mexico in the United States. The resultant ecologic disaster may trigger regulatory changes, with more stringent standards possibly leading to additional costs or delays in new projects (although a complete ban on offshore drilling is unlikely). This may affect oil market perspectives, since deepwater drilling accounts for roughly 13 per cent of world offshore production, which alone constitutes about one fifth of world oil reserves (See *Le Figaro*, Forage en mer : le casse-tête des pétroliers, 9 June 2010).
- 6 IMF stabilization programmes were arranged for: Armenia, Belarus, Bosnia and Herzegovina, Costa Rica, El Salvador, Georgia, Guatemala, Hungary, Iceland, Latvia, Mongolia, Pakistan, Romania, Serbia, and Ukraine (IMF, 2009). The current-account deficits of these countries ranged from 5 per cent of GDP to over 20 per cent.
- 7 China announced a 4 trillion renminbi (RMB) (\$586 billion) economic stimulus package on 9 November 2008, amounting to 14 per cent of its 2008 GDP, or roughly 7 per cent of GDP over the two years covered by the plan. The headline measure included increased central government spending of RMB 1,180 billion (\$172 billion), as well as local government spending and a vast lending programme by State-owned banks.
- 8 *TDR 2009* estimated the magnitude of discretionary fiscal stimulus (excluding the automatic stabilizers) as amounting to 6.2 per cent of GDP. China’s budget balance only deteriorated from a surplus of 0.6 per cent in 2007 to a deficit of 3.1 per cent of the GDP forecast for 2010 (chart 1.3), which shows that properly pre-emptive countercyclical fiscal stimulus partly pays for itself (Barboza, 2008; Dyer, 2008; and Yu, 2010).
- 9 For the impact of the global crisis on employment, see Jansen and von Uexkull, 2010.
- 10 In asset markets, the size of net flows may not fully reflect any potential build-up of fragility. For instance, if market participants broadly share the same views and aim at similar portfolio adjustments and market positioning, large asset price movements can also occur even with a relatively modest amount of capital flows.
- 11 Alluding to ill-guided attempts by the Hoover Administration to balance the federal budget during the Great Depression, Krugman (2008) stated: “But even as Washington tries to rescue the economy, the nation will be reeling from the actions of 50 Herbert Hoovers.”
- 12 The EU is the leading destination of United States merchandise exports, with a share of 21.2 per cent in 2008, compared with Canada’s share of 20.1 per cent and China’s share of 5.5 per cent; for goods and services, the EU’s share in 2008 was over 25 per cent compared with China’s share which was less than 5 per cent (UNCTAD, *Handbook of Statistics* database; and United States Bureau of Economic Analysis database).
- 13 What started as a subprime crisis in the United States quickly turned into a global crisis mainly because of the high degree of vulnerability of European banks. The European Central Bank (ECB) is often credited with having responded promptly to the emerging stress in the euro area money market in August 2007, which was caused by banking problems that had remained undetected. Germany’s Industrie Kredit

- Bank (IKB) and France's BNP Paribas were leading examples of banks with considerable exposure to the United States mortgage market. McGuire and von Peter (2009) point out that, in addition, the vast international expansion of European banks since 2000 had also left them with a huge dollar funding gap. It was the need for frequent rollovers in wholesale markets and a reliance on foreign exchange swap markets for that purpose that caused those euro money market dislocations, which then prompted the ECB to provide emergency liquidity in euros, and later also in dollars through central bank swap arrangements. Fender and McGuire (2010) report that at the end of 2009 the dollar funding gap persisted, and that German banks maintained the largest gap among European banking systems.
- 13 At the G-20 Ministerial meetings in St. Andrews in November 2009 and in Washington, DC, in April 2010, further details were worked out concerning the consultative mutual assessment process of national and regional policy frameworks, programmes and projections. The IMF was charged with preparing a report on alternative policy scenarios based on members' inputs, for consideration at the G-20 Leaders Summit in Toronto in late June 2010.
- 14 Giles (2010) and Giles and Oliver (2010) reported on conflicting views on policy at the Busan Ministerial in June. In an op-ed in the *Financial Times* on 23 June 2010, German Finance Minister Schäuble asserted that the German "course could be described as one of 'expansionary fiscal consolidation'". This idea
- of expansionary fiscal consolidation is also central to the ECB's analysis of past experiences with fiscal consolidations in Belgium, Finland, Ireland, the Netherlands and Spain (ECB, 2010b; on this issue see also Alesina and Ardagna, 2009). An important "fallacy of composition" (Keynes, 1936) is involved here, as the experiences of individual small countries are irrelevant when the EU as a whole is embarking on unconditional fiscal austerity. The contrast in policy visions became even clearer in the run-up to the Toronto Summit of the G-20 in June 2010, with the United States and Germany representing the two opposing poles in the stimulus versus austerity debate (Walker and Karnitschnig, 2010). The G-20 Toronto Summit Declaration states that "the G-20's highest priority is to safeguard and strengthen the recovery and lay the foundation for strong, sustainable and balanced growth, and strengthen our financial systems against risks" but also announces that "advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016."
- 15 The Financial Stability Board was created by the G-20 Summit in London in April 2009 as the successor to the Financial Stability Forum founded in 1999. Its task is the international coordination of the work of national financial authorities and international standard setting bodies, along with the development of effective regulatory, supervisory and other financial sector policies, and promoting their implementation.

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**Annex to chapter I**

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## CREDIT DEFAULT SWAPS

A credit default swap (CDS) is a derivative financial instrument in which one party buys protection against the default on a given debt instrument. This annex describes the main characteristics of CDSs and discusses their potential costs and benefits.

The origin of the CDS market dates back to the early 1990s when, in the aftermath of the Exxon Valdez oil spill of March 1989, the United States bank, JP Morgan, bought protection against a possible Exxon default from the European Bank for Reconstruction and Development (EBRD). This contract reduced JP Morgan's exposure to Exxon and increased the return on EBRD reserves that could only be used to lend to high rated borrowers (Tett, 2009).

In the second half of the 1990s, regulators and internal risk managers agreed that CDSs were an effective means of dispersing risk, and allowed banks to use these instruments to reduce their capital. As a result, the CDS market started to grow very rapidly: in 2005, the notional value of all CDSs tracked by the Bank for International Settlements (BIS) was about \$10 trillion, and by the end of 2007 it had surpassed \$58 trillion (about \$3 trillion higher than the world GDP in that year).

Before the latest financial crisis, many regulators, especially in the United States, were enthusiastic about the risk diversification properties of CDSs. For instance, in 2006 Alan Greenspan argued that what CDSs did was "lay-off all the risk of highly leveraged institutions ... on stable American and international institutions" (quoted in Das, 2008). However, many

of these institutions did not turn out to be as stable as expected and are now either bankrupt or in life support. As a consequence, many observers now share UNCTAD's original scepticism on the social value of innovative financial instruments (*TDR 2009*) and the regulation of CDS and other derivative instruments plays a prominent role in the global debate on financial reform.<sup>1</sup>

### **Description and terminology**

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In a CDS, the *buyer* makes periodic payments (*the spread*) to the *seller* in order to be protected against default (*credit event*) on a debt instrument (*the reference obligation*) by a given borrower (*the reference entity*). The difference between a bond spread and the CDS spread is usually referred to as *the basis*.<sup>2</sup>

The reference entity can be a corporate borrower or a sovereign State. CDS contracts written on sovereign States are usually referred to as sovereign CDS. A CDS contract on a corporate borrower can be triggered by the bankruptcy of the reference entity. As the concept of bankruptcy does not apply to sovereign States, a sovereign CDS can only be triggered by one of the following three events: (i) failure to pay the interest or principal on a bond or loan; (ii) an announcement of the intention to suspend payments (moratorium); or (iii) a change in the contractual terms in a way that puts creditors at a disadvantage



(for instance, a change in the currency of denomination of the debt instrument or an extension of the maturity of the debt instrument).

If a credit event does take place, the CDS can be settled either by physical delivery or in cash. When settling by physical delivery, the buyer delivers the defaulted debt instrument to the seller and receives a payment equal to the face value of the instrument (this is the *notional principal* of the CDS). When settling in cash, the seller makes a payment to the buyer equal to the difference between the par value and the market price of the reference obligation. CDS contracts specify how the market price of the reference obligation is to be measured. Originally, CDS contracts were tailored to the specific needs of their buyers and sellers; now most CDS contracts follow standard forms designed by the International Swaps and Derivatives Association.

When a CDS is used to hedge or transfer an existing credit risk, the party that buys protection eliminates (or reduces) its credit risk and the party that sells the CDS increases its total credit risk. By contrast, a naked CDS is a contract which is not matched by the underlying credit risk. After the transaction, the buyer is short on credit risk and the seller is long on credit risk. Naked CDSs are normally used to short the underlying instrument with the aim of making a profit if the value of the instrument decreases or a default does indeed happen.

### **CDS and insurance contracts**

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Insurance and CDS contracts are similar in the sense that in both cases the buyer makes a periodic payment and receives a much larger sum of money if a given event takes place.

Even though CDSs operate like insurance contracts, they are not classified as insurance and thus escape regulation.<sup>3</sup> CDS contracts are thus exempt from regulation that requires the presence of an insurable interest (which would make naked CDSs illegal) and that the insurer holds adequate reserves based on actuarial risk. Since unregulated sellers of CDSs do not need to hold reserves and do not use actuarial models to price their instruments, they try to hedge their risk with other market operations, and price

and value CDS contracts on a mark-to-market basis by using arbitrage relationships with other market instruments. However, CDS contracts can transfer but cannot eliminate credit risk. Therefore, the credit risk remains in the system but it becomes more difficult to track and identify. Consequently, CDSs may reduce transparency and amplify counterparty risk and price volatility especially because fluctuations in CDS spreads feed back into market prices leading to a vicious circle of high volatility.

### **CDS price and default risks**

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There are several problems with the assumption that market signals like CDS spreads (or bond spreads) are good measures of default risk. The most basic problem is that spreads are too volatile to reflect changes in slow moving fundamentals.<sup>4</sup> Price volatility is driven jointly by changes in the expected loss from default and changes in the overall risk premiums, with the latter factor accounting for approximately four fifths of the volatility of all spreads (Remolona, Scatigna and Wu, 2007). In the case of sovereign debt, risk premiums are driven mainly by global factors and have little to do with domestic fundamentals (González-Rozada and Levy Yeyati, 2008). Therefore, it is hard to conclude that sovereign spreads are a good measure of default risk.

Moreover, price discovery in the CDS market is limited by the fact that trading in this market tends to be thin. Even though arbitrage imposes a tight long-run relationship between CDS spreads and bond spreads, the short-run relationship between these two spreads (as measured by the basis) is far from being stable; it is affected by liquidity in the two markets and by contractual details (such as the definition of the trigger event and the deliverable obligation). Based on the observations that CDS spreads are more volatile than spreads in the cash markets, and that the volume of activity on the CDS markets is correlated with the level of the spreads, a recent study by Barclays Capital (2010) concludes that CDS spreads are dubious indicators of default risk.

That CDS spreads are not a good measure of default risk is evident on examining sovereign CDSs for the United Kingdom or the United States. These CDSs had a positive value in February 2009 (when



the spread on United Kingdom sovereign CDSs peaked at 175 basis points and that for United States CDSs peaked at 100 basis points) indicating that there were economic agents willing to pay up to \$17,500 each year for a contract that would deliver \$1,000,000 if the Government of the United Kingdom defaulted. However, since almost all debt of the United Kingdom is denominated in pound sterling, which that country's Government can print, the probability that the United Kingdom will default is basically zero. (In the worst-case scenario, the country can inflate away its own debt; however, a devaluation of the currency is not considered a credit event.) In the United States, the fact that spreads on its sovereign CDSs have a positive value is even more puzzling. In this case, not only is the probability of a credit event negligible, but also the counterparty risk is close to being infinite. If the United States were to default on its debt, the ensuing financial calamity would probably lead to a general state of default throughout the world. CDS contracts would become completely worthless because no seller of CDSs would be able to deliver on its obligation.<sup>5</sup> To sum up, markets are giving a positive value to an instrument that is supposed to deliver a payment if a near-zero probability event occurs in the full knowledge that if the event were to occur the counterparty would not honour its obligation to make the payment. Even the shadiest Las Vegas casino seems to offer better odds!

As the fundamental value of an asset is the expected net present value of the income stream of the asset, sovereign CDSs for the United States should have zero value. And yet in February 2009 they were trading at a spread of 100 basis points. How is this possible? While there are theoretical models that justify rational bubbles in which assets are priced well above their fundamental value (Blanchard, 1979), these models require a certain degree of uncertainty at the precise moment when the asset will reveal its true value. In the case of a CDS contract with no fundamental value, such uncertainty does not exist because all players know that the true value will be revealed on the day the CDS expires. It is then legitimate to ask why investors are willing to pay a positive price for an asset with zero value.

The answer to this puzzle lies in the fact that most banks have internal regulations aimed at limiting their exposure to corporate and country risk. A European bank with a large exposure to the United States corporate sector can reduce its exposure by

buying corporate CDSs, but it also needs to buy sovereign CDSs in order to reduce its exposure to the overall United States risk. Even though these sovereign CDSs are completely useless (for the reasons explained above), the bank will buy them anyway in order to satisfy its own internal rules and reduce the need to hold internal reserves.<sup>6</sup> This suggests that the demand for high-rated CDSs is purely due to the presence of (internal) regulatory arbitrage.<sup>7</sup> Once the demand for these types of instruments becomes established, market participants have an incentive to start trading them and making bets on their short-run movements. In fact, the popularity of naked CDSs indicates that the huge success of the CDS market is not due to the need to cover a certain exposure, but to the desire to bet on the short-term volatility of country spreads.

Valuation problems are even more acute for certain classes of corporate CDSs. In these cases, both the CDS and the reference obligation (which may also be a derivative instrument like a collateralized debt obligation) are thinly traded or not traded at all. Consequently, prices are fully model driven, without price discovery but with large, self-reinforcing and destabilizing feedback amplified by the fact that, in many cases, the notional value of CDS contracts on a given instrument is a multiple of the face value of the reference obligation.

Summing up, CDS spreads overreact to information and market sentiments, and are more likely to amplify fluctuations than to provide accurate information on default risk.

### ***Are CDSs socially useful?***

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The credit crisis triggered a debate on the social benefits of financial innovation (*TDR 2009*), and CDSs have been at the very centre of that debate. While most economists agree that there are several problems with the current structure of the CDS market (especially with its lack of transparency and centralized clearing), they are divided on the issue of the social benefits of CDSs, especially naked CDSs. Both sides started from the observation that a naked CDS is the best instrument for market participants interested in shorting an asset.<sup>8</sup> Those who emphasize the benefits of CDSs argue that the possibility to go

short facilitates price discovery and may either prevent bubbles or make bubbles burst earlier (Zingales, 2010). They liken CDSs to medical tests, which may reveal painful news, but the sooner one knows, the better. Those who emphasize the costs of naked CDSs argue that these instruments increase volatility and make coordinated runs, speculative attacks and “bear raids” easier (Portes, 2010; and Soros, 2010). As CDS spreads are mostly driven by short-term market sentiments and appear to do a poor job at discovering and measuring default risk, the latter view seems to be more appropriate than the former.

Moreover, while CDSs are often praised for increasing market liquidity, there is evidence that at times of widespread financial distress, speculators become users rather than providers of liquidity (Das, 2010). For all these reasons, in an analysis which applies network theory to financial markets, Haldane (2009) points out that CDSs are akin to horizontal networks that are known to increase interconnectedness and reduce the stability of the system.<sup>9</sup>

While most of the current discussion has focused on the alleged costs and benefits of naked CDSs, there are also potential problems with CDSs used for hedging purposes.

Litan (2009) argues that these derivative instruments provide several advantages in terms of risk

sharing, as they allow banks to reduce credit concentration without severing their relationships with well-established customers. While there is some merit to this argument, one should also consider that banks tend to have a large amount of information on their customers, and, when a bank makes a loan and then buys a CDS, the bank is effectively transferring the risk to a party that has less information than the bank (Baker, 2010). This looks more like insider trading than like a transaction with the potential to increase economic efficiency and risk sharing.

CDSs may also be a source of moral hazard. One of the pitfalls of the “originate and distribute” model is that banks that do not plan to keep a credit on their books have limited incentive to invest in credit screening procedures and their lending standards may be more lax (*TDR 2009*). The same applies to lenders that decide to use CDSs to transfer their credit risk to non-regulated third parties. Consequently, CDSs issued for hedging purposes may lead to systemic problems through three channels: (i) an increase in total risk taking; (ii) the transfer of risk to less informed, less regulated and, possibly, less capitalized players; and (iii) an increase in opacity.

Finally, CDSs may increase instability because, in case of default, insured creditors do not have the incentive to avoid socially costly, value destroying liquidation of the collateral. ■

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## Notes

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1 For instance, the G-20 Declaration on Strengthening the Financial System of 2 April 2009 includes a commitment to “promote the standardization and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision.” However, the G-20 effort has yet to produce any concrete results, especially as global coordination has since given way to uncoordinated national initiatives.

2 If the risk-free rate on 5-year loans is 5 per cent and 5-year bonds issued by reference entity  $x$  pay 7 per cent, the bond spread for entity  $x$  is 2 per cent. If the 5-year CDS spread for reference entity  $x$  is 2.3 per cent, the basis for reference entity  $x$  is 0.3 per cent. The basis is not fully arbitrated because of counterparty risk, liquidity and investor preferences. There are in fact instances in which the basis widens because bond spreads and CDS spreads move in opposite directions.

- 3 The financial services industry lobbied against any attempt to extend insurance regulations to the CDS market or have CDSs regulated by any other body. The market for these instruments expanded very rapidly after the United States Commodity Futures Modernization Act of 2000 exempted them from regulation and supervision by the United States Securities and Exchange Commission.
- 4 Shiller (1981) was the first to demonstrate that stock prices exhibit greater volatility than the present value of realized dividends.
- 5 Nassim Taleb put it well in an interview with the *Wall Street Journal* (Heard on the Street, 17 May 2004) when he said that buying sovereign CDSs for the United States is like buying insurance on the Titanic from someone on the Titanic.
- 6 Alternatively, consider the case of a bank that is exposed to a distressed United States company which is considered too big to fail. It is likely that CDSs on this distressed company will have high spreads. But if the company is indeed too big to fail, internal risk managers may consider a much cheaper sovereign CDS to be equivalent to the more expensive corporate CDS.
- 7 Basel II regulations do not affect the demand of CDSs for highly rated sovereign debt because there is no capital charge for the debt of highly rated sovereigns.
- 8 Without CDSs, shorting assets becomes complicated and requires capital. A CDS allows shorting an asset by simply paying the CDS spread.
- 9 The bankruptcy of the car parts maker Delphi offers a good example of these network effects. At the time of default, Delphi's debt was approximately \$4 billion and CDS contracts on Delphi's debt were estimated to range between \$20 and \$30 billion. A centralized clearing house would have solved some of the problems associated with the large gross CDS positions.

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