



TRADE AND DEVELOPMENT REPORT 2018

POWER, PLATFORMS AND
THE FREE TRADE DELUSION

Chapter I

**CURRENT TRENDS AND CHALLENGES
IN THE GLOBAL ECONOMY**



CURRENT TRENDS AND CHALLENGES IN THE GLOBAL ECONOMY

A. Making sense of global economic trends

1. The Panglossian disconnect

At some point in the past year, signs of a synchronized pick-up in growth, which began in early 2017, changed the global economic mood music to a generally more upbeat tempo.¹ Positive assessments of future growth prospects from leading forecasting institutions have led central bankers and macroeconomic policymakers in advanced economies to accept that the time has come to end the easy money policies in place for the past decade. The debate is now about when a “monetary reversal” should begin, and how fast and how far the process should proceed.

But there are already signs that the band members are not fully in step with the new score. Recent growth estimates have been more mixed than forecast and show growing unpredictability. For example, eurozone growth (EU-19) in the first quarter of 2018 is estimated to have decelerated to 0.4 per cent relative to the previous quarter, the slowest rate since the third quarter of 2016 (Eurostat, May 2018).² In the United States, annualized GDP growth for the first quarter has been revised down 2.2 per cent, lower than the previous three quarters, while second quarter growth rebounded spectacularly to 4.1 per cent, thanks to increased household spending and a sharp rise in export earnings. In G20 countries as a group, year-on-year growth in the first quarter of 2018 at 3.9 per cent was still much lower than the 5.4 per cent rates recorded in the middle of 2010, during the short-term recovery just after the crisis (figure 1.1). All this suggests that the recovery observed since 2017 remains uneven and its trajectory uncertain.

More significantly, despite the optimism surrounding the official discussion on economic prospects, there is a growing sense of uncertainty, driven both by recent evidence and by a more sober assessment of

medium-term trends, of not knowing exactly what is going on in the global economy, or the direction that it is taking. The uncertainty is compounded by the multiple disconnects between what is officially projected and announced, and what people around the world are experiencing: wage stagnation and rising inequality despite falling unemployment; excessive asset-price inflation and volatile currency movements despite a financial system deemed safer, simpler and fairer; depressed real investment despite high corporate profits; and ratios of debt to income that are close to or even higher than those that prevailed just before the global crisis a decade ago.

In this context, talk of an accelerating pace of economic recovery, tighter labour markets and emerging inflationary pressures serves to make the shift to tighter monetary policy more palatable to an anxious

FIGURE 1.1 G20 real GDP growth rates, first quarter 2009–first quarter 2018 (Year-on-year percentage change)



Source: Organisation for Economic Co-operation and Development, OECD.Stat database.

public. It also dampens calls for fiscal expansion. As discussed in *TDR 2017*, fiscal austerity has been the norm in the advanced economies since 2010³ but current projections warn against a more proactive fiscal stance. Rather, the prevailing view is that fiscal deficits should continue to be suppressed and public debt reduced. The recent measures adopted by the United States Administration (which are otherwise favoured by private capital), such as the tax cuts announced in 2017 and plans to enhance infrastructure spending (albeit with the vaguest of financial commitments), are being viewed with suspicion, since they would widen the fiscal deficit of the United States.

The conventional position, therefore, is that fiscal consolidation must remain the order of the day, notwithstanding the potential benefits of public spending for reducing inequalities and imparting greater cyclical stability to economies. This leaves monetary policy as the only active macroeconomic instrument available to policymakers – and in a context of economic revival, the consensus is that such policy should now gradually wind down and begin to tighten. The difficulty with this position is that it involves walking a knife-edge between overheating and potential recession, even as it sidesteps the continuing problems of insufficient good quality employment generation and rising inequality. In addition, this policy stance creates financial bubbles in the form of asset-price appreciations, volatile cross-border capital flows and – perhaps most important of all – unsustainable build-up of debt in both advanced and emerging market economies.

In many senses, different parts of the global economy are as, if not more, vulnerable than they were in 2007 and 2008 prior to the global panic created by the collapse of Lehman Brothers. In such a context, attempting to resolve the disconnect between real and financial movements in the economy through monetary policies alone may well precipitate another painful episode of restructuring through crisis.

2. Asset market surges

The monetary policy reversal in advanced countries begs a question. If the recovery is not robust, why are central banks and governments fixated on withdrawing the one measure that has kept their economies afloat since the crisis? Standard explanations such as the threat of inflation cannot really provide the answer, since inflation in advanced economies is

tepid and still below (the very low) target rates, and cost push pressures are generally weak as wages are not rising significantly, if at all.

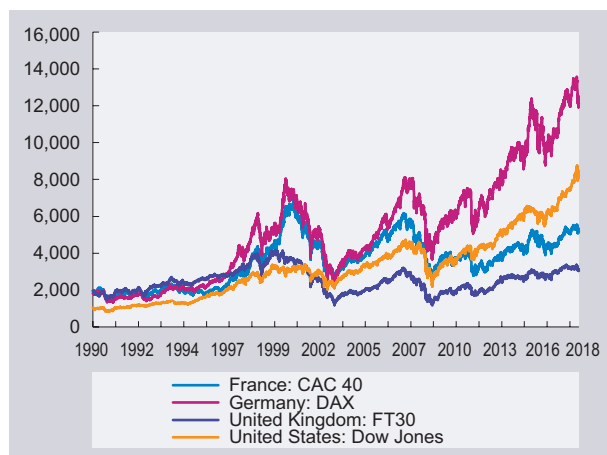
The more plausible explanation is a concern with overheating in asset markets in both advanced and developing economies. The cheap and readily available liquidity in developed country markets has enabled investors to engage in various forms of the carry trade, which have fuelled asset-price spirals in two ways. First, the low cost of capital has encouraged speculators to invest in a range of asset markets in anticipation of high returns. The resulting surge of capital flows to bond, equity and property markets in many different countries has driven prices up and ensured the realization of investors' expectations, generating more such investment. Second, the infusion of liquidity triggered credit expansions, once banks had partially corrected their post-crisis balance sheets with government and central bank support. The result is improved access to credit for households and corporates, even though many of them still have large volumes of legacy debt on their balance sheets. Some of that credit was in turn used for investments in assets, which strengthened the price spiral. The resulting price inflation in asset markets is increasingly seen as both unwarranted and unsustainable, a symptom of "financial euphoria" in a Minsky-type cycle.

This boom in asset markets as growth remained sluggish, is indicative of the persistent disconnect between trends in the real economy and financial sectors.

The impact of the liquidity surge on equity markets has been marked, as valuations touched levels not warranted by "fundamentals" or by potential earnings. This is widely accepted; but, as long as the music plays, those in the markets have to keep dancing – and with few players willing to exit, the boom has continued. Figures 1.2 and 1.3 present long-term trends in markets in some developed economies and some emerging markets in Asia. A noteworthy tendency is the growing synchronization of movements across both sets of markets both during the boom and when markets collapsed during the 2008/09 crisis.

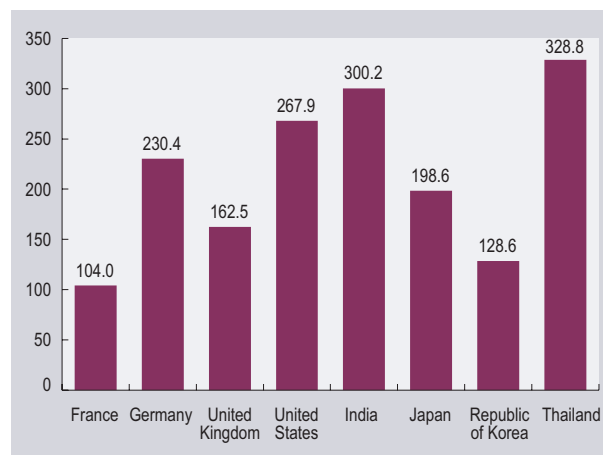
Such synchronization did not exist during the early hyperglobalization years. At the time of the 2001 dot-com bust, for example, while equity markets experienced downturns in the Western developed countries like France, Germany, the United Kingdom

FIGURE 1.2 Stock market, selected developed economies, January 1990–March 2018 (Index)



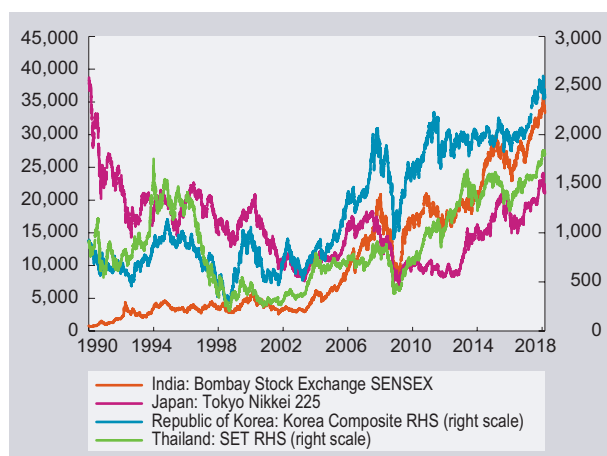
Source: CEIC Data's Global Database.

FIGURE 1.4 Change in stock market indices, selected economies, 2009–2018 (Percentage)



Source: UNCTAD secretariat calculations, based on CEIC Data's Global Database.

FIGURE 1.3 Stock market, selected developed and emerging Asian economies, January 1990–March 2018 (Index)



Source: See figure 1.2.

and the United States, and in Japan and the Republic of Korea in Asia, those in emerging markets like India and Thailand performed reasonably well. But after 2003, stock markets have moved in tandem to a far greater degree. In particular, after adoption of policies that infused cheap liquidity into the advanced countries in response to the global crisis, markets across the world have been buoyant. However, although the rise in the equity market index between March 2009 and March 2018 was high across the board, the extent of increase varied significantly across countries. For

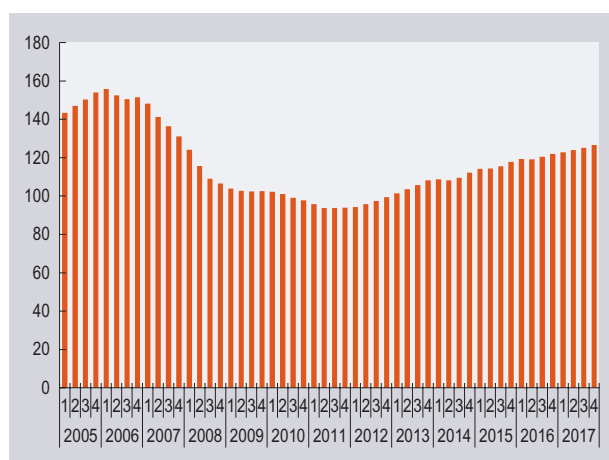
example, the increase was 230 per cent in Germany, 163 per cent in the United States, 300 per cent in India and 329 per cent in Thailand (figure 1.4).

Property prices took longer to adjust after the 2008 crash, but even in real estate markets, buoyancy returned with the surge in liquidity, even if to a lesser extent than was true of equity markets. In both the United States and the euro area (figures 1.5 and 1.6) property prices have risen significantly in recent years – since 2012 in the case of the United States and 2014 in the case of the European Union. However, synchronization has been far less pronounced even across the advanced country property markets. Within Europe, for example, real residential property prices have been stagnant in France, falling in Italy and rising in Germany (figure 1.7).

3. Asset markets and income inequality

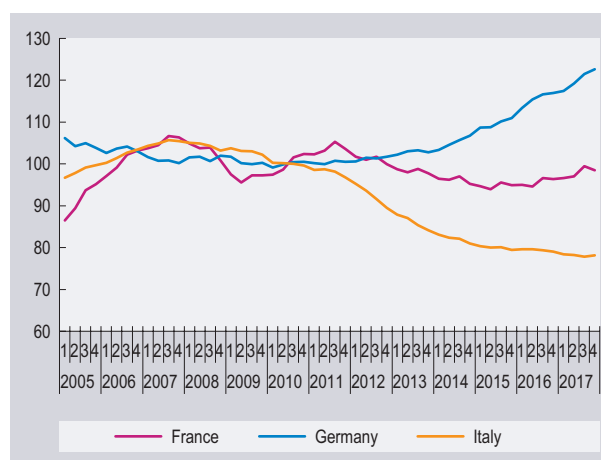
Sharp price increases in asset markets have aggravated the inequalities associated with growth during the hyperglobalization years. Figure 1.8, which compares the increases in average nominal wages between 2009 and 2015 (the last year for which data are currently available) and stock market appreciation, shows the substantial differences in the increases of the two in a set of advanced and developing economies. The gap is likely to have grown further since then in all of these countries. This underlines the regressive redistribution of wealth in favour of the financial

FIGURE 1.5 United States residential property prices, first quarter 2005–fourth quarter 2017
(Real price index, 2010=100)



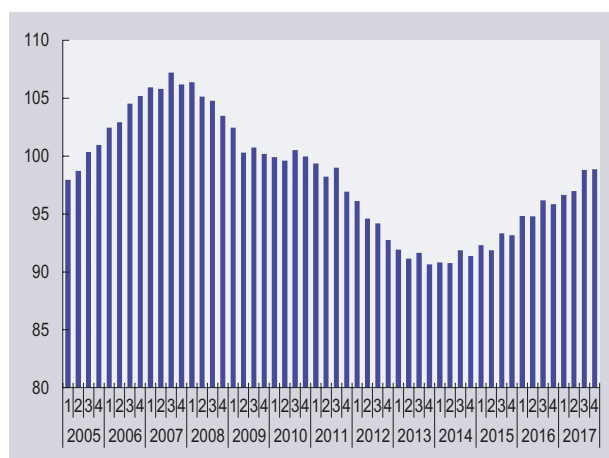
Source: Bank for International Settlements (BIS), property price statistics.

FIGURE 1.7 Residential property prices, selected European economies, first quarter 2005–fourth quarter 2017
(Real price index, 2010=100)



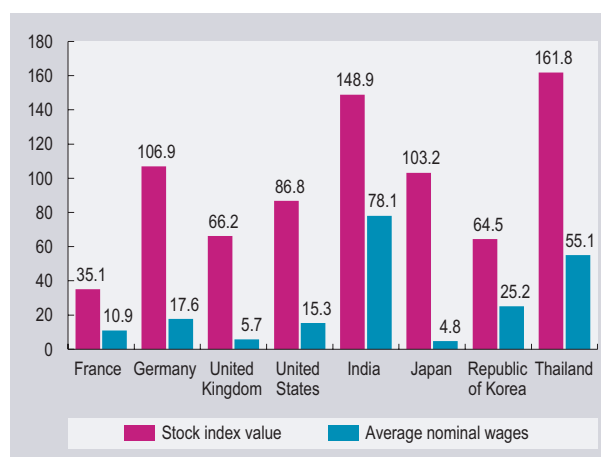
Source: See figure 1.5.

FIGURE 1.6 Euro area residential property prices, first quarter 2005–fourth quarter 2017
(Real price index, 2010=100)



Source: See figure 1.5.

FIGURE 1.8 Stock market appreciation and nominal wages increase, selected economies, 2009–2015
(Percentage change)



Source: UNCTAD secretariat calculations, based on CEIC Data's Global Database; and International Labour Organisation (ILO), *Global Wage Report*.

Note: The latest available data on nominal wages allow for comparisons only through 2015.

elite that has resulted from the disconnect between the real and financial economies.

The increase in inequality is a continuation of a long-term trend, as noted in *TDR 2017*. The sharp increase in inequality associated with hyperglobalization has been reflected inter alia in declining shares of wages in national income. Even during the “boom” years between the early 2000s and 2007, the share of wages fell from 57.5 per cent to less than 55 per cent in developed countries, and from 53 to 49.5 per cent in developing countries, which until then were

the lowest points on record.⁴ Thereafter, the decline has continued in advanced economies, and while the wage share has recovered somewhat in developing and transition economies, it remains significantly below the levels of the 1990s or even the early 2000s.

One consequence of that trend has been potentially sluggish growth in household demand, which could

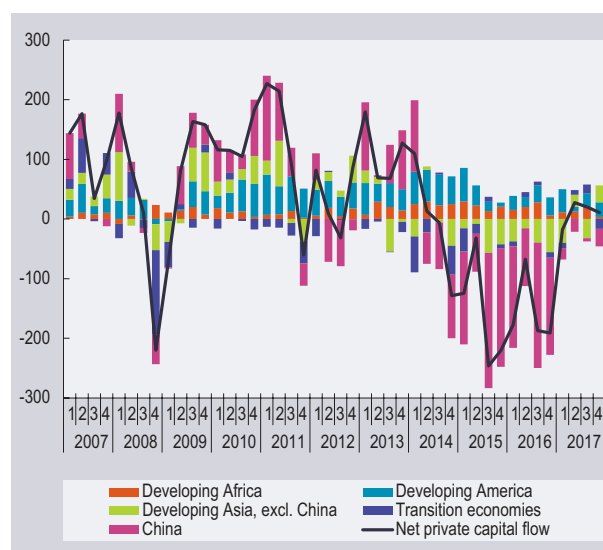
be sustained, if at all, only on the basis of debt. This was the trajectory in the developed world before the global crisis; what is alarming is that a similar trajectory is now evident in many developing countries as well. The next subsection describes how this is playing out and creating extreme vulnerabilities in many parts of the world.

4. Volatile capital flows

A clear sign of vulnerabilities accumulated during the easy money years is that as the United States Federal Reserve and other central banks began the process of tentatively unwinding their easy money and low interest rate policies, the environment for capital flows to developing countries, especially the emerging market economies, became extremely uncertain and volatile. From 2010, with quantitative easing under way, net private capital flows to developing regions surged. Investors faced with dramatically lowered yields on financial assets in the main financial centres restructured their portfolios favouring carry trades and, more generally, higher yield emerging market assets (*TDR 2016*, *TDR 2017*). But when developed country governments signalled an anticipated return to more conventional monetary policies, net private capital flows to all developing regions turned steeply negative, beginning late in 2014 and remained in negative territory through 2016 (figure 1.9).

However, 2017 saw a return to modestly positive overall net capital inflows mainly to developing Asia (excluding China), high-income Latin American economies and some transition economies. This upward trend is unlikely to last in the wake of adverse current account trends and currency volatility in several large developing countries, including Argentina, Brazil, India, Indonesia and Turkey. Recent estimates from the Institute of International Finance (IIF) suggest that, starting in February 2018, there has been a reversal of portfolio capital flows to emerging economies. According to IIF data for 25 emerging economies, sales of bonds and equities by foreign investors exceeded purchases in April 2018 by \$200 million, which was the largest outflow since November 2016 (Otsuka and Toyama, 2018). The figure for sales of bonds and equities rose to \$12.3 billion in May led by outflows of \$8 billion in Asia and \$4.7 billion in Africa and the Middle East (Jones, 2018). However, since foreign direct investment held up, the IIF estimated net capital flows to emerging markets at a positive \$32 billion in April, as

FIGURE 1.9 Net private capital flow by region, first quarter 2007–fourth quarter 2017 (Billions of current dollars)



Source: UNCTAD, Financial Statistics Database, based on IMF, Balance of Payments database; and national central banks.

compared to a monthly average of \$7 billion in 2017. This has been corroborated by the IMF Emerging Markets Capital Flows Monitor (Koepke and Goel, 2018), according to which, while net capital flows to emerging markets had been positive in the first quarter of 2018, there was a reversal of portfolio capital flows to these markets starting mid-April through to late May. However, strong foreign direct investment flows have made up for the decline in portfolio flows.

5. The global explosion of debt

In this context, the continued dependence of even limited global growth on debt remains a core concern. By the third quarter of 2017, global debt stocks had risen to close to \$250 trillion – or to more than three times global output – from less than \$150 trillion at the onset of the global financial crisis. The most recent estimate by UNCTAD for the ratio of global debt to GDP puts this at nearly one third higher now than in 2008. One implication is that even the current modest global recovery rides on a credit bubble. But the “wealth effect” that appreciation in asset values has in the form of enhanced consumption has been much weaker during the asset-price boom experienced after 2012 as compared to the run-up to the global financial crisis. This is partly because the burden of legacy debt accumulated during the previous boom had not been

TABLE 1.1 Completed and pending mergers and acquisitions deals worldwide, 2016–2018

	Value (Millions of current dollars)	Number
H1 2016	1,793,769.6	24,510
H2 2016	2,287,519.7	25,058
H1 2017	1,858,420.4	26,134
H2 2017	2,069,205.3	26,415
H1 2018	3,031,137.9	23,777

Source: Thomson Reuters.

substantially undone, dampening household spending. When a bubble rides on the unresolved remnants of a previous bubble, its effectiveness as a stimulus for private spending is much reduced.

Moreover, in keeping with the disconnect between the financial and real realms spoken of earlier, debt expansion has not financed increased investment. The ratio of investment to GDP for emerging markets and developing economies, which stood at 30.4 per cent in crisis year 2008, was only marginally higher at 32.3 per cent in 2017, according to the IMF World Economic Outlook database. In the advanced economies, the figure fell from 22.8 to 21.2 per cent.

On the other hand, encouraged by appreciated equity values and access to cheap and easy money, corporations have opted for mergers and acquisitions (M&A). According to Thomson Reuters data, the value of completed and pending M&A deals worldwide crossed \$3 trillion in the first half of 2018, rising by close to 65 per cent compared with the first half of 2017 (table 1.1). These M&A, which often require buying up rivals in an oligopolistic context, have taken company valuations even higher, completely delinking them from either current fundamentals or possible future earning streams. High profits also allowed large corporates to use the cash reserves they held to buy back their own stocks at high value, boosting the value of the stockholding of promoters and incumbent managers. This too has added to the fragility and uncertainty characterizing the current environment.

At the same time, the economic dynamics driving ballooning debt burdens and potential debt crises have changed. A decade ago, unsustainable household debt in the United States and excessive

borrowing by financial institutions triggered disaster. With core banking sectors in lead economies having deleveraged – to an extent and not least due to tighter regulatory measures – the biggest worry at present is corporate debt, with corporate bond markets and non-bank intermediaries playing an increasingly important role relative to core banking sectors. By some estimates, globally, over a third of non-financial corporations are now highly leveraged, with debt-to-earnings ratios of 5 and above, while noninvestment-grade corporate bonds have quadrupled since 2008 (Standard & Poor Global, 2018; Lund et al., 2018). In the United States, the ratio of credit to non-financial corporations to GDP, which had fallen from 69.7 per cent in 2007 to 66.1 per cent in 2011, has since risen to 73.5 per cent in 2017.⁵

In this context, the debt vulnerabilities of developing countries have built up on several fronts (United Nations, forthcoming 2018a). While the bulk of global debt stocks is still held in advanced economies, the share of developing countries in these stocks increased from around 7 per cent in 2007 to around 26 per cent a decade later. Total external debt stocks of developing countries and economies in transition are estimated to have reached \$7.64 trillion in 2017, having grown at an average yearly rate of 8.5 per cent between 2008 and 2017. This substantially reverses the achievements of the 2000s, during which many developing economies managed to stabilize and improve their debt positions because of the combination of a favourable external economic environment, international debt relief and strong domestic growth performance. The principal difficulty faced by developing countries in regard to maintaining debt sustainability has been their hastened and often premature integration into rapidly expanding international financial markets, and the concomitant much larger presence of private lenders in developing country liabilities. For developing countries as a whole, the share of public and publicly guaranteed (PPG) external debt owed to private creditors increased from 41 per cent in 2000 to over 60 per cent in 2017. In sub-Saharan Africa alone, the share of private non-guaranteed external debt (PNG) in overall external debt rose from a low of around 6 per cent in 2000 to about a quarter by 2015. This has entailed important structural shifts in external balance sheets, from debt to equity and towards bond- rather than bank-related finance.

Least developed economies have mostly been affected in terms of their external public debt positions and

associated rising debt service costs in the wake of sudden reversals of procyclical inflows of cheap credit from the international financial markets. Median levels of external public debt for this group of countries increased from 33 per cent of GDP in 2013 to 47 per cent in 2017. As a result, the number of low-income developing economies facing significant debt challenges has increased from 22 to 35, with countries in sub-Saharan Africa accounting for most of this increase (United Nations, 2018b). Between 2014 and 2017, the number of developing countries for which debt service represents more than 15 per cent of government revenues has increased from 21 to 29.

The explosion of non-financial corporate debt over recent years has more directly affected emerging market economies, where the ratio of credit to non-financial corporations to GDP went up from

56.3 per cent in 2008 to 104.6 per cent in 2017. Where emerging market corporates face difficulties in appropriately hedging their exposures, this represents a worrying vulnerability to private sector debt crises that, if systemic enough, can easily spill over into public sector debt crises. More generally, in many emerging market economies, changes in their external balance sheets from debt to equity (on the asset as well as the liability side) between 2000 and 2016, promoted by governments as a way of lowering external debt vulnerabilities, have only served to heighten other financial vulnerabilities, such as a large and volatile foreign presence in local equity markets (Akyüz, forthcoming 2018). In addition, a more recent feature of portfolio capital flows to these economies is a renewed high share of flows through debt instruments rather than equity (van Dijkhuizen and Neuteboom, 2018).

B. Emerging policy challenges

At the global level, excess liquidity has rendered the system vulnerable to crises. This is causing central bankers in developed countries to look for opportunities to unwind their unconventional monetary measures, to prevent further build-up of fragility. But the moment central banks made clear their intention to allow rates to rise and drawback the monetary lever, markets turned unstable, as such measures would undermine the basis on which carry trade-type investments were undertaken. As central banks, using the justification of a (still uncertain) synchronized global recovery, decide to unwind balance sheets and raise rates, investors will turn bearish.

As we have seen, vulnerabilities are particularly serious in the emerging markets. The large foreign capital inflows that drove asset-price inflation also led to the accumulation of stocks of foreign financial capital, brought in by investors with short-term interests, who are likely to exit when access to cheap money in developed countries comes to an end. If and when they do, the resulting capital flight will have destabilizing effects in not just stock, but also currency markets, with attendant external effects (on firms that have foreign currency borrowings on their books, for example). Countries that have been most favoured by foreign investors and experienced the

largest spike in asset prices, like India and Thailand, would likely be most vulnerable.

This creates a dilemma for central bankers. If they do not reverse the easy money regime, the collapse in asset markets, when it occurs, will be steeper and more damaging. On the other hand, reversing the policy regime would abort the halting recovery that is under way. There are no clear responses to this dilemma, especially as (other than in the United States) there are no plans for any compensating fiscal stimuli to cover for the possible instability. So, even with the more optimistic assessments of future economic prospects, considerable uncertainty prevails. The real issue now is how hard the landing in asset markets is likely to be and the implications that would have for the real economy. The landing is likely to be harder, and the external effects more damaging, the more prolonged the speculative spiral.

Current conditions clearly seem to be pointing to a crisis of some kind. However, a situation of heightened volatility and uncertainty around a weak and erratic growth path can persist for quite some time, especially if accommodating monetary policy is further extended, and the proposed sequence of interest rate increases in the major economies is softened.

In the interim, flows of easy money will continue to support asset appreciation worldwide, including through outflows to developing countries, at least for some more time.

There are other measures that could add further froth to financial markets. For example, the recent tax reform in the United States (which represents a net private windfall gain of nearly 1 per cent of GDP per annum going predominantly to the wealthy, and a corresponding loss for the government), together with similar transfers of wealth into the hands of the corporate sector and wealthy individuals in other developed economies (through privatization and similar measures) could continue to support financial innovation and speculation, as well as activities such as M&A, stock buy-backs and other portfolio operations. These contribute to increased financial concentration and political leverage, even as they provide a temporary boost to growth; they also add to the forces potentially creating future instability in financial markets.

But policymakers face other factors that are potent sources of instability. Navigating these requires both astute planning and a much greater degree of international cooperation and coordination than is currently evident. Two in particular deserve closer attention: the revival of global oil prices, which were depressed over recent years, and their likely effects on inflation and balance of payments in oil-importing countries; and the possible impacts of the protectionist pressures that now appear to be building between the major trading partners.

1. The oil price hike

Since mid-May 2018, the price of Brent crude has been hovering close to the \$80 per barrel mark. That was a \$47 per barrel (or 64 per cent) rise compared to the previous low recorded in June 2017. This increase in price occurred despite the absence of any major revival in global demand for oil. It has been driven largely by two factors operating on the supply side. One is the success of what has been termed “OPEC-plus” in curtailing global oil supplies, which began with a change in stance by Saudi Arabia. In 2014, Saudi Arabia, which accounted for nearly a third of OPEC production, resisted production cuts to stall the oil price decline, on the grounds that this would render shale producers competitive and increase their market share at the expense of its own. However, this

position changed over time, as the low oil prices hit the Saudi Government’s finances, requiring unpopular subsidy cuts and heavy borrowing by the state. Therefore, it agreed to control supply to raise prices, and OPEC went even further in December 2016 by striking a deal with the Russian Federation and other non-OPEC oil producers to cut their supplies to the global market by 558,000 barrels of crude a day. These cuts were on top of the 1.2 million barrels a day in cuts already agreed to by OPEC members. In total, this amounted to a reduction equal to almost 2 per cent of the then global oil supply. As a result of these cuts oil inventories have fallen sharply and oil prices have risen.

Other measures that are more geopolitical in nature (such as the decision of the United States to withdraw from the nuclear deal with the Islamic Republic of Iran and reimpose sanctions) are likely to worsen the oil supply shortfall, and have affected expectations accordingly. The net result was a sharp rise in world oil prices. To the extent that this increase contributes to overall inflation, the justification being provided by central banks to unwind their easy money policies would be validated and rate rises are likely to follow. But, as noted earlier, that move could have unintended effects that abort the incipient recovery.

2. United States protectionism and potential trade wars

Another factor intensifying uncertainty is the protectionist turn in the United States. From January 2018 the United States Administration has announced various measures that have come close to triggering what many are calling a “trade war”, beginning with quotas and tariffs on solar panels and washing machine imports from China, and then moving onto steel and aluminium for a wider set of countries, as well as investigating United States car imports.

The tariffs were imposed under a World Trade Organization (WTO) clause relating to imports that threaten national security, though the idea is to curb competition from “cheap metal that is subsidized by foreign countries”, which amounts to a “dumping” charge. Subsequently, further trade sanctions were imposed on China, on the grounds that it was using unfair tactics such as hacking commercial secrets and demanding disclosure of “trade secrets” by United States companies in return for access to the Chinese market. Those measures included investment

restrictions and tariffs on other Chinese exports to be imposed in stages.

These measures – and other tariffs imposed on other trading partners such as the European Union, Canada and Japan – are being contested at the WTO, but the consequences of such a move are not clear and will anyway be drawn out. The other response has been in the form of announcing retaliatory tariffs, targeted at specific activities and exports of the United States. The European Union announced duties on a series of United States imports totalling over \$3 billion and Canada has countered with tariffs on over \$16 billion worth of imports. The initial response from China was measured. In an early April 2018 statement, the Chinese Government announced tariffs on United States imports worth around \$3 billion, which included a 15 per cent duty on 120 American products such as fruits, nuts, wine and steel pipes and a 25 per cent tax on eight others, like recycled aluminium and pork. This was seen as a symbolic gesture indicating that China would respond when necessary. In June 2018 the United States announced the launch of substantially enhanced tariffs on imports from China, the first tranche of which was a 25 per cent tariff on 818 products, imports of which into the United States were valued at \$34 billion. And in early July 2018 President Trump threatened to impose an additional \$200 billion of tariffs on Chinese goods. This triggered a more concerted response from China on imports from the United States. There are further lists of products to be taxed that are pending as at the time of writing. A tit-for-tat process is already under way.

The impact of such a wave of protectionism is uncertain. It is true that the United States aggregate trade deficit increased by close to 13 per cent to \$568 billion

in 2017. Of that, around \$375 billion was on account of the deficit between China and the United States. The point, however, is that imposing these unilateral tariffs, is not going to help in reducing these deficits, which reflect macroeconomic imbalances, and things could get even worse with retaliatory action. Moving in this direction would likely disrupt prevailing global value chains around which much of trade is now built. Such disruption would, in the first instance, affect the profits of multinational operations rather than national output, but with a likely adverse knock-on impact on investment given the heightened level of uncertainty. However, over time it could encourage relocation or ‘reverse’ relocation in some areas in order to jump tariff barriers, thereby partially arresting the process of globalization. On the other hand, to the extent that it increases government revenues and therefore expenditures in individual nations, it could drive growth based on domestic demand with reduced leakages in the form of imports. So the effect on global growth and its distribution is not easily predicted. But so long as trade continues, which it would since factors other than tariffs drive trade, trade deficits and surpluses would persist.

In sum, while unilateral protectionist actions by the United States may or may not help strengthen its domestic producers, they are unlikely to make a significant difference to the size of its external deficit. Moreover, they are likely to introduce disruptions to trade patterns and add to uncertainty, which in the absence of expansionary macroeconomic measures will probably damage world trade. They will also have distributional consequences which are likely to weaken growth (see appendix I.A below). The Trump Administration sees its protectionist actions as a way of escaping the long years of relative stagnation. What it may actually get is more of the same.

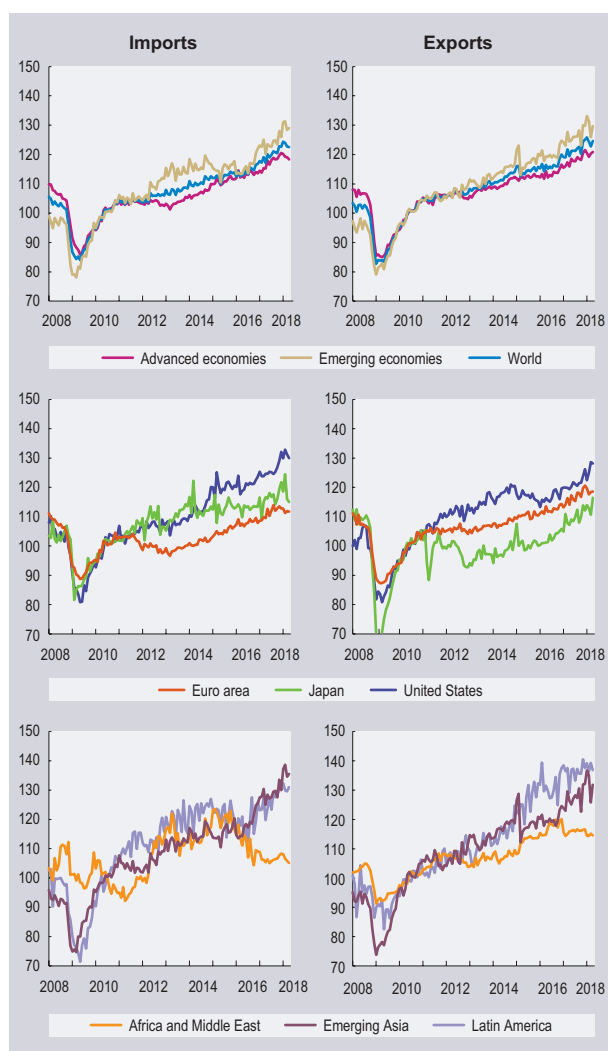
C. Global trade patterns

1. Signals from global trade

World merchandise trade has picked up recently but still remains below recent highs. World merchandise exports amounted to \$17 trillion in 2017, higher than the \$16 trillion recorded in the previous year, but below the \$19 trillion level recorded in 2013 and 2014, though this partly reflects the decline of commodity prices from the pre-2014 highs.⁶

Trade measured in volume terms is also showing signs of losing momentum. In 2017, the volume of world merchandise trade grew at 4.6 per cent, up from 1.5 per cent in 2016. However, trade is estimated to grow at 4.2 per cent in 2018. So, while merchandise trade growth is off its post-crisis lows, the recovery, even before the recent rise in trade tensions, shows signs of tapering off. This means that unless there are substantial cross-country variations in trade

FIGURE 1.10 World trade volume trends,
January 2008–April 2018
(Index numbers, 2010 = 100)



Source: Centraal Planbureau (CPB) Netherlands Bureau of Economic Policy Analysis, World Trade database.

Note: Country groupings are those used by the source.

performance underlying the aggregate trends, individual countries cannot expect trade to serve as the lead stimulus to growth. A critical issue is the extent to which subdued trade growth affects the performance of China as a significant driver of global demand, because if this is adversely affected, other countries would face sluggish demand for their exports.

According to disaggregated figures from the CPB database,⁷ there were two noteworthy features of the recovery in world trade in 2017. First, the largest increases in import demand came from emerging economies, which saw imports grow at 6.9 per cent in 2017 compared with 0.6 per cent in 2016. The corresponding figures for the developed countries were

3.5 and 2.1 per cent. Second, Asia, Latin America and the United States led the table in terms of import volume growth, with Asia (8.8 per cent growth) well ahead of Latin America (6.2 per cent) and the United States (4 per cent). Euro area imports grew at a much slower rate of 3.1 per cent. Asia, according to the WTO, contributed 2.9 percentage points to world import growth, or 60 per cent of the overall increase.

However, the evidence for the first four months of 2018 suggests that after what appeared to be a revival, import demand from some of the post-crisis growth poles in the world economy is slowing (figure 1.10). For the world as a whole, year-on-year growth rates of import volumes during the first four months of 2018 stood at 4.7 per cent as compared with 4.8 per cent in the corresponding period of the previous year. But import growth had come down from 6.9 per cent to 5.9 per cent in the case of the emerging economies.

Asia's retreat as a source of demand was partly led by China, which besides experiencing a slowdown in output growth is simultaneously engaged in an effort at rebalancing growth away from investment to consumption. Investment, which accounted for 55 per cent of GDP growth in 2013, contributed only 32 per cent in 2017, resulting in a decline in imports of capital goods that may not have been compensated by additional imports of consumption goods. Given that development, the continued presence of the United States as a contributor to growth in global demand is even more crucial for global trade buoyancy. This makes the United States Administration's threat of raising broad protectionist walls potentially even more detrimental to growth in the rest of the world, coming as it does at a time when global demand is already subdued. While Asia's role as a growth pole has been dampened, the contribution of the United States is increasingly uncertain.

2. Commercial services trade

Services trade, by contrast, does not show such loss of momentum. World services exports, which fell in 2015 and were sluggish in 2016, registered a significant revival in 2017, from a little less than \$5 trillion to \$5.3 trillion. However, the value of services exports was not very much higher than the \$5.1 trillion registered in 2014.⁸ The shift to higher growth in 2017 characterized all groups: developed countries, developing countries and transition economies, which after consecutive years of negative or

TABLE 1.2 World primary commodity prices, 2008–2018
(Percentage change over previous year, unless otherwise indicated)

Commodity groups	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 ^a
All commodities ^b	33.5	-31.6	24.7	28.6	-3.0	-3.8	-7.9	-36.1	-9.7	17.8	17.1
Non-fuel commodities ^c	22.9	-18.2	27.3	18.7	-12.8	-6.6	-7.8	-19.0	2.8	10.2	0.4
Non-fuel commodities (in SDRs) ^c	19.0	-16.2	28.7	14.7	-10.1	-5.8	-7.8	-12.1	3.5	10.5	-5.5
All food	32.6	-9.9	12.3	24.0	-6.5	-10.0	-0.1	-16.1	4.1	-0.6	-4.0
Food and tropical beverages	31.8	-2.3	12.3	24.1	-9.8	-9.4	3.8	-14.1	2.7	-1.1	-5.4
Tropical beverages	19.4	1.2	19.6	31.0	-22.2	-19.7	23.7	-11.0	-3.0	-3.1	-6.3
Food	35.9	-3.3	10.1	21.8	-5.4	-6.4	-1.2	-15.1	4.6	-0.4	-5.2
Vegetable oilseeds and oils	33.9	-22.5	12.3	23.9	0.3	-11.0	-7.3	-20.4	7.5	0.4	-1.0
Agricultural raw materials	8.1	-16.1	38.9	23.1	-19.4	-8.8	-11.8	-13.3	-0.2	5.3	-4.8
Minerals, ores and metals	20.8	-13.8	34.8	20.5	-7.0	-9.3	-13.0	-17.1	4.9	12.2	6.7
Minerals, ores and non-precious metals	19.2	-26.9	41.4	12.1	-16.9	-1.7	-15.0	-24.6	2.2	27.8	7.2
Precious metals	23.4	7.5	27.5	30.8	3.4	-15.8	-11.0	-9.9	7.1	0.4	6.1
Fuel commodities	37.9	-38.5	23.3	32.2	-0.4	-1.2	-7.5	-44.2	-18.2	26.1	27.3
<i>Memo item:</i>											
Manufactures ^d	4.9	-5.6	1.9	10.3	-2.2	4.0	-1.8	-9.5	-1.1	4.9	..

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

Note: In current dollars unless otherwise specified.

- a** Percentage change between the average for the period January to May 2018 and January to May 2017.
b Including fuel commodities and precious metals. Average 2014–2016 weights are used for aggregation.
c Excluding fuel commodities and precious metals. SDRs = special drawing rights.
d Unit value of exports of manufactured goods of developed countries.

low growth recorded growth rates of 7.1, 7.9 and 12.2 per cent respectively.

Quantity data available for the two largest components of trade in services – maritime transportation and tourism – offer additional insight on trends in the trade in services. World seaborne trade gathered momentum in 2017, with volumes expanding by 4 per cent, the fastest growth in five years. Within this, containerized trade and dry bulk commodities recorded the fastest rates of expansion. Following the relatively weak performances of the two previous years, containerized trade increased by a firm 6 per cent and dry bulk commodities trade increased by 4.4 per cent in 2017 (UNCTAD, forthcoming 2018).

International tourism performed poorly in 2016, when international tourist arrivals grew at only 3.9 per cent, the lowest rate since 2009. However, international tourist arrivals rose by 7 per cent in 2017, the strongest growth registered in seven years. The United Nations World Tourism Organization estimates that this buoyancy would be sustained with arrivals rising by 4 to 5 per cent in 2018. Growth rates rose across all regions, with Europe and Africa registering 8 per cent growth in arrivals, Asia-Pacific 6 per cent, the

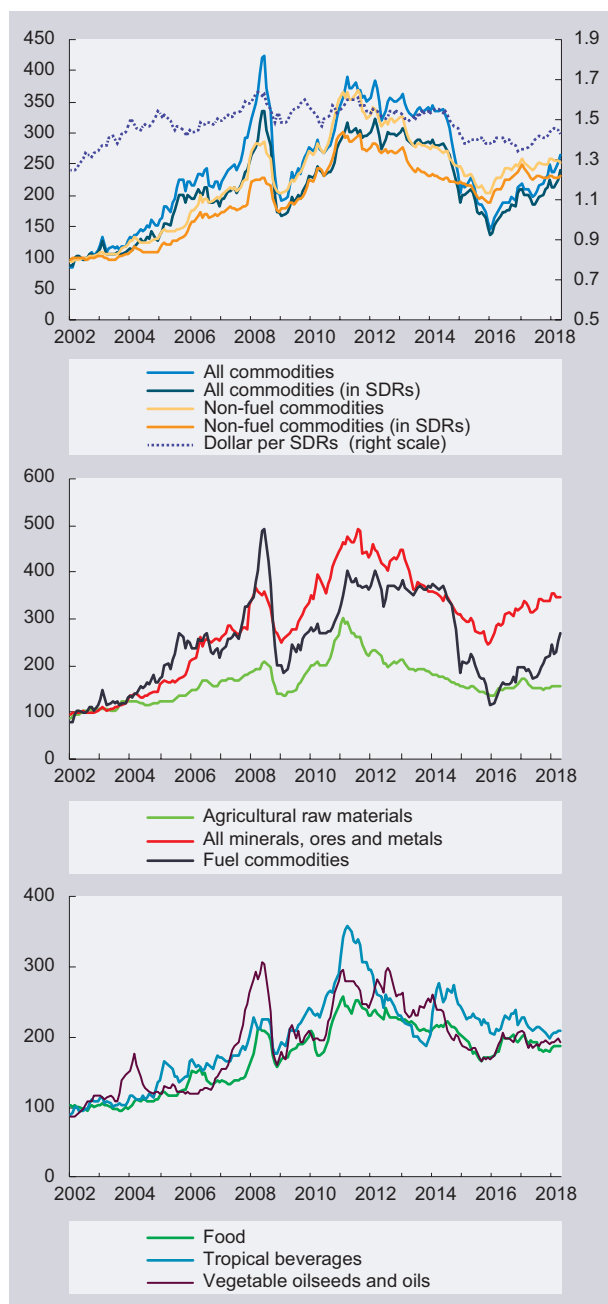
Middle East 5 per cent and the Americas 3 per cent (in which South America recorded 7 per cent).

3. Commodity price trends

A return of buoyancy to commodity markets is likely to benefit some developing country commodity exporters. The prices of a broad range of commodities are set to rise over 2018, continuing (with some exceptions) the trend observed since January 2016, which is when the decline in commodity prices from 2011 was reversed. That rising price trend gathered momentum and spread to a larger range of commodities during the first half of 2018. Overall, according to the World Bank,⁹ commodity prices in the first quarter of 2018 rose in three fourths of the commodities covered by it. However, in the case of more than 80 per cent of these commodities, prices are still below their 2011 peaks.

There are two other noteworthy features in these trends. First, for one large group of commodities, consisting of agricultural food products, the price decline of 2017 intensified in the first half of 2018 (table 1.2). The All Food Index fell by 4 per cent in

FIGURE 1.11 Monthly commodity price indices by commodity group, January 2002–May 2018
(Index numbers, 2002=100)



Source: UNCTAD secretariat calculations, based on UNCTADstat. For more details on the data sources see <http://unctadstat.unctad.org/wds/TableViewer/summary.aspx?ReportId=140863>.

the first half of 2018 relative to the same period of the previous year. All categories (food, tropical beverages, and vegetable oilseeds and oils) reflected this tendency. Second, it appears that commodity price movements are being determined less by strengthening demand conditions and more by developments on the supply side. The case of oil (discussed in section B) is striking in this regard, with production cuts not just by OPEC countries but others like the Russian Federation and many non-OPEC producers, and supply disruptions resulting from sanctions and political unrest, underlying the recent sharp price increases. But even in the case of metals, supply-side factors – such as measures to address pollution – held back production in China, which is a leading commodity importer. The consequent substitution of domestic production with imports rather than additions to demand increased imports, affecting steel, aluminium and iron ore. In the case of commodities for which supply was easy, prices were stable or even fell.

Overall, prices of metals seem to be losing momentum. As compared to an increase of 27.8 per cent in 2017, the index of prices of minerals, ores and non-precious metals rose by just 7.2 per cent in the first half of 2018 relative to the same period of the previous year. The continued buoyancy of prices was true mainly of oil and the precious metals.

From a medium-term perspective, while the commodity price cycles for the major groups of commodities were more or less similar (figure 1.11), within the non-fuel group there were significant differences between agricultural raw materials, on the one hand, and fuel commodities and minerals, ores and metals on the other. For a considerably long period since early 2011, the prices of agricultural commodities have been declining or stagnant. Food price indices for major crops and food crops as a whole have fallen by more than a third relative to their recent peaks (Bellmann and Hepburn, 2017). While supplies have been plentiful, the major reason is depressed demand, aggravated by the slowdown in China.

D. The drivers of growth

As noted earlier, the decade-long strategy of reviving growth through unorthodox monetary means (“quantitative easing”) in the advanced economies has had only limited success in spurring income and employment growth. The persistent weakness of effective demand, compounded by post-crisis deleveraging by households and firms, dampened productive investment, while higher income inequality and lower employment rates prevented a strong rebound of consumption. It does not help that governments remain reluctant to spend to support growth. The result is a new normal of low growth.

In the two decades prior to the global crisis, in a context of financial liberalization and tight fiscal policies, two means of stimulating growth operated to differing degrees in the various regions of the world: debt-fuelled consumption expansion and export expansion. A mapping of global growth shows that these have continued to be the major strategies in the post-crisis period. However, both options tend to increase vulnerabilities and fail to generate robust global growth.

Table 1.3 shows the configuration of demand in selected countries and regional groups across the world economy. The categorization is derived from a model-based analysis of different forms of expansion and contraction of demand in the global system.¹⁰ In this framework, domestic output increases in response to increased demand through private investment, government spending and exports, and shrinks because of subtractions from aggregate demand in the form of private savings, taxes and imports. Private saving is part of income, but when it is not equally compensated by investment, it drops out from the flow of effective demand. Taxes represent income diverted to the government, which if not spent by the public sector becomes “government saving”. Imports represent income spent on output generated abroad. Accordingly, the growth rate of aggregate supply can be decomposed into its three main demand components or “growth drivers”:

1. private demand, whose growth rate depends on investment, savings and the tax, saving and import rates;
2. government demand, whose growth rate depends on government spending on goods and services, taxes and the tax, saving and import rates;

3. external demand, whose growth rate depends on exports, imports and the tax, saving and import rates.

Based on this framework, table 1.3 presents the results of an analysis of the drivers of global growth in the current year.¹¹ The average rate of growth of aggregate supply over the two-year period 2017–2018 is estimated, along with the relative contributions of each of its components.¹² The countries or country groups in the table are classified according to which growth driver is dominant. Within each category, countries are ranked by the relative importance of that particular driver.¹³ A ranking of economies in this way sheds light on the character of the growth strategy per se (how the observed growth of output is achieved), rather than on how fast that economy is growing.

A striking result in table 1.3 is that in 19 out of 30 cases, growth relies more strongly on net exports than on domestic demand, whether private or public. This raises a number of concerns. First, an economy that shows a relatively strong dependence on net export demand, as defined above, must record stronger growth of exports than of imports. This can result from either a successful strategy of increasing exports over time, or a successful strategy of containing domestic demand for imports relative to demand for exports, or a combination of the two.

Countries showing a tendency towards a relative reduction of imports are likely to be those dealing with current account deficits, such as France, India, Turkey, the United Kingdom and some countries in Central America and the Caribbean. In these and similar cases, increases in net export demand result from containing imports, through reductions of government demand (possibly because of fiscal austerity measures that constrain public spending) or private demand (possibly because of reductions in workers’ real incomes that erode consumption and by extension private investment). Either way, the result is a shrinking current account deficit. This creates an underlying bias that depresses global demand in the aggregate, particularly if a considerable number of relatively large countries choose such a macroeconomic strategy.

An obvious alternative way for these countries to reduce their external deficits would be for other

TABLE 1.3 Drivers of demand in different countries, 2017–2018

	Aggregate supply	Fiscal	Private	External	Relative strength
External demand is main driver					
United Kingdom	1.7	-0.5	0.1	2.1	***
Other transition economies	6.6	0.8	0.8	5.1	***
North Africa	6.9	0.6	1.0	5.4	***
Other East Asia	3.9	0.6	0.4	2.9	***
Republic of Korea	3.6	0.1	0.8	2.7	***
Other West Asia	5.9	1.3	0.4	4.3	***
Non-European Union Europe	2.4	0.2	0.5	1.7	***
Russian Federation	3.4	-0.3	0.9	2.8	***
Mexico	3.1	-0.1	1.1	2.1	***
Japan	1.5	-0.9	0.8	1.6	***
Germany	2.3	-0.1	0.9	1.5	**
Italy	2.0	-0.2	0.8	1.4	**
Caribbean	3.1	0.8	0.9	1.5	**
Other European Union	2.9	0.4	0.9	1.6	**
France	2.2	0.4	0.7	1.1	**
Turkey	6.4	1.4	2.3	2.9	*
Indonesia	5.4	1.0	2.0	2.5	*
Other developed countries	3.6	1.3	0.8	1.5	*
India	7.4	1.5	2.9	3.2	*
Private demand is main driver					
Other South America	0.2	-0.5	1.2	-0.5	***
Argentina	4.5	0.3	3.0	1.2	***
Canada	2.5	0.7	1.6	0.2	***
United States	2.7	0.7	1.2	0.8	**
Australia	2.7	1.0	1.3	0.5	**
Brazil	1.8	-1.0	1.5	1.3	*
China	6.6	1.9	2.5	2.4	*
Government demand is main driver					
Other sub-Saharan Africa	3.0	2.3	0.1	0.6	***
Saudi Arabia	0.2	2.6	-3.5	1.0	***
Other South Asia	5.0	3.1	1.4	0.5	***
South Africa	1.4	0.7	0.5	0.2	**

Source: United Nations Global Policy Model.

Note: Stars indicate the relative strength of the main driver of aggregate demand with respect to the second strongest driver (* if difference is smaller or equal to 30 per cent of main driver, ** if difference is greater than 30 per cent and smaller or equal to 50 per cent of main driver, *** if difference is greater than 50 per cent of main driver). Country groups are as follows: *Other East Asia* includes the Democratic People's Republic of Korea, Hong Kong (China), Malaysia, Mongolia and Singapore; *Non-European Union Europe* includes Norway, Serbia and Switzerland; *Caribbean* includes Costa Rica, the Dominican Republic and Jamaica; *Other European Union* includes Croatia, Estonia, Greece, the Netherlands, Norway, Portugal, Spain and Sweden; *Other West Asia* includes Iraq, Lebanon and the United Arab Emirates; *North Africa* includes Algeria, Egypt, Libya, Morocco and Tunisia; *Other transition economies* includes Georgia, Kazakhstan and Ukraine; *Other developed countries* includes Israel and New Zealand; *Other South America* includes Chile, Colombia, Ecuador and Peru; *Other South Asia* includes Afghanistan, Bangladesh, the Islamic Republic of Iran and Pakistan; *Other sub-Saharan Africa* includes Angola, the Democratic Republic of the Congo, Kenya, Nigeria and most sub-Saharan African countries excluding South Africa.

trading countries that consistently run surpluses to increase their domestic demand and thus their imports, which would in the process contribute to an addition to global demand for exports. Besides helping other countries, this would also facilitate a recovery of global growth. Indeed, in the economies in the upper section of table 1.3, for whom the main driver of aggregate supply growth is net export demand, and which are known as “surplus” economies, the contribution of domestic demand to growth of either the public or the private sector (or both), is considerably weak, if not negative, and so there is considerable scope for expansion.

A second cause for concern is with respect to economies whose aggregate supply growth is mostly driven by net external demand. Nearly half of them rely heavily on commodity or oil exports. (This includes Saudi Arabia, for which government demand is a strong driver, but where there is also a role for external demand.) These economies tend to be large importers of manufactures from their main export markets. Since global commodity demand tends to be procyclical, rising during the booms and falling during slowdowns, the “strong exporters” in this group as a whole are likely to be vulnerable to, and contribute to, boom–bust growth cycles. The growth dynamics of this group therefore have a considerable bearing on the potential instability of global growth.

The middle section of table 1.3 includes six economies (and one country group) for whom the strongest demand driver is the private sector. Among these, a noteworthy case is China. First, despite running a current account surplus, net external demand is not its main growth driver. As a matter of fact, relative to its own GDP, its current account surplus is shrinking, to just above 1 per cent, as compared with about 9 per cent of GDP in 2007. Second, the contributions to growth of the three components (public, private and external) are remarkably similar. This reflects some success in rebalancing the economy, as well as in contributing to global demand to the extent that the domestic growth drivers are strong, with respect to its own economy as well as relative to world output. While debt levels in China have been increasing, this was partly the result of a planned credit expansion seeking to rebalance growth away from external sources; and there have been recent moves to reduce domestic debt, especially that held by corporations. However, the other five economies in the group where private sector demand is stronger than the other two

drivers (Argentina, Australia, Brazil, Canada and the United States) are experiencing rising financial vulnerability, since the growth of private demand has been accompanied by increasing levels of debt. As discussed earlier in section A, in some cases the debt burden is carried by the corporate sector, and in other cases it is with households. Corporate debt increases have been mostly fed by two factors. Some corporate borrowing has been directed towards activities like M&A and “share buy-backs”, which have led to unsustainable increases in stock valuations. There is also a link between corporate indebtedness and capital flows, because of the carry trade possibilities enabled by loose monetary policies in advanced economies and liberalized capital accounts in recipient economies. The debt accumulation of private households is also strongly associated with price appreciation in real estate and stock markets, as occurred before the 2008 crisis.

It should be noted that private sector debt burdens are also high in other economies that do not currently exhibit a strong role for private demand, such as India, Turkey and the United Kingdom. As noted above, these economies seem to be experiencing domestic demand deflation, which weakens growth

prospects even as it does not resolve issues of financial vulnerability.

Finally, there are four countries/country groups where the government is the main growth driver. Of these, as noted above, in Saudi Arabia the contribution of external demand feeds the strong role of public sector demand, and fiscal expansion has been strongly dependent on oil revenues. Patterns like this, which can also be found among other commodity and oil exporters (such as those in sub-Saharan Africa included in this section of the table, as well as other developing countries in Asia and Latin America) reflect “windfall gain cycles” where the inflows from abroad are partly channelled to pay for increases in government spending. In “normal” times, the actual contribution of the public sector to growth is moderate or low in the economies in this section of the table, as it is in those in other sections, except for a couple of cases where the contribution to growth is above 2 per cent. This confirms the observation made in *TDR 2017* about the unjustifiable shift to continuing fiscal austerity in many countries, precisely in a period when other growth drivers have been weak or contribute to greater financial vulnerability.

E. Regional growth trends

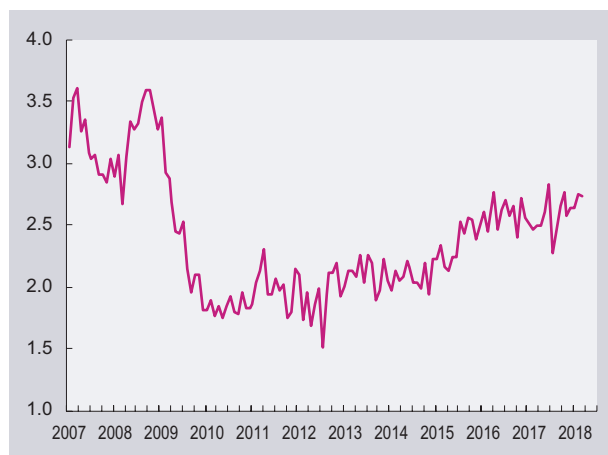
1. Developed countries

Amid signs of a loss of momentum in the global economy, the United States is a partial exception. Europe and Japan, after showing promise of consistently positive and significant rates of growth, have seen growth rates fall. But the United States appears to be staying on course. Although the latest annualized growth estimates for the first quarter of 2018 have been revised down to 2.2 per cent, second quarter estimates show growth rebounding to 4.1 per cent. By May 2018, the United States economy had experienced the second-longest phase of expansion since the 1850s, according to figures released by the National Bureau of Economic Research. However, even in the United States, the 16 quarters of uninterrupted positive GDP growth had not yet restored the quarterly growth rate to its previous post-crisis high. Moreover, the pace of the expansion was slower than in many expansionary episodes in the

past, and the slowest in the post-war period. The current Administration’s ambition is to use tax cuts to the tune of \$1.5 trillion, higher import tariffs and a promised increase in infrastructural spending to raise the rate of growth from around 2 to 3 per cent per annum.

The sharp fall in the unemployment rate in the United States, from close to 10 per cent in the middle of the crisis to 4.0 per cent in June 2018, is seen as evidence of the strength of recovery. This is significantly below the 5 per cent level recorded in January 2008, before the onset of the crisis, and the lowest since 2000. However, doubts have been expressed about the meaning of these figures, since the definition of employment is such that even the underemployed, or workers employed for less than the 40 hours a week they are willing to work, are treated as employed.¹⁴ Furthermore, paradoxically, the low unemployment rate also decreased as a result of the deterioration

FIGURE 1.12 United States private-sector nominal average hourly earnings, 2007–2018
(Year-on-year percentage change)



Source: UNCTAD secretariat calculations, based on U.S. Bureau of Labour Statistics, nominal wage data.

of the labour market during the crisis: facing long-term unemployment, many workers abandoned the search for a job, leaving the labour force. This drove down the unemployment rate. Confirming this trend, the employment rate – which measures the ratio of employed workers to total population – is still lower than before the crisis (at 59 per cent in 2017, compared to 61 per cent in 2005). Recent data indicate that this trend is reversing as formerly “discouraged” workers re-enter the labour market attracted by its improved conditions. How this will impact the unemployment rate remains to be seen.

Nominal wage growth in the United States has been well below its pre-crisis high and the pick-up in wage growth from early 2015 lost momentum from the second half of 2016 (figure 1.12). Together with cheap imports and subdued oil prices, this has kept the inflation rate in the United States low. As noted by the Economic Policy Institute, “Until nominal wages are rising by 3.5 percent to 4 percent, there is no threat that price inflation will begin to significantly exceed the Fed’s 2 percent inflation target.”¹⁵ Overall, the assessment that the United States is on a new robust growth path which would raise wages and trigger inflation is not grounded in the data.

Beyond the United States, optimism about the global economy was related to expectations that Europe would begin to experience a robust recovery as well – but such expectations have been muted because of

the slowdown in growth in the first quarter of 2018. Growth in the euro area, which rose from 1.8 to 2.5 per cent per cent between 2016 and 2017, is projected to drop to 1.9 per cent in 2018 (table 1.4). Explanations for faster growth in 2017 flagged the unconventional monetary easing measures adopted by the European Central Bank since early 2015 and the beneficial effects on trade of higher growth in China, India and the United States. Conversely, the slowdown is attributed to the blunting of the stimulus offered by quantitative easing, depressed wage growth (Jezard, 2018), and the inadequacy of external demand to make up the shortfall.

Within the eurozone, there is generalized evidence of a slowdown, including in the largest two economies, Germany and France. Germany (accounting for 30 per cent of the zone’s output) saw quarter-on-quarter growth rates falling from 0.6 per cent in the last quarter of 2017 to 0.3 per cent in the first quarter of 2018, according to figures from the Federal Statistical Office in early May. Slower trade growth played a role there. France also suffered a setback. GDP grew by only 0.2 per cent in the first and the second quarters of 2018, after expanding 0.6 per cent in the last quarter of 2017. Elsewhere, Italy and Spain saw economic performance affected by extremely high bond yields, resulting from investor fears triggered by adverse economic and political developments. These psychological effects contributed to the persistence of austerity policies in the two countries. Overall, therefore, the news from Europe is looking less rosy after the optimism generated by the performance in 2017.

Growth in the United Kingdom is expected to be lower in 2018 compared to 2017, with uncertainty over Brexit negotiations adding to structural weaknesses reflected in weak productivity growth and sluggish business investment. Even more pessimistic news came from Japan, which had appeared to be finally coming out of a long recession because of a combination of fiscal stimuli and aggressive monetary easing. When the Japanese economy grew by 0.6 per cent in the last quarter of 2017, that was the eighth straight quarter of positive growth, marking the longest expansionary stretch in 28 years. However, the optimism that was generated thereby was dashed when estimates for the first quarter of 2018 showed that the Japanese economy had contracted by 0.2 per cent over the three months ending March 2018. Expectations now are that lower than expected consumption spending and exports will

TABLE 1.4 World output growth, 1991–2018
(Annual percentage change)

Country or area	1991–		2001–										
	2000 ^a	2008 ^a	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 ^b
World	2.8	3.5	1.9	-1.8	4.3	3.1	2.5	2.6	2.8	2.8	2.5	3.1	3.1
Developed countries	2.6	2.2	0.1	-3.6	2.6	1.5	1.1	1.2	1.9	2.3	1.7	2.3	2.1
<i>of which:</i>													
Japan	1.3	1.2	-1.1	-5.4	4.2	-0.1	1.5	2.0	0.4	1.4	1.0	1.7	0.9
United States	3.6	2.5	-0.3	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.2	2.7
European Union (EU-28)	2.2	2.2	0.5	-4.4	2.1	1.7	-0.4	0.3	1.7	2.3	2.0	2.5	2.0
<i>of which:</i>													
Eurozone	2.1	1.9	0.5	-4.5	2.1	1.6	-0.9	-0.2	1.3	2.1	1.8	2.5	1.9
France	2.0	1.8	0.2	-2.9	2.0	2.1	0.2	0.6	0.9	1.1	1.2	2.2	1.5
Germany	1.7	1.3	1.1	-5.6	4.1	3.7	0.5	0.5	1.9	1.7	1.9	2.5	2.0
Italy	1.6	1.0	-1.0	-5.5	1.7	0.6	-2.8	-1.7	0.1	1.0	0.9	1.6	1.3
United Kingdom	2.7	2.5	-0.5	-4.2	1.7	1.5	1.5	2.1	3.1	2.3	1.9	1.8	1.2
European Union Member States after 2004	1.9	5.0	3.7	-3.4	1.7	3.1	0.6	1.2	3.0	3.8	3.1	4.6	4.0
Transition economies	-4.9	7.2	5.3	-6.6	4.8	4.7	3.3	2.0	1.0	-2.2	0.3	2.1	2.2
<i>of which:</i>													
Russian Federation	-4.7	6.8	5.2	-7.8	4.5	4.3	3.5	1.3	0.7	-2.8	-0.2	1.5	1.7
Developing countries	4.8	6.3	5.5	2.6	7.8	6.1	5.0	5.0	4.5	4.0	3.9	4.4	4.6
<i>Africa</i>	<i>2.6</i>	<i>5.8</i>	<i>5.5</i>	<i>3.4</i>	<i>5.4</i>	<i>1.3</i>	<i>5.9</i>	<i>2.3</i>	<i>3.7</i>	<i>3.3</i>	<i>1.7</i>	<i>3.0</i>	<i>3.5</i>
North Africa, excl. the Sudan and South Sudan	2.9	5.0	6.4	3.6	4.3	-6.1	9.7	-3.5	1.3	4.2	3.1	5.2	4.6
Sub-Saharan Africa, excl. South Africa	2.7	7.0	6.0	5.3	7.0	5.0	5.3	5.4	5.6	3.6	1.3	2.6	3.8
South Africa	2.1	4.4	3.2	-1.5	3.0	3.3	2.2	2.5	1.7	1.3	0.6	1.2	1.1
<i>Latin America and the Caribbean</i>	<i>3.1</i>	<i>3.8</i>	<i>4.0</i>	<i>-1.9</i>	<i>5.9</i>	<i>4.4</i>	<i>2.8</i>	<i>2.8</i>	<i>1.0</i>	<i>-0.3</i>	<i>-1.1</i>	<i>1.1</i>	<i>1.7</i>
Caribbean	2.2	5.1	2.6	-0.9	3.0	2.2	2.2	2.7	2.8	3.9	1.5	2.1	2.7
Central America, excl. Mexico	4.4	4.5	4.3	-0.7	3.9	5.4	4.8	3.7	4.0	4.1	3.9	3.7	3.7
Mexico	3.2	2.2	1.1	-5.3	5.1	3.7	3.6	1.4	2.8	3.3	2.7	2.3	2.1
South America	3.0	4.3	5.0	-1.0	6.4	4.7	2.6	3.2	0.3	-1.7	-2.6	0.6	1.4
<i>of which:</i>													
Brazil	2.8	3.7	5.1	-0.1	7.5	4.0	1.9	3.0	0.5	-3.5	-3.5	1.0	1.4
<i>Asia</i>	<i>6.3</i>	<i>7.5</i>	<i>6.1</i>	<i>4.3</i>	<i>8.8</i>	<i>7.4</i>	<i>5.6</i>	<i>6.1</i>	<i>5.7</i>	<i>5.4</i>	<i>5.7</i>	<i>5.5</i>	<i>5.5</i>
East Asia	8.7	9.0	7.7	7.0	9.9	8.3	6.7	6.8	6.5	5.9	5.9	6.2	6.0
<i>of which:</i>													
China	10.6	10.9	9.7	9.4	10.6	9.5	7.9	7.8	7.3	6.9	6.7	6.9	6.7
South Asia	4.8	6.7	4.5	4.1	8.8	5.3	2.6	4.8	6.3	5.8	8.4	5.7	6.1
<i>of which:</i>													
India	6.0	7.6	6.2	5.0	11.0	6.2	4.8	6.1	7.0	7.6	7.9	6.2	7.0
South-East Asia	4.9	5.6	4.4	2.0	7.8	4.9	5.9	5.1	4.5	4.6	4.6	5.2	4.8
West Asia	4.1	5.7	4.1	-1.9	6.0	8.6	4.9	6.2	3.4	4.2	3.1	3.0	3.3
Oceania	2.7	2.8	0.3	2.0	5.8	1.7	2.4	2.6	6.9	5.2	2.4	2.3	2.4

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: Update as of mid-2018; ECLAC, 2018; OECD.Stat, available at : <https://stats.oecd.org/Index.aspx?DataSetCode=EO> (accessed 18 June 2018); IMF, 2018; Economist Intelligence Unit, EIU CountryData database; J.P.Morgan, *Global Data Watch*; and national sources.

Note: Calculations for country aggregates are based on GDP at constant 2010 dollars.

a Average.
b Forecasts.

reduce Japanese growth closer to 1 per cent in 2018 as compared to 1.7 per cent in 2017.

As noted earlier, despite the signs of a loss of momentum that challenge the claims of a robust growth path in the advanced nations, central banks in most of these countries are choosing to withdraw the easy money and low interest policies that they have pursued for such an extended period. This has affected the extent to which the hesitant recovery in some advanced nations and the accompanying commodity price increase can deliver a return to stable growth in the rest of the world.

2. Transition economies

The transition economies that are members of the Commonwealth of Independent States (CIS) have been recovering from two years of no or negative growth. They recorded a strong rebound in 2017, with growth of 2 per cent, as compared with 0.2 per cent in 2016. That figure is expected to marginally improve in 2018. An important factor underlying the recovery was an increase in commodity prices, especially of oil, which accounts for close to 60 per cent of merchandise exports from the Russian Federation. The spike in oil prices improved both the current

account on the balance of payments and the revenues of the Government in the Russian Federation. The result was a transition from recession (contraction of 2.8 per cent in 2015 and 0.2 per cent in 2016) to recovery in 2017, when growth was 1.5 per cent. This is likely to move closer to 1.7 per cent in 2018.

That recovery should benefit the whole of the CIS, as the Russian Federation accounts for 80 per cent of GDP of the region and is its principal growth driver as a major source of import demand and remittances for other countries in the CIS. The other CIS countries are also likely to benefit from loan-financed infrastructure spending under the Belt and Road Initiative in China. However, dramatic improvements in performance on the back of higher oil prices are unlikely, because of the dampening effects of austerity programmes of some of these economies.

The growth dynamics of the transition economies in South-Eastern Europe is determined by the performance of the European Union, which consumes anywhere between half and 80 per cent of exports from these economies. Uncertainties in Europe can affect the pace of GDP growth in this region. Still expectations are that growth would accelerate from 2.3 per cent in 2017 to around 3 per cent in 2018.

While oil-exporting countries have obtained a temporary reprieve from balance-of-payments difficulties and currency depreciations, current account deficits persist in many countries such as Georgia and Ukraine. Since these deficits are financed by capital inflows, increases in global interest rates can reduce flows, increase balance-of-payments stress and trigger currency depreciation. Vulnerability persists within the improved growth scenario.

3. Latin America

Having benefited from the recovery from recession in two large economies in the region (Argentina and Brazil), the rise in commodity prices, and a consequent 3 per cent improvement in the terms of trade, Latin American economies recorded higher growth in 2017, especially in relation to the slowdown starting 2015. The recovery is expected to continue with GDP growth in Latin America and the Caribbean projected at around 1.7 per cent in 2018, compared to 1.1 per cent in 2017 (table 1.4). All countries benefited from the higher prices, though price increases were

particularly sharp in the case of hydrocarbons and oil derivatives, iron ore and soya bean.

The biggest economy in the region, Brazil, recorded positive expansion of 1 per cent in 2017, after contraction amounting to 7 per cent of GDP over the previous two years. This growth from a low base persisted in early 2018, although signs of deceleration (partly precipitated by a truckers' strike) appeared in the second quarter, creating uncertainties about the pace of recovery for the remainder of the year. The year-on-year growth in 2018 is projected to be around 1.4 per cent.

Until recently, Brazil was attracting attention because of the weakness of its currency. The real depreciated significantly over the first six months of 2018. The pace of depreciation was moderated only by the issue of currency swaps by the central bank (under which investors receive interest at the benchmark Selic rate, but are promised compensation for any fall in the value of the real against the dollar). This combination of a hedge against currency depreciation and a reasonable Selic interest rate kept investments flowing in, especially given the carry trade opportunities that exist when the spread between United States rates and the Selic is high. However, low inflation rates encouraged the Government to bring down the Selic rate from 14.25 per cent in October 2016 to 6.5 per cent in March 2018, at a time when interest rates in the United States were being nudged upward. In addition, lower volatility encouraged the central bank to reduce the volume of swaps issued, from well over \$100 billion to less than \$25 billion. Once these measures that supported the carry trade were diluted, the real could not hold and even became the target of a speculative attack. The fall of the currency stalled only when the central bank president declared that he could "intensify" the use of swaps. A sharp depreciation of the currency can trigger a currency crisis and destabilize financial markets with adverse external effects on the real economy. Particularly hard hit would be firms with debt denominated in foreign currencies, with bankruptcies and asset-price deflation which could hold back investment. And if the central bank decides to hike interest rates sharply to prevent foreign investor exit and capital flight, the investment climate would worsen further. But the low deficit on the current account, not-too-high external debt and significant foreign reserves of around \$380 billion give Brazil some ammunition to weather possible external turbulence in the second half of 2018.

External vulnerability appears greater in Mexico, which experienced a drop in the GDP growth rate to 2.3 per cent in 2017 from 2.7 per cent in 2016, partly because of the adoption of a conservative fiscal stance and partly because of the uncertainties surrounding NAFTA. However, seasonally adjusted GDP growth in the first quarter of 2018 accelerated recording a 1.1 per cent increase relative to the previous quarter. This may be under challenge because of the imposition of higher tariffs by the United States on a range of imports from Mexico. Growth can also be adversely affected because of an increase in interest rates from already high levels, necessitated by rising interest rates in the United States and a substantially depreciated currency. If rates are not raised, capital flight could severely damage the currency. However, a more proactive fiscal stance on the part of the newly elected Government could increase domestic demand.

The Central American countries have performed reasonably well in terms of growth. While the GDP growth rate of the subregion came down marginally from 4.1 to 3.9 per cent between 2015 and 2016, it dropped to 3.7 per cent in 2017 and is estimated to be at that level in 2018 as well. The Caribbean, on the other hand, has seen a rise in growth rates from 1.5 to 2.1 per cent between 2016 and 2017, and is projected to grow at a significantly higher 2.7 per cent in 2018.

Interestingly, the danger of retreat by foreign investors seems to affect almost all emerging market economies, irrespective of their recent economic performance. In some countries where the effects on the currency have already been significant, interest rates have been hiked up – to as much as 40 per cent for foreign investors in Argentina. The damaging effects this can have on domestic investment and growth should be obvious.

4. West Asia

Growth in West Asia in 2017 was at its lowest in the post-crisis period, as low oil prices and voluntary production restraints affected income growth in the oil-producing countries, and political conditions adversely affected economic performance in countries like the Syrian Arab Republic and Yemen. Strikingly, GDP in Kuwait and Saudi Arabia contracted by 3.2 and 0.7 per cent respectively. This, however, is likely to change in 2018, given the sharp

increase in oil prices and the positive effect that would have on budgetary revenues and expenditures. However, such gains may be partly neutralized by the need to keep production low to prevent oil prices from returning to their earlier lows. Overall, growth is likely to accelerate in all member states of the GCC (Cooperation Council for the Arab States of the Gulf), namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. This would have knock-on effects on other countries in the region as well, through increased trade flows, remittances and capital flows.

In Turkey, however, growth is likely to decelerate. The Turkish lira depreciated by more than a third over the year ending mid-June 2018, as foreign investors began to pull out capital from the country. Turkey, like Argentina, illustrates the dangers associated with an open capital account. The Government and central bank have responded by repeatedly raising interest rates, which touched 17.8 per cent in June 2018, the highest since the financial crisis a decade back. Yet depreciation has continued, with potentially damaging consequences. Turkish private sector companies that are reportedly saddled with close to \$340 billion of foreign currency debt in mid-2018 are being severely hit by the sharp deceleration of the lira, threatening bankruptcies and slowing investment and growth. Investment is also likely to be held back by the high interest rates following hikes of as much as 500 basis points over a short span of less than two months.

In the Islamic Republic of Iran, the decision of the United States to withdraw from the nuclear deal and reimpose sanctions is likely to adversely affect economic performance, as the country had just managed to move to steady growth after suffering many years of sanctions. Importers of oil from the Islamic Republic of Iran are likely to shift to other sources, affecting revenues and foreign exchange availability. Sanctions on the Iranian energy sector halved the country's oil exports, to around 1.1 million barrels per day, in 2013. After the easing of sanctions, the Islamic Republic of Iran currently exports around 2.5 million barrels daily. That trend may well be reversed. Imports into the Islamic Republic of Iran are also likely to be hit. Meanwhile, uncertainty has seen the rial depreciating. While the official rate is around 42,000 rials to the dollar, the black market rate was reportedly ruling at more than double that at the end of June 2018.

5. Developing Africa

After having experienced a rise in the average growth rate from 1.7 to 3.0 per cent between 2016 and 2017, developing countries on the African continent are projected to grow at 3.5 per cent in 2018. A major factor in this recovery is the reversal of the commodity price decline, which is crucial for this set of countries given their dependence on commodity exports. The rise in oil prices particularly benefits countries like Algeria, Angola, the Democratic Republic of Congo, Ghana and Nigeria.

Growth rates and growth drivers varied across the continent, with the less resource-dependent East African subregion continuing to record higher annual rates of growth of more than 5 per cent, largely because of performance in countries such as Djibouti, Ethiopia, Uganda and the United Republic of Tanzania. The other two subregions with comfortable growth rates are Northern Africa, helped in large measure by growth in Egypt, and Western Africa with many economies, such as Benin, Burkina Faso, Côte d'Ivoire, Ghana and Guinea, recording reasonably high growth. The two worst performing subregions are Middle Africa and Southern Africa.

Factors driving growth included, besides increased commodity prices, increased infrastructure investments. However, much of the expenditure driving growth was funded with borrowing from abroad in many cases, resulting in a return of the “high indebtedness” problem. By the late 2000s, debt relief programmes had substantially reduced the debt burden of African countries. But since then, countries have accumulated new debt and a number of African countries are currently being identified as being debt-distressed. With international interest rates set to rise, the health of these economies could deteriorate quickly.

Nigeria, the largest economy in Africa, saw a return to moderate growth in 2018, after two years of contraction and stagnation. Growth in 2018 is projected at 2.5 per cent as compared with negative 1.6 per cent in 2016 and 0.8 per cent in 2017. When oil prices collapsed after 2014, Nigeria was badly hit, with falling state revenues (as oil accounts for 90 per cent of federal revenues), rising fiscal and trade deficits, and a recession. The reversal of the oil price decline has restored growth and improved conditions, with the volatility pointing to the need for economic diversification. However, while growth in the first quarter

of 2018, at 1.95 per cent, was a major improvement over the 0.91 per cent contraction in the first quarter of 2017, it was a dip from the 2.11 per cent year-on-year growth recorded in the fourth quarter of 2017, pointing to the tenuous nature of the recovery.

South Africa, the second largest economy in Africa, saw an improvement in its low rate of growth last year, with GDP increasing from 0.6 per cent in 2016 to 1.2 per cent in 2017, but growth is projected at 1.1 per cent in 2018 (table 1.4). The fact that the economy is not out of the woods was brought home when GDP contracted by 2.2 per cent in the first annualized quarter of 2018. Agricultural GDP contracted by 24.2 per cent, which reportedly was the largest quarter-on-quarter fall in 12 years. Manufacturing GDP also contracted by 6.4 per cent. Underlying this volatility is low growth in the medium term, with GDP growth rates never exceeding 2.5 per cent in any quarter over the last four years, and touching zero or negative levels in two, and around 1 per cent in many quarters.

A fundamental and well-recognized failure of South Africa is its inability to diversify out of mining into manufacturing. In fact, gross value added in manufacturing fell from around 21 per cent in the early 1990s to around 13 per cent in 2016. While the ratio of gross value added in mining to GDP declined, the sector that has gained is Finance, Real Estate and Business Services, in the case of which the ratio of gross value added to GDP rose from close to 16 to 23 per cent. Underlying this increase is a sharp increase in capital flows into the country, facilitated by an increasingly open capital account. Between 2008 and 2016 foreign investment flows into South Africa rose (in rand terms) by 250 per cent, because of a 230 per cent increase in direct investment and a 350 per cent increase in portfolio inflows. One consequence was a relative strengthening of the South African rand, which appreciated (while fluctuating) from 15.1 rand to the dollar in June 2016 to 11.8 in March 2018 (or by more than 20 per cent). This underscores the dilemma of developing countries in currency markets: both appreciation and depreciation bring with them different problems. In South Africa, the recent appreciation is hardly conducive to the growth of production in either agriculture or manufacturing, and so the result has been slow and volatile output growth.

Egypt, the third largest economy in Africa, was rescued from a crisis because of the benefits of increased

production and exports of natural gas, especially from new fields such as the Zohr gas field. Egypt claims to have completed four important gas extraction projects in 2017 to add 1.6 billion cubic feet of gas per day to its production. Partly as a result of that, despite being faced with a balance-of-payments crisis and a collapse of its currency which forced it to approach the IMF for a \$12 billion line of credit in November 2016, Egypt has been registering reasonable rates of growth of 4.3 and 5.1 per cent in 2016 and 2017 and is expected to grow at 5.4 per cent in 2018.

In 2016, the Egyptian Government was faced with a current account deficit of 7 per cent of GDP and foreign reserves were running out. While the Government sought to keep the exchange rate of the Egyptian pound stable, black markets rates relative to the dollar rose, and remittances fell sharply in the expectation of a devaluation. Between 2011 and 2014 the growth rate hovered at around 2 per cent and the unemployment rate was more than 12 per cent, with the figure at more than 40 per cent among the 15–24 age group who constituted one fifth of the population in 2010. The external economic crisis forced the Government to turn to the IMF, which focused on the fiscal deficit of 12 per cent, the public debt to GDP ratio, and the pegged exchange rate. In return for an IMF loan, Egypt agreed to cut fuel, electricity and food subsidies sharply and float the Egyptian pound (which depreciated from 8.8 to the United States dollar in October 2016 to 16 in November and 18.5 by January 2017). Fiscal austerity increased unemployment and the currency float triggered inflation of more than 25 per cent early in 2018, but growth was buoyed by the discovery of gas reserves and increased exports of gas and petroleum products. Rising oil prices and a devaluation-supported increase in non-petroleum exports helped as well, to some extent concealing a situation of continuing economic vulnerability.

6. *Developing Asia*

After recording GDP growth rates of 5.7 and 5.5 per cent in 2016 and 2017, the developing countries in Asia are expected to sustain that rate in 2018 as well. This is partly because while growth in China is expected to decelerate from 6.9 in 2017 to 6.7 per cent in 2018, in India it is expected to rise from 6.2 to 7 per cent. However, first quarter growth in China beat expectations, coming in at 6.8 per cent – the third straight quarter of growth at that rate. Growth in the

second quarter was marginally lower at 6.7 per cent. The deceleration in China was in substantial measure the result of the process of deleveraging pushed by the Government to address the credit bubble. Total social financing, or the sum total of official and shadow bank lending, reportedly fell by 14 per cent (or by \$110 billion) in the first four months of 2018. This is reflective of a medium-term trend. This is because of a fall in lending by the shadow banking sector, the share of which in total social financing came down from close to 50 per cent to 15 per cent. It had been 8 per cent in 2002. Shadow bank lending fell by 64 per cent in yuan renminbi terms during January to April 2018 as compared to the same period the previous year (by \$274 billion in United States dollar terms). Total social financing which averaged two times GDP in the period from 2002 to 2008, rose to 3.2 times in the context of the post-crisis stimulus. It fell to 2.4 times GDP over 2014 to 2017 (Hodges and van Scheltinga, 2018). An example of what this does to demand comes through from the evidence that automobile loans that grew by more than 50 per cent in 2009 and around 33 per cent in 2010, had risen by just 3 per cent in the first four months of 2018.

An important driver of the deleveraging process has been the adoption of a strategy of rebalancing that reduces the role of public and private investment financed by debt in driving growth. The ratio of gross capital formation to GDP, which peaked at 48 per cent in 2011 had come down to 44.4 per cent by 2017. Rebalancing has also reduced the role of net exports in driving GDP growth. The ratio of net exports to GDP came down from 8.6 per cent in 2007 to 1 per cent in 2014, rose to 3.4 per cent in 2015 and fell again to 0.7 per cent in 2017. The result has been a slowing of growth in China, as a result of which growth in East Asia that rose from 5.9 to 6.2 per cent between 2016 and 2017 is expected to fall back to its 2016 level in 2018. Similarly, growth in South-East Asia is expected to drop from 5.2 per cent level recorded in 2017 to 4.8 per cent this year.

Meanwhile, with a GDP growth of 7.7 per cent year-on-year in the first quarter of 2018, India is currently among the world's fastest growing economies. The year-on-year quarterly growth rates have risen from 5.6 per cent in the first quarter of financial year (April–March) 2017/18 to 6.3, 7.0 and 7.7 per cent in the subsequent three quarters pointing to an acceleration of growth. But this is at variance with the story emerging from the annual figures. If annual rates are considered, the GDP growth rate fell from 7.1 per

cent in 2016/17 to 6.7 per cent in 2017/18. Growing demand for exports has led to a moderate recovery in industrial production, although the effects of demonetization are still evident in private consumption trends within the economy. The resulting increase in capacity utilization in manufacturing along with a recapitalization of public banks has enabled a rise in investment for the first time in several years. But at the same time, a disconcerting feature is the deceleration of growth in the primary sectors. The service sector is expanding with trade, hotels, transport and communication leading the way.

A lending spree by the banking system during the high growth years has led to the accumulation of large volumes of bad debt or non-performing assets in the balance sheets of leading banks. This, besides threatening financial stability, is curbing credit expansion and is likely to adversely affect investment and growth. Further, the Indian rupee is under pressure on foreign exchange markets. Over the first five months of 2018 the currency had depreciated by more than 7.5 per cent relative to the dollar. Depreciation relative to other major currencies like the British pound, the euro and the yen, has been much less. Yet, the fall vis-à-vis the dollar is of significance, especially since much of the trade and foreign debt of India is denominated in dollars. A leading determinant of the depreciation is the rise in the current account deficit on the balance of payments of India intensified by the sharp rise in the international price of oil.

A similar picture is emerging in Pakistan. Despite robust growth, the currency has lost a quarter of its value against the dollar since the beginning of the year. Higher oil prices have led to a widening trade deficit and foreign exchange reserves have dropped sharply. A widening external debt position, currently standing at \$92 billion or 31 per cent of GDP has raised concerns about its sustainability. Expectations are that the new government has no choice but to turn to the IMF for a large loan, which would require adopting austerity measures that are likely to affect growth adversely. Over the medium term, much will depend on whether large infrastructure projects will support a stronger export push.

Growth in ASEAN countries remains stable in the light of strong domestic demand, rising private consumption, and infrastructure investments (especially in countries such as Indonesia and the Philippines). But concerns are rising that these trends can be overshadowed by sluggishness in the global economy

and the worsening of trade relations between the United States and China, both of which are key export markets for many countries in the region. In addition, as elsewhere in emerging markets, the build-up of household and corporate debt is a source of vulnerability. Since 2010, Cambodia, Indonesia, Malaysia, Myanmar, the Philippines and Thailand have increased their non-financial sector debt ratios by an average of almost 20 percentage points. Growth in Indonesia which stood at a comfortable 5.1 per cent in 2017, is officially estimated at 5.1 per cent in the first quarter of 2018 as well. The effects of monetary tightening in the United States and elsewhere threaten the sustainability of this pace of growth, despite the benefits from improved commodity prices.

Benefiting from a revival of exports of information technology products, especially memory chips, the Republic of Korea registered improved export growth in the first quarter of 2018, which helped take GDP growth to 1.1 per cent, as compared with a contraction of 0.2 per cent in the last quarter of 2017. The new Government elected in 2017 on a redistributive platform has raised the minimum hourly wage by 16 per cent and promises to create more jobs, reduce working hours and push for permanency for contract workers. This could trigger some wage-led expansion, which, combined with the pick-up in exports, can raise growth even more. Similar growth trends are visible elsewhere in South-East Asia. Thailand, too, has registered a better-than-expected 4.8 per cent GDP growth rate in the first quarter of 2018, after having grown at 3.9 per cent in 2017, which was the highest since 2013. Here, too, improved exports and increased tourism revenues played a role.

On the whole, across Asia the problem is not so much a weakening of growth, as fear that interest rate increases and monetary tightening could trigger capital outflows, leading to financial and currency instability. Combined with the effects of rising protectionism in the United States and possible responses, this could adversely impact growth resulting in levels lower than initially predicted.

7. Growth in an environment of instability

Across the transition, emerging market and developing countries, two tendencies are visible. First, there are some positive trends in some countries, in the form of the probable continuation during 2018

BOX 1.1 Global scenarios: From toiling to troubling

In the baseline projections for the global economy all countries are assumed to keep their current policy stances unchanged through to 2023. Based on information available in 2018, fiscal policy is assumed to remain as observed in section D, with notable trends towards tightening in France, Brazil and Indonesia and moderate expansion in the Republic of Korea and the United States. Expansionary monetary policy (both in the form of low interest rates and quantitative easing) is expected to continue, although at a more moderate pace, as renewed financial instability – possibly triggered by international disputes over trade and exchange rates – threatens global growth. In this baseline scenario, global GDP growth is projected to slow down to 2.9 per cent in 2018 and hover around this rate through to 2023 (see appendix I.A for details).

The “trade war” scenario explores the consequences for the global economy of an escalation of recent tariff increases. It is generally recognized that the immediate impact of tariffs on growth, through lower trade volumes, is unlikely to be very large but that greater damage can come from increased uncertainty and the possible disruption to global supply chains (Eichengreen, 2018). In fact, ubiquitous calls to preserve or expand international market shares suggest that trade volumes might not significantly fall. However, even if trade volumes are unaffected, higher tariffs could still have serious consequences for global growth through their impact on income distribution and aggregate demand. To highlight this possibility, the scenario assumes that the government of each opposing party reimburses its exporters for any tariffs paid to foreign governments, thereby keeping exports and domestic prices at “pre-war” levels.

In this scenario, confrontation unfolds under four assumptions. First, three country blocs are assumed to face off; the United States is assumed to impose a 20 per cent tariff on all its imports from China and two thirds of its imports from Canada, Japan, Mexico, the Republic of Korea and the European Union. It is assumed that all countries retaliate with equivalent tariffs, dollar for dollar.

Second, all countries are assumed to fully indemnify their exporters for the tariffs paid to foreign governments, using the revenue obtained by taxing imports and, where this is not sufficient, general tax revenue. If this set of measures generates a positive net revenue, this is used towards principal payments on sovereign debt. For example, under the given assumptions it is estimated that in 2019 the United States Government will gain approximately \$280 billion in tariff revenues and will transfer to United States exporting businesses an amount equal to \$181 billion to compensate for the higher tariffs paid by them in Canada, China, Japan, Mexico, the Republic of Korea and the European Union – a version of the border adjustment tax. The net revenue for the United States will be \$99 billion.

While trade flows remain unchanged, a large redistribution of resources is projected to take place: businesses will transfer resources to foreign governments (in the form of tariffs) and these will transfer them to their exporting businesses (in the form of reimbursements). Globally, the result of these flows is a transfer of resources between governments with some obtaining a net revenue and others a net loss.

Third, countries that suffer a net fiscal loss are assumed to resort to exchange rate depreciation in an attempt to gain competitiveness and increase their international market shares, expecting to compensate some of the tariff losses. In recent years, exchange rate targeting has been achieved through a variety of actions, including “managed floating”, quantitative easing and other forms of policy-driven liquidity expansions.

Fourth, labour shares are assumed to fall slightly as a form of “wartime” economic mobilization undercuts wage claims. Since the assumed policy mix of tariffs and export subsidies does not influence domestic prices, any changes in labour shares will be achieved through nominal wage cuts and increases of productivity passed through to profits.

The direct result of the redistribution of income towards profits will be a loss of domestic demand as workers’ reduced purchasing power forces them to cut consumption. But the fall of the labour share will also undermine domestic demand indirectly by sapping business confidence. Fearing more policy changes that may further compress private consumption (and corporate sales), businesses become less willing to invest.

A “trade war” is projected to damage growth and employment and to increase income inequality in the countries involved, even in the case in which trade flows do not change. Moreover, in the current context of increasing financial fragility in several developing countries, a trade war may lead to even more serious consequences, through unruly capital movements. For example, increased exchange rate volatility could induce risk aversion and trigger capital flight as lenders and portfolio managers, following a well-rehearsed script, seek safer assets and higher margins of safety. This could lead to severe currency depreciations in a number of financially vulnerable developing countries and activate a spiralling sequence of declining investment, hikes in unemployment, falling consumption, inflating sovereign debts (when denominated in foreign currencies) and falling government spending. Full-blown financial panic would only be a few steps away. The global consequences would then depend on contagion forces which continue to be difficult to predict.

of the higher growth recorded in 2017, and, in some cases, an improved current account situation at least until the recent spike in oil prices. Oil exporters have benefited significantly from the sharp rise in oil prices. By contrast, oil importers, including those that gained from the rise in non-oil commodity prices, are increasingly under stress.

Second, there has already been depreciation of the value of national currencies, triggered by net capital outflows, especially in the so-called emerging markets. As discussed, these net capital outflows appear to have been precipitated by interest rate increases in the developed countries, as a result of which the carry trade investments that had been undertaken in recent years are being unwound. A combination of interest rate increases and currency depreciations would subject the firms in countries that are exposed to foreign currency debts to considerable stress. These could even lead to bankruptcies and asset-price deflation, with substantial adverse external effects on financial stability and growth.

The scenario then is one of instability in many forms. The likely emerging scenario, in the absence of quick proactive macropolicy measures by governments, is as follows:

1. Net outflows of capital, especially of portfolio capital, from emerging markets, are triggered largely by monetary tightening and increases in interest rates in the United States and other advanced countries.
2. The consequent depreciation of currencies is then worsened by speculative attacks, even as domestic inflation is triggered by the depreciation.
3. Debt service payments valued in domestic currency, on substantially increased corporate debt, rise sharply, precipitating default and bankruptcies.
4. This further depresses investment precisely at a time when it was expected to revive.

As long as the medium-term scenario is one shaped by fiscal conservatism which depresses economic activity, governments in both developed and developing countries are then left hoping for a robust recovery – but never experiencing one. Instead, they are more likely to face a repeat of the instability and crises of a decade ago. This could be made even worse by ongoing tensions in the trading system (box 1.1 and appendix I.A). In an interdependent global economy, inward-looking policies do not offer a way forward; substantial and coordinated shifts in macroeconomic strategy appear to be the only way out of this trap. ■

Notes

- 1 The January 2018 edition of the IMF *World Economic Outlook* noted: “Some 120 economies, accounting for three quarters of world GDP, have seen a pickup in growth in year-on-year terms in 2017, the broadest synchronized global growth upsurge since 2010.” By April 2018, when the IMF issued the next edition of the *World Economic Outlook*, the prognosis was even better.
- 2 <http://ec.europa.eu/eurostat/documents/2995521/8897618/2-15052018-BP-EN.pdf/defecccc-f9d9-4636-b7f8-d401357aca46>.
- 3 The average growth of real government expenditure of developed countries during the post-crisis period (excluding the extraordinary stimuli of 2009/10) was a mere 0.6 per cent, far short of the pre-crisis figure.
- 4 Figures are derived from the United Nations Global Policy Model and based on national statistics and United Nations Statistics Division records.
- 5 Bank for International Settlements (BIS) statistics obtained from: <https://stats.bis.org/statx/srs/table/f4.1>.
- 6 Figures from the WTO database at: https://www.wto.org/english/res_e/statis_e/merch_trade_stat_e.htm.
- 7 Centraal Planbureau, The Netherlands, <https://www.cpb.nl/en/data>.
- 8 Data on trade in services described in this paragraph come from UNCTADstat and correspond to the concepts and definitions in IMF, 2009.
- 9 <http://databank.worldbank.org/data/databases/commodity-price-data>.
- 10 The notion of “aggregate supply” (X) is derived directly from the main national accounting identity that defines gross domestic product (GDP):

$$GDP = C + I + G + E - M \Rightarrow \text{“Aggregate Supply” } (X) = GDP + M = C + I + G + E$$
 where C stands for consumption, I private investment, G government spending, E exports and M imports.
 This expression can be rearranged by replacing consumption with “disposable income minus savings”, where disposable income is GDP minus taxes. Further, using t to denote the average aggregate tax

rate, s to denote the private saving propensity and m the import propensity, the expression for aggregate supply growth reduces to:

$$\hat{X} = [\dot{\gamma}_t + \gamma_t(\hat{G} - \hat{i})] \frac{G}{T} + [\dot{\gamma}_s + \gamma_s(\hat{I} - \hat{s})] \frac{I}{S} + [\dot{\gamma}_m + \gamma_m(\hat{E} - \hat{m})] \frac{E}{M}$$

$$\text{where: } \gamma_t = \frac{t}{t+s+m}; \gamma_s = \frac{s}{t+s+m}; \gamma_m = \frac{m}{t+s+m}$$

Dots denote variations over time and hats denote growth rates. See Godley, 1999; and Berg and Taylor, 2001.

- 11 The data in the table is generated using the United Nations Global Policy Model, which is based on historic data sets from official statistics up to the year 2016, and on an “alignment” tool that uses most current information up to the first and second quarter of 2018 and projects results to the end of the current year as a “model solution”. Hence, the table should not be taken as a forecast, but as a conditional model projection subject to the most current information.
- 12 A two-year period is chosen because such drivers are either directly or indirectly influenced by policy, the effects of which usually take a couple of years to materialize.
- 13 For example, the United Kingdom is at the top of the section where net external demand is the strongest. The average growth of aggregate supply during these two years is 2.1 per cent, of which the estimated average contribution of net exports is 2.6 per cent. This is followed by a meagre 0.1 per cent contribution of private demand and by a negative 0.6 contribution of government demand. The relative gap between the first and the second growth drivers is the largest for the United Kingdom relative to countries in this section. By contrast, Indonesia shows a growth of aggregate supply of 5.5 per cent, with a 2.3 per cent contribution of external demand, which is only slightly above the contribution of the second strongest driver, private demand.
- 14 For further discussion see Valletta, 2018 and Polychroniou, 2018.
- 15 Economic Policy Institute, “Nominal Wage Tracker”, <https://www.epi.org/nominal-wage-tracker/>, accessed 23 June 2018.
- 16 <https://www.un.org/development/desa/dpad/publication/united-nations-global-policy-model/>.
- 17 This is captured in the underlying behaviour of the model and is not an explicit assumption.

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Appendix I.A: A “trade war” scenario

This appendix presents model projections of an escalation of trade tensions between the United States, and Canada, China, Japan, Mexico, the Republic of Korea and the European Union.

The direct impact of actual tariff increases on the economies involved appears negligible – for example, recent United States tariffs hit \$34 billion of imports from China, or less 0.02 per cent of the GDP of the United States. However, the indirect consequences of a “trade war” have raised more serious concerns, with most assessments focusing on supply-side effects such as the possible disruption of global supply chains and the risk that technology flows across countries may become restricted. By contrast, there has been comparatively little recognition of the macro-economic mechanisms that may play out in a trade war, especially in terms of distributional and financial imbalances and their impact on aggregate demand. The projections presented here address this gap.

Seen through the lens of these projections the most serious effect of a trade war may be to trigger a fall in aggregate demand, regardless of the extent to which trade volumes initially suffer. Consequently, the projections remain relevant even if the current trade tensions are eventually defused. In fact, the impact of trade policy cannot be seen in isolation from the distributional conflicts, inadequate aggregate demand and rising financial vulnerabilities that have become centrepieces of today’s global economy.

The projections are calculated with the United Nations Global Policy Model (GPM),¹⁶ a dynamic macroeconomic model based on a globally consistent database of macrofinancial variables. A distinguishing feature of the GPM is its demand-driven character, implying that it does not assume full employment or constant income distribution (as is often the case in other global models). While the GPM is not a trade model (therefore it contains no details on tariffs and limited details on trade of specific merchandises) it provides an aggregate picture in which trade is linked to macroeconomic features, including growth and income distribution.

Two scenarios are presented here: a baseline scenario, which charts out the path the global economy would take without a trade war or any exogenous shocks, and the trade war scenario.

Country grouping

For the purpose of these projections the global economy is divided into 30 countries/groups, including 19 individual countries (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, the Republic of Korea, the Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States) and 11 aggregated groups (Other European Union, Other Europe, Other Developed Countries, Other Transition Economies, Other East Asia, Other West Asia, Other South Asia and Pacific, Other South America, Caribbean, North Africa and Other Africa).

For ease of presentation only, the 30 blocs are rearranged into six blocs. Three of these are participants in the trade war: China, the United States and Other Warring Countries (Canada, Japan, Mexico, the Republic of Korea and the European Union). The other three blocs contain the “non-belligerent” countries: Other Developed Countries, Other Developing Countries and a bloc of Vulnerable (developing) Countries (Argentina, Brazil, Indonesia, South Africa and Turkey) characterized by volatile growth rates, persistent current-account imbalances, large accumulation of net external liabilities and significant exchange rate fluctuations.

The challenges of the Vulnerable Countries are, to a lesser extent, shared by many other economies, both developed and developing. Hence, as noted further below, depending on the gravity of such vulnerabilities several of these economies may be subject to major macrofinancial adjustments in the event the trade war escalates.

Baseline scenario

Projected outcomes of the trade war are assessed in comparison with projected outcomes in the baseline scenario, a scenario with no trade war or any exogenous shocks. But while a no-shock baseline scenario is the standard term of comparison in model projections, it is not necessarily the most likely future scenario. In fact, as this chapter has argued, the global economy exhibits unsustainable trends (in policies, indebtedness, asset prices etc.) that cannot deliver

reasonable growth for the next five years. Several crisis scenarios may be more likely but are less useful as terms of comparison for another crisis scenario, such as a trade war. In this sense, a no-shock baseline scenario is inevitably ambiguous but provides an informative comparison.

In the baseline projections, all countries are assumed to keep their current policy stances unchanged through 2023. Based on information available in 2018, fiscal policy is expected to reflect the discussion in section D of this chapter, with a trend towards moderate relaxation of the fiscal deficit in the United States (following the tax reform that has taken effect in 2018) and towards moderate tightening in China, Other Warring Countries and Vulnerable Countries. The group of Other Developed Countries is projected to keep its fiscal stance unchanged at the current level. It has been clearly stated in the corpus of the chapter that such a configuration of policies is neither conducive to a sustained and inclusive pattern of growth, nor sustainable to the extent that imbalances would tend to implode in the form of financial crises. The experience of the years before the Great Recession are painful testimony of such concern. However, it can also be observed by looking at the data from this period that it is difficult, if not impossible, to forecast the timing and concrete manifestations of such a kind of crisis, just as it is also impossible to predict the nature of the policy responses.

The external imbalance of the United States is expected to worsen, given the larger fiscal deficit and moderate “releveraging” by the private sector (responding to asset appreciations and financial deregulation). Under such conditional projections the deficit of the current account of the United States will rise from about 3.4 per cent of GDP in mid-2018 to about 4.5 per cent in 2023. China is assumed to continue its shift towards greater reliance on domestic demand, with the external balance stabilizing around a surplus of about 2 per cent of GDP, close to the average for the period after the Great Recession. The group of Other Warring Countries has recorded rising external surpluses in the recent past, which are likely to continue over this period. The group of Other Developed Countries is projected to experience a moderate rise of their export surplus, along with moderately expansionary domestic demand. Other Developing Countries as a group will experience robust growth (though at a more moderate pace than in the past) and a balanced external sector. By contrast, the set of Vulnerable Developing Countries

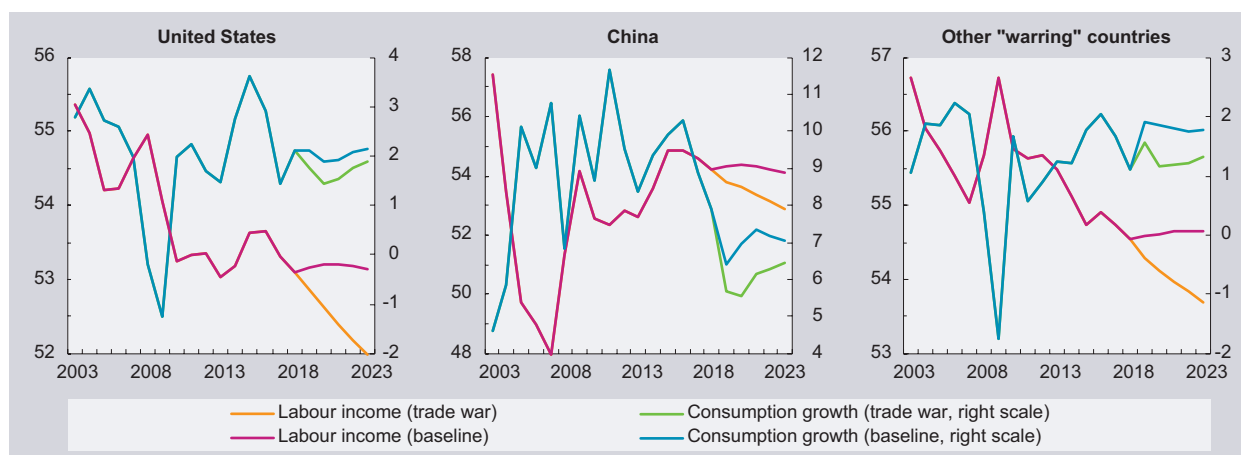
are projected to remain in deficit and further increase their external debt.

Real exchange rate changes during 2018 are estimated to continue along the trajectory of 2017, implying nominal appreciations of the euro, the United States dollar and the British pound and, conversely, some degree of nominal depreciation in many other countries, including China, Japan and Mexico which are singled out as being involved in the simulated trade war. Throughout the years 2019 to 2023 the inherited trends are maintained at a more moderate pace, both for nominal and real exchange rates. By contrast, many economies in the developing world have experienced sharper depreciations in the years 2016 and 2017 and, more recently, in 2018. Hence a relatively protracted period of weaker currencies is projected for these groups, even though the tendency to devaluation will reduce over time.

The labour income share of GDP has been on a declining path for nearly two decades or more in almost all developed countries and in numerous developing countries. This trend has meant a massive transfer of income from wage earners to profit earners since the early 1990s (4 per cent of GDP in the United States, 5 per cent in Germany, 10 per cent in France, 12 per cent in Italy). In China, the sharply falling trend that characterized the period of insertion in global trade was reversed from 2007 to 2015. It has since stabilized after recovering almost half of the previous years’ losses. The picture has been more varied for the other sets of countries assumed here to be directly involved in the trade conflict. Despite such varying trends, for the purpose of this exercise labour shares are assumed to remain relatively stable in China and in the United States while they are assumed to decrease only slightly in Other Developed Countries, Other Developing Countries and Vulnerable Countries.

As also stressed graphically for the groups involved in the trade war (see figure 1A.1), the trends in labour income shares have been closely related to the growth of consumption in real terms (with the usual caveat, discussed in this and other *TDRs*, that economies with considerably deregulated financial markets can maintain rapid increases in debt-driven consumer spending, usually supported by asset appreciations). Such a correlation, which denotes the known causality from income, spending/saving behaviour of wage earners and consumption, plays a meaningful role in the outcome of the trade war scenario described below.

FIGURE 1A.1 Labour income share and consumption in countries involved in the trade war, 2003–2023
(Labour income as a percentage of GDP; consumption in annual growth rates)



Source: United Nations Global Policy Model and World Database.

Expansionary monetary policy (in the form of both low interest rates and quantitative easing) is expected to continue in all developed countries, although at a more moderate pace, as renewed financial instability – possibly triggered by international disputes over trade and exchange rates – threatens global growth.

In the baseline scenario global GDP growth is projected to slow down to 2.9 per cent in 2018 and hover around this rate through to 2023.

Trade war scenario

The trade war scenario is based on the view that the major consequences of a tariff escalation would come from macroeconomic adjustments rather than a change in trade volumes. To explore these consequences, governments are assumed to fully compensate their exporters for any tariffs paid to foreign governments, so that tariffs will not have any immediate impact on trade volumes. Trade volumes are projected to change eventually because of changes in national incomes (which affect import demands) rather than tariffs.

While short-term exchange rate fluctuations are generally reflected in changes in profit markups, in a trade war policymakers are more likely to be proactive. On the one hand, governments are typically sensitive to the requests of exporters. On the other hand, multilateral discussions on policy

coordination have emphasized growth strategies that are still based on increasing most countries' export shares, notwithstanding the inconsistency of that position. Assuming that all participants in the trade war will try to preserve their export shares reflects this reality.

From the perspective of an importing economy it should be clear that the network of production and specialization cannot be rebuilt domestically from one day to the next. An existing domestic structure of production, as well as consumption patterns that depend heavily on acquired technologies and preferences, do not change drastically. From the perspective of producers in the exporting country, the implication of shutting down the entire market of the importing country because of the "cost of the tariff" would certainly have more severe implications in terms of employment and social stability in the originating country than the "price cost" for the exporter itself. In other words, the domestic implication of the tariff faced abroad becomes a far greater social and economic concern for the policymaker than what the tariff actually represents. In sum, this assumption simply reflects the known historical experience that when the corporate sector faces financial difficulties, the government usually steps in with support mechanisms.

At the same time, producers, and especially the large companies that have been increasing their market shares over the past two decades, are assumed to continue to exercise their leverage in labour markets

to lower wage costs in response to a more challenging trading environment.

In a nutshell, the scenario presents a situation where increased tariffs will lead to the government of each belligerent party reimbursing its exporters, so as to retain global export shares and avert employment collapses, while in the receiving economy domestic prices will remain, in principle, at previous levels. This effectively implies transfers (even if these are small compared with the sizes of these economies) from surplus economies to the United States. Additionally, some countries will allow their real exchange rates to depreciate marginally to maintain global market shares.

In the trade war scenario, the tariff escalation triggers downward pressures on wages and generates uncertainty around the path of economic policy. This damages aggregate demand, economic growth and, ultimately, trade activity and financial stability. More specifically, the scenario is defined by the following four assumptions:

1. Tariffs

The United States is assumed to impose a 20 per cent tariff on all its imports from China and two thirds of its imports from Canada, Japan, Mexico, the Republic of Korea and the European Union. It is assumed that China and these other countries retaliate with equivalent tariffs, dollar for dollar. No country is assumed to impose higher tariffs than those it was targeted by or impose them on a larger trade volume.

2. Tariff revenues

Warring governments fully compensate their exporters for the tariffs paid to foreign governments, using the revenue obtained by taxing imports and, where this is not sufficient, general tax revenue. If this combination of tariffs and transfers produces a net revenue, this is used to reduce the government's deficit and debt. For example, in 2019 the United States Government is projected to gain approximately \$280 billion in tariffs and to transfer to United States exporting businesses \$181 billion for the tariffs paid to Canada, China, Japan, Mexico, the Republic of Korea and the European Union – a version of the border adjustment tax. The United States Government is projected to gain a net \$99 billion in revenue that it then uses to reduce its deficit and debt.

Under this assumption, a redistribution of resources is projected to take place: businesses will transfer resources to foreign governments (in the form of tariffs) and these will transfer them to their exporting businesses (in the form of reimbursements). Globally, the result of these flows is a transfer of resources between governments, with some obtaining a net revenue and others a net loss. The largest transfer will be from China to the United States, and it will be in the order of 0.5 per cent of the GDP of China. The other countries estimated to experience net losses are Japan, Mexico and the Republic of Korea, to degrees significantly lower than those of China, both absolutely and relative to GDP (see figure 1A.2, which shows the net international transfer in nominal terms).

3. Currency devaluation

Countries that suffer a net fiscal loss resort to exchange rate devaluation in an attempt to increase their export shares and gain additional export revenue. In recent years, exchange rate targeting has been achieved through a variety of actions, including “managed floating”, quantitative easing and other forms of policy-driven liquidity expansion.

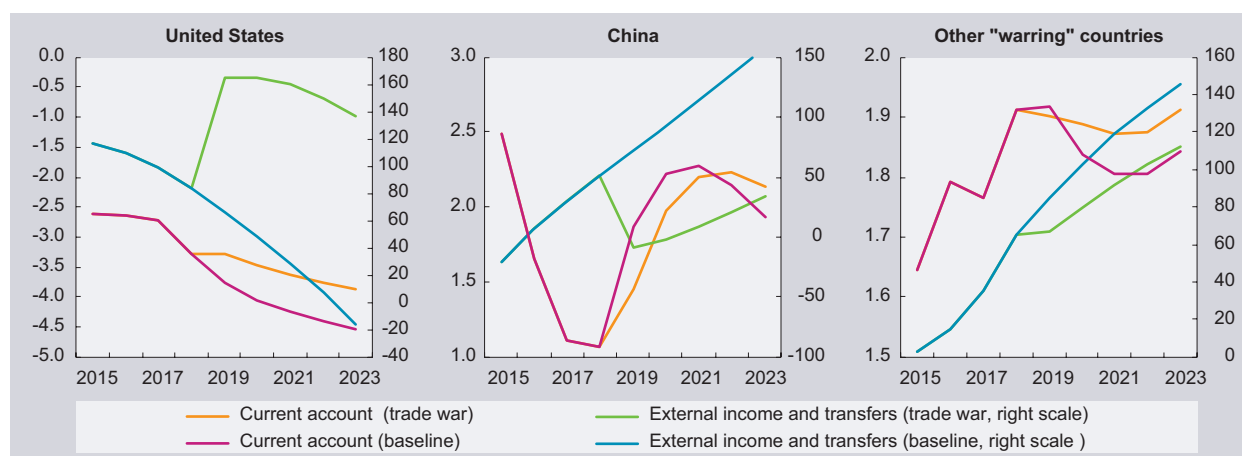
For the purpose of this simulation, China, Japan, Mexico and the Republic of Korea, which are the countries that eventually make a net tariff payment to the United States, are assumed to let their currencies depreciate approximately 2 per cent below the baseline. As noted above, the depreciation trend is partly embedded in the fact that the main reserve currencies are projected to strengthen in the coming years in the wake of the normalization of monetary policy.

4. Labour shares

Labour shares of national income are assumed to fall as the trade war is used in the public discourse to justify calls for (more) wage moderation. Projected decreases are approximately half of those observed during the recessions and economic slowdowns of the last two decades. The decline will deepen real exchange depreciations, which depend not only on the nominal rate but also on domestic inflation, of which unit labour costs are the main factor.

The direct result of the redistribution of income towards profits will be a weakening of domestic demand, as workers' relatively reduced purchasing

FIGURE 1A.2 External income and transfers, and the current account in countries involved in the trade war, 2015–2023
(External income and transfers in billions of dollars; current account as a percentage of GDP)



Source: See figure 1A.1.

power causes consumption to decelerate. This is observed in all warring countries, with the largest impacts projected in China and Other Warring Countries, especially Germany, Japan and the Republic of Korea (see figure 1A.1 and table 1A.1). The dynamics of wage-share compression and weaker aggregate demand will have a spillover effect on other countries as well, observed in the form of slight falls in their wage shares (this being entirely an outcome, not an assumption).

The impacts of the distributional shifts will eventually be felt by investors, despite the implied rising profit shares. The model estimates that dampening effects on investment may be significant in all warring countries. In China, the United States, the European Union and Other East Asia, the growth rate of private investment is projected to decrease by approximately 1 percentage point per year through 2023, leading to cumulative drops of about 6 per cent or more (see table 1A.1). Other countries will also experience declines of investment, because of the global impact on aggregate demand emanating from the countries in litigation, as well as on confidence. The impact of the deceleration of investment trends on economic growth is in this case considerably more noticeable than in other circumstances. In this case, investment in practically all economies highlighted has been experiencing a relatively declining trend in the last years (among those, the case of China reflects an intended domestic restructuring effort). Moreover, as has also happened in earlier periods of economic deceleration triggered

initially by consumer demand, the deceleration or decline in consumption and investment demand affect growth in obvious ways (see figure 1A.3).

The combined effects of monetary policy normalization in reserve currency economies, with partial devaluations in affected economies paying net tariffs, and the overall effects of slowdown of unit labour costs (in the wake of wage-share compressions) will lead to a slight decline of real exchange rates in China (see table 1A.1) as well as in Japan, Mexico and the Republic of Korea.

A trade war is projected to damage growth, income distribution and employment, in all countries, though this will be more marked in the countries assumed to be involved in the tariff skirmishes. Admittedly, the United States will experience a decline in the current-account deficit, while China and, to a lesser degree, other warring countries will experience the opposite effect of reduced surpluses. For the United States and China, this will be almost entirely the result of the tariff transfer and not because of a change in the configuration of global production and demand (see figure 1A.2). Taking away such tariff changes, the deficit in the United States could be comparable to the baseline, since there will be both a deceleration in imports due to the changes in domestic consumption and investment, as well as a deceleration of United States exports in response to the changes in global demand. Indeed, the shocks to distribution, consumption and investment at a global level will

TABLE 1A.1 Outcomes for countries/other groups
 (Constant dollar prices, annual percentage changes)

	United States					China					Other "warring" countries					Vulnerable developing economies					Other developed economies					Other developing economies				
	2018		2023		Cum. change over 5 years	2018		2023		Cum. change over 5 years	2018		2023		Cum. change over 5 years	2018		2023		Cum. change over 5 years	2018		2023		Cum. change over 5 years	2018		2023		Cum. change over 5 years
	2.7	2.2	1.8	2.2	6.7	5.8	5.3	1.8	1.8	1.3	-2.9	2.8	3.2	2.9	-1.5	2.5	2.3	2.0	3.7	4.1	3.7	4.1	3.7	4.1	3.7	4.1	3.7	4.1	3.7	4.1
GDP growth (percentage)	2.7	2.2	1.8	2.2	6.7	5.8	1.8	1.8	1.3	-2.9	2.8	3.2	2.9	-1.5	2.5	2.3	2.0	3.7	4.1	3.7	4.1	3.7	4.1	3.7	4.1	3.7	4.1	3.7	4.1	
Trade war scenario	1.8	-2.5																												
Private investment (percentage)	6.1	2.7	1.9	3.8	3.9	2.9	2.7	1.9	0.9	-5.9	2.9	2.2	1.7	-2.1	3.4	2.9	2.4	4.8	4.1	4.8	4.1	3.5	3.5	4.1	3.5	3.5	4.1	3.5	-2.9	
Trade war scenario	1.9	-5.8																												
Consumption growth (percentage)	2.1	2.2	1.9	7.9	7.1	6.5	1.1	1.8	1.3	-2.8	4.5	3.5	3.3	-1.0	2.4	2.4	2.3	5.6	4.4	5.6	4.4	4.3	4.3	5.6	4.4	4.3	4.3	4.3	-1.3	
Trade war scenario	1.9	-1.9																												
Labour income share (percentage of GDP)	53.1	53.1	54.1	54.2	54.1	54.7	54.6	54.7	55.8	-4.1	50.6	50.6	48.2	-0.3	56.3	55.8	50.6	48.2	48.2	56.3	48.2	48.2	55.8	48.2	48.2	55.8	50.6	50.6	-1.6	
Trade war scenario	54.1	-2.5																												
Real exchange rate (index: world = 1)	1.341	1.350	1.372	0.831	0.854	0.821	1.197	1.256	1.257	-	0.842	0.779	0.790	-	1.507	1.476	1.496	0.661	0.657	1.507	1.476	1.496	0.661	0.657	1.507	1.476	1.496	-	-	
Trade war scenario	1.372	-																												
Current account balance (percentage of GDP)	-3.3	-4.5	-3.9	1.1	1.9	2.1	1.9	1.8	1.9	0.2	-3.1	-2.0	-2.4	-0.5	1.6	2.9	2.3	0.6	0.5	1.6	2.9	2.3	0.6	0.5	1.6	2.9	2.3	-0.5	-2.9	
Trade war scenario	-3.9	4.5																												
Balance of income and transfers (billions of current dollars)	83.6	-16.3	137.2	51.6	158.2	34.5	65.6	145.2	112.2	-131.8	-91.7	-145.9	-144.6	2.5	-0.2	-7.3	-8.0	-108.9	-133.8	-0.2	-7.3	-8.0	-108.9	-133.8	-0.2	-7.3	-8.0	-1.6	8.6	
Trade war scenario	137.2	641.3																												
Export volume growth (percentage)	3.7	2.3	1.5	7.1	7.9	7.8	5.0	2.9	2.2	-4.9	3.9	4.8	4.2	-4.1	3.2	3.2	2.6	1.3	4.4	3.2	2.6	2.6	3.2	4.4	3.8	3.8	2.6	4.4	-4.7	
Trade war scenario	1.5	-4.8																												

Source: See figure 1A.1.

FIGURE 1A.3 Growth of GDP and investment, 2015–2023
(Annual percentages)



Source: See figure 1A.1.

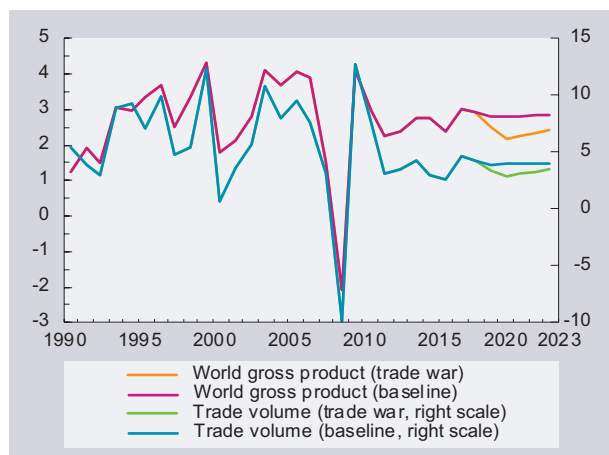
result in sizeable slowdowns in global demand, and hence export and import growth (see figure 1A.4 and table 1A.2). On account of the export slowdown, China and Other Developing Countries will suffer real losses in their current account. China, however, will manage to regain most of its external net position after four years, resulting from the real exchange rate adjustment and presumably from the persistent structure of trade linkages with other partners not directly involved in the trade dispute. The historical data on bilateral manufacture exports and imports suggest that when China experiences a slowdown of its exports to a particular set of countries outside its region, it can resort to cutting regional imports in a commensurate way.¹⁷

In the current context of increasing financial fragility in several developing countries, a hypothetical trade war of the kind simulated in this exercise may lead to even more serious consequences for such

countries. The main channels involve currency depreciations, unruly capital movements and deflationary policy responses. For example, the higher projected exchange rate volatility could affect investors' confidence and trigger capital flights as lenders and portfolio managers, following a well-rehearsed script, seek safer assets and higher margins of safety. This could exacerbate and activate a spiralling sequence of falling investment, spiking unemployment, falling consumption, inflating sovereign debts (especially the liabilities denominated in foreign currencies) and falling government revenue and spending.

It should be clear, though it is not empirically projected in this model simulation, that several developing countries experiencing increasing financial and distributional imbalances can be shaken by events of even minor significance for the global economy. In particular, for approximately a decade, the set of "vulnerable" countries singled out in this exercise

FIGURE 1A.4 World gross product and trade volume growth rates, 1990–2023
(Annual percentages)



Source: See figure 1A.1.

TABLE 1A.2 World variables
(Constant dollar prices; annual percentage changes)

	2018	2023	Cumulative change over 5 years
World gross product (WGP) growth			
Baseline	2.9	2.9	
Trade war scenario		2.4	-2.7
Private investment growth			
Baseline	4.0	3.2	
Trade war scenario		2.3	-5.0
Consumption growth			
Baseline	3.7	3.6	
Trade war scenario		3.2	-2.5
Trade volume growth			
Baseline	4.1	3.8	
Trade war scenario		3.2	-4.6
Labour income share of WGP			
Baseline	52.3	52.3	
Trade war scenario		51.6	-2.2

Source: See figure 1A.1.

Note: WGP is calculated weighing country blocs based on 2005 GDP.

have all experienced deceleration or high fluctuations of GDP growth and persistently negative current-account balances. Over time, these countries have

accumulated negative balances on external assets and liabilities. They have also all experienced depreciating real exchange rates that have not helped their external balances recover (either because a “trade recovery” did not materialize because of structural constraints, or because the external debt payments have been larger than the trade revenues).

As noted above, however, such vulnerabilities should not be considered unique to countries in this group. Many developing and developed countries may experience unwelcome shocks in the event of severe disruptions of direct investment and financial flows. For all countries, any further weakening of aggregate demand in developed countries, triggered by a tariff struggle or any other spark in global markets, combined with more wage compression, fiscal austerity and related factors that discourage productive investment and employment, may lead to another global crisis or, at the very least, to sharply deteriorating conditions in the international macrofinancial environment, with governments and central banks having far less room to intervene than in earlier crises.

Chapter II of this *Report* shows that the patterns of trade flows have been changing since the mid-1990s. Figure 1A.4 highlights this by showing the trends of growth of global GDP and export volume, stressing the dissociation that starts after the Great Recession. It is apparent that the changes estimated to affect global trade in this simulation, resulting not from tariffs per se but from more fundamental macroeconomic effects, are not significant compared with changes in other recent periods, when global aggregate demand has fluctuated more severely than is projected in this scenario.

As is discussed in this *Report*, there is no doubt that global trade, even before the slowdown after the crisis, has fallen short of its promise to promote higher value added activities more evenly across the world economy. Still, after decades of experiencing the limits of “free trade”, it would be tragic to embrace the opposite excess – a trade-tariff war – rather than to consider what governments could do, through global policy coordination, to avert the continuing deterioration of income distribution and employment that are at the root of most recent economic crises. ■