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Structural transformation for
inclusive and sustained growth

Chapter I

CURRENT TRENDS AND CHALLENGES IN THE WORLD ECONOMY

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Chapter I

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A. A year of living dangerously

The world economy in 2016 is in a fragile state, with growth likely to dip below that registered in both 2014 and 2015. The mediocre performance of developed countries since the 2008–2009 economic and financial crisis is set to continue, with the added threat that the loss of momentum in developing countries over the past few years will be greater than previously anticipated. Without a change of course in the former, the external environment facing the latter looks set to worsen with potentially damaging consequences for their prosperity and stability in the short to medium run. More widespread contagion from unforeseen shocks cannot be ruled out, knocking global growth back even more sharply. The decision by the United Kingdom electorate to leave the European Union (EU) is such a shock.

Growth in the United States this year is likely to slow down, as the momentum that was built through the quick detoxification of its banking system and a more aggressive use of monetary policy loses traction. Unemployment has dropped steadily to the level registered before the crisis hit and real earnings have begun to pick up. However, given its weak underlying employment rate, the number of distressed households with high levels of debt and exporters struggling with a strong dollar, there are no guarantees that the economy will enjoy a robust period of growth any time soon.

Recovery in the euro zone has lagged behind that of the United States, in part because of the more timid use of monetary policy but also very tight fiscal stances in some countries. The tentative pick-up of growth from 2015 seems likely to stall this year, and could even be reversed due to the uncertainty triggered by the announced departure of the United Kingdom from the EU ("Brexit"). Economic growth continues to be held back by weak domestic demand and only sporadic signs of an improvement in real wages. Efforts to tackle the sharply diverging economic performances of the countries in the euro zone are complicated by political uncertainties, such as the ongoing migration crisis, and doubts about the future pace and direction of European integration.

European economies outside the euro zone have performed better in recent years, mainly because the monetary authorities in many of those countries have been willing, and able, to orchestrate financial bubbles. The economy of the United Kingdom, even without the threat of Brexit, is set for a difficult period ahead given its levels of indebtedness and a persistently high trade deficit. The longer term consequences of the leave vote are still unclear, given the unprecedented nature of the decision and the political uncertainty it has created, though growth will undoubtedly slow in the short term. Just how steep the drop could be, given the highly financialized

and flexible markets in the United Kingdom, is difficult to predict.

Japan continues to exhibit a distinct set of economic characteristics that have emerged from decades of underperformance, with persistently low and erratic growth accompanied by a low unemployment rate (currently around 3 per cent), a huge level of domestic debt and a strong payments position. However, like other developed economies, Japan has seen the share of wages in income drop significantly over the past few decades (registering amongst the largest declines in developed economies, albeit in part for demographic reasons) without seeing a recovery in investment. Consumption has remained weak, leaving exports as the preferred source of expanding demand. More recently, with the weakening of global markets and an appreciating yen, efforts have turned to stimulating government spending; so far with only a modest response.

The continuation of weak demand conditions in the developed economies is stifling growth in the global economy. In this context, neither financial bubbles nor export surpluses offer a sustainable solution to tepid growth and weak labour market conditions. Financial bubbles can, at best, provide a temporary boost but tend to aggravate the deflationary gap by increasing inequality and create supply-side distortions that impede productivity growth. Export surpluses can certainly benefit those that achieve them but they are ultimately a beggar-thy-neighbour response in a world of insufficient global demand.

As argued in past *Reports*, a more balanced policy response is called for in the developed economies, combining an expansionary fiscal stance resulting from both spending and taxation decisions, supportive monetary and credit policies along with strengthened financial regulations, and redistributive measures through minimum wage legislation, direct taxation and welfare enhancing social programmes. The appropriate policy mix will vary across countries, though large public infrastructure spending would seem to be a common thread. Moreover, part of the required policy measures need to be taken at the multilateral level, including initiatives to stem tax evasion and avoidance and to implement a low-carbon growth pattern.

In the absence of concerted recoveries across the developed economies, international trade is registering a fifth straight year in the doldrums, becalmed by a lack of global aggregate demand. This has taken the wind out of the growth sails of many developing countries, particularly commodity exporters, and recent growth spurts have relied largely on capital inflows. Whilst greater inflows can, in part, be explained by improved macroeconomic management in recipient countries, the bigger factors have been moves to open the capital account that picked up speed in many developing countries in the new millennium and the post-crisis policy mix in developed economies which has pushed investors to seek high-return (and higher risk) opportunities abroad.

Domestic financial markets in developing countries have become much more open to non-resident investors, foreign banks and other financial institutions while restrictions on their own residents investing abroad have been reduced and financial institutions have diversified into cross-border activities unrelated to international trade and investment. These developments have deepened their financial integration and amplified boom conditions across all developing regions. But they have also created new sources of vulnerability.

Developing economies will likely register much the same average growth rate as 2015, 3.8 per cent, but with considerable variation across countries and regions, and with downside risks increasing. There have been sharp slowdowns, and even a return to recession, in some countries including big emerging economies, notably Argentina, Brazil, the Russian Federation and South Africa. Other economies are also set for chilly times ahead with smaller commodity producers particularly vulnerable. The commodity cycle is in its second year of a sharp downward trend. The drop in mining, fuel and agricultural raw material prices has been particularly sharp; that of other commodities, including food and tropical beverages, less so. A moderate recovery has taken place in recent months, but there is little anticipation of this continuing in the coming years.

With investors exiting developing and transition economies, net capital flows turned negative in the second quarter of 2014, and amounted to -$656 billion in 2015 and -$185 billion in the first quarter of 2016. Even though there was a respite in the second quarter of 2016, there remains a risk of deflationary spirals in which capital flight, currency devaluations and collapsing asset prices would stymie growth and shrink

government revenues, and cause heightened anxiety about the vulnerability of debt positions.

Size can still provide a buffer against unfavourable headwinds blowing in from the global economy. The two largest developing economies, China and India, may escape the worst of these threats thanks to expanding domestic markets and a combination of sufficient foreign reserves and an effective use of policy space.

China's economy has slowed sharply over the past few years, although it is still maintaining a relatively high growth rate of 6.5–7 per cent. While this, in part, reflects its ongoing evolution away from an excessive reliance on external markets to boost growth, the surge in domestic credit in response to the crisis has created a debt bubble which, along with excess capacity in several sectors of the economy, will not be easy to manage if it bursts. India has so far managed the downside risks of the post-crisis period and is now growing faster than China. Private investment, which began rising strongly from the start of the millennium, continued even as the crisis hit. However, it has weakened in the past few years, while public investment has yet to take off in a context of serious infrastructure gaps that could constrain future growth.

The reluctance of developed economies to deal effectively with their own high levels of indebtedness (or rather the tendency to do so through bailouts for creditors and austerity for debtors) and their insistence in relying almost entirely on monetary policy to orchestrate recovery highlight the potential dangers facing policymakers in developing countries. Alarm bells have begun to ring over exploding corporate debt across emerging economies, and it appears that much of the surge of financial inflows into emerging and developing economies has found its way into real estate and financial asset bubbles rather than long-term productive investment projects.

If the global economy slows down more sharply, an important part of developing country debt incurred since 2008 – not only debt issued and held within the borders of individual economies but also cross-border debt, including debt accumulated by private residents and governments – could become stressful or even unpayable. Thus, the international community will need to prepare itself for managing debt work-outs in a faster, fairer and more orderly manner than is currently the case.[1]

Separately, a slowdown in productivity growth, rising inequality, insufficient global demand and mounting levels of debt would pose serious challenges to policymakers at national and international levels; together they pose a massive threat to shared prosperity and stability. The International Monetary Fund (IMF) has warned policymakers to be alert; perhaps it is also time for them to become a little more alarmed.

While there is agreement that these weaknesses are closely interconnected, there is no sign of a concerted move towards policy coordination across systemically important economies. The United States has begun to recognize that its economic policy decisions can carry a sizeable impact beyond its own borders, with the Federal Reserve responding with an even more cautious stance on interest rate rises. But a more ambitious policy package is needed to address existing imbalances and to ease the constraints on faster growth, whether in large or small countries, surplus or deficit economies, commodity or manufacturing exporters, creditors or debtors. A global new deal will need to move beyond business as usual.

There are signs that international bodies such as the IMF and the Organisation for Economic Co-operation and Development (OECD) are rethinking their approach to macroeconomic adjustment (although this has not yet been sufficiently translated into their policy recommendations or conditionality). The necessary next step is for them to move away from a narrow discussion of structural reform that promotes a familiar package of liberalization and deregulation measures, and instead consider the wide range of actions needed to diversify the structure and level of sophistication of economic activity. Such actions should aim to increase productivity, create more and better jobs, boost household incomes, increase fiscal revenues and investment, and foster technological progress; and all these need to be implemented in the context of a world that is rapidly moving towards a low-carbon future. This is a subject taken up in subsequent chapters of this *Report*.

B. Recent trends in the world economy

1. Growth performance

In 2016, global output is likely to decelerate moderately to a growth rate around 2.3 per cent, compared with 2.5 per cent 2015. This is the sixth year in a row that the global economy repeats a modest expansion, well below that of pre-crisis levels. This year's performance reflects an expected slowdown in developed countries growth, from 2 to 1.6 per cent; economic stagnation in transition economies, an improvement over their contraction in 2015; and the continuing growth in developing countries of about 4 per cent, resulting from sustained growth in most Asian countries, a deceleration in Africa and economic recession in Latin America and the Caribbean (table 1.1).

Among the developed countries, the United States is expected to continue growing in 2016, albeit with a significant deceleration to less than 2 per cent, and probably closer to 1.5 per cent. Growth is almost exclusively led by private consumption, as unemployment drops to a level close to that registered before the crisis hit and as workers' real earnings have begun to pick up. In a longer term perspective, however, these improvements remain modest, considering that low unemployment is partly due to a fall in the employment participation rate,[2] and that real median earnings have been essentially flat since the 1970s, despite persistent productivity growth.[3] On the other hand, the contribution of investment spending has been weak (and has actually declined since mid-2015) despite low interest rates. There has been no additional government stimulus, with the drag from lower federal government spending offset by positive contributions to growth by state and local government spending. Finally, after their strongly negative impact in 2014 and 2015 owing to the appreciation of the dollar, net exports have made a slight positive contribution to growth in the first months of 2016, including through a decrease in imports.

After several years lagging well behind the United States, owing to the more timid use of monetary policy and an even greater proclivity for austerity measures in some countries, growth in the euro zone accelerated from 0.9 per cent in 2014 to 1.7 per cent in 2015. Although no further acceleration is expected in 2016. This improvement did not result from an expansion of net exports, despite the depreciation of the euro in 2014–2015, but rather from higher domestic consumption and investment levels, with some increase in real wages as a result of rises in the minimum wage and falling energy prices. Faster growth was also backed by an expansionary monetary policy and a less stringent fiscal stance. These improvements, however, remained below expectations, as monetary expansion by the European Central Bank (ECB) has not translated into a proportionate increase of credit to the real sectors. This reflects the still limited credit demand of the private sector and persistent difficulties in several national banking systems that are still burdened by high levels of non-performing loans (NPLs), which may require further capitalization, as seems to be the case for a number of banks, most notably in Italy, but also in Germany, Ireland and the United Kingdom (EBA, 2016). In addition, fiscal policies are not providing the needed support to economic growth, despite being slightly more accommodative in Germany – to handle the migration crisis.

European economies outside the euro zone have performed better in recent years, partly because they faced lower fiscal constraints, but mostly because they had more expansionary monetary stances, which led to asset appreciation. Such policies were applied in particular in the United Kingdom, where high trade deficits and high debt levels could be financed with

Table 1.1

WORLD OUTPUT GROWTH, 2008–2016

(Annual percentage change)

Region/country	2008	2009	2010	2011	2012	2013	2014	2015	2016[a]
World	**1.5**	**-2.1**	**4.1**	**2.8**	**2.2**	**2.2**	**2.5**	**2.5**	**2.3**
Developed countries	**0.1**	**-3.6**	**2.6**	**1.5**	**1.1**	**1.1**	**1.7**	**2.0**	**1.6**
of which:									
Japan	-1.0	-5.5	4.7	-0.5	1.7	1.4	0.0	0.5	0.7
United States	-0.3	-2.8	2.5	1.6	2.2	1.7	2.4	2.6	1.6
European Union (EU-28)	0.4	-4.4	2.1	1.8	-0.4	0.3	1.4	2.0	1.8
of which:									
Euro zone	0.5	-4.5	2.1	1.6	-0.9	-0.3	0.9	1.7	1.6
France	0.2	-2.9	2.0	2.1	0.2	0.7	0.2	1.2	1.5
Germany	1.1	-5.6	4.1	3.7	0.4	0.3	1.6	1.7	1.7
Italy	-1.1	-5.5	1.7	0.6	-2.8	-1.8	-0.3	0.8	0.8
United Kingdom	-0.5	-4.2	1.5	2.0	1.2	2.2	2.9	2.3	1.8
EU member States after 2004	3.6	-3.6	2.0	3.1	0.5	1.1	2.7	3.4	2.6
South-East Europe and CIS	**5.4**	**-6.6**	**4.7**	**4.6**	**3.3**	**2.0**	**0.9**	**-2.8**	**0.0**
South-East Europe[b]	5.8	-1.9	1.5	1.7	-0.6	2.4	0.3	2.0	2.8
CIS, incl. Georgia	5.3	-6.8	4.9	4.8	3.5	2.0	0.9	-3.0	-0.2
of which:									
Russian Federation	5.2	-7.8	4.5	4.3	3.5	1.3	0.7	-3.7	-0.3
Developing countries	**5.2**	**2.4**	**7.8**	**5.9**	**4.8**	**4.6**	**4.4**	**3.9**	**3.8**
Africa	5.5	3.2	5.2	1.1	5.6	2.0	3.7	2.9	2.0
North Africa, excl. Sudan	6.3	2.8	4.1	-6.6	10.1	-3.7	1.5	2.9	1.7
Sub-Saharan Africa, excl. South Africa	6.1	5.8	6.7	4.7	4.6	5.2	5.8	3.5	2.8
South Africa	3.2	-1.5	3.0	3.2	2.2	2.2	1.5	1.3	0.3
Latin America and the Caribbean	3.7	-2.1	5.9	4.5	3.0	2.7	1.1	0.2	-0.2
Caribbean	2.6	-0.9	3.1	2.2	2.1	2.9	2.8	3.6	2.5
Central America, excl. Mexico	3.8	-0.7	3.7	5.4	4.8	3.6	3.9	4.1	4.0
Mexico	1.4	-4.7	5.2	3.9	4.0	1.4	2.2	2.5	2.2
South America	5.0	-1.0	6.6	4.8	2.6	3.3	0.3	-1.4	-1.8
of which:									
Brazil	5.1	-0.1	7.5	3.9	1.9	3.0	0.1	-3.8	-3.2
Asia	5.7	3.8	8.8	7.0	5.2	5.5	5.5	5.1	5.1
East Asia	6.9	5.9	9.7	7.8	6.0	6.3	6.2	5.4	5.5
of which:									
China	9.6	9.2	10.6	9.5	7.7	7.7	7.3	6.9	6.7
South-East Asia	4.2	1.6	8.0	4.8	5.8	4.9	4.4	4.4	4.3
South Asia	4.8	4.4	9.1	5.5	3.1	5.0	6.3	6.1	6.8
of which:									
India	6.2	5.0	11.0	6.1	4.9	6.3	7.0	7.2	7.6
West Asia	4.0	-2.0	6.2	7.7	4.1	3.4	3.0	2.9	2.1
Oceania	2.0	0.8	4.1	3.7	2.7	2.2	3.6	4.7	2.9

Source: UNCTAD secretariat calculations, based on United Nations, Department of Economic and Social Affairs (UN DESA), *National Accounts Main Aggregates* database, and *World Economic Situation and Prospects (WESP): Update as of mid-2016;* ECLAC, 2016; Organisation for Economic Co-operation and Development (OECD), 2016a; International Monetary Fund (IMF), *World Economic Outlook*, April 2016; Economist Intelligence Unit, *EIU CountryData* database; JP Morgan, *Global Data Watch*; and national sources.

Note: Calculations for country aggregates are based on GDP at constant 2005 dollars.

a Forecasts.

b Albania, Bosnia and Herzegovina, Montenegro, Serbia and the former Yugoslav Republic of Macedonia.

capital inflows. The recent vote to exit the European Union could compromise these policy stances by reducing the attractiveness of the United Kingdom economy to foreign investors, leading to asset and currency depreciations, lower domestic consumption and investment, and a deterioration of balance sheets in all sectors, including lending institutions with higher levels of NPLs.

Japan continues to struggle against economic stagnation and the risk of price deflation, owing largely to weak private consumption. With little dynamism from global demand and an appreciating yen, exports provide little economic stimulus. Furthermore, despite a combination of negative interest rates and a programme of quantitative easing, the Bank of Japan could not avoid consumer price deflation in the first half of 2016, which was far from the goal of 2 per cent inflation. Lower yields in government bonds provided some extra room for expanding public expenditure, which remains an important factor to stimulate the economy. Fiscal policy faces competing goals, between aiming at fiscal consolidation targets through a new increase in consumption taxes and supporting economic activity. Recent decisions (postponing the announced tax increase and launching a new public spending package) indicate that the second goal will prevail, at least in the short term. In addition, sustained growth would require a reorientation of income policies that would reverse the long-term drop in the wage share of GDP.

GDP in the transition economies of the Commonwealth of Independent States (CIS) is expected to stagnate in 2016, after the sizeable contraction of 2015. The factors that adversely affected many of these economies in 2015 (in particular low commodity prices, net capital outflows, falling real wages, conflicts and unilateral coercive measures) still weigh on growth, but have softened, and in some cases have started to reverse. The mild recovery of oil prices, stabilization of exchange rates and moderation of domestic price inflation have restored some room for manoeuvre in the Russian Federation to start recovering domestic demand and industrial production. Still, its GDP growth, as that of other major oil producers such as Azerbaijan and Kazakhstan, is likely to contract moderately in 2016. Most oil-importing countries (Armenia, Belarus, Georgia, Kyrgyzstan, Republic of Moldova and Tajikistan) face a mixed outlook, as they continue to benefit from low fuel prices, but their exports, investment and remittances remain hampered by the ongoing recession in the Russian Federation. Ukraine's economy is expected to return to growth, albeit at a slow pace, as political tensions diminish and inflation decelerates. Finally, growth in South-East Europe is expected to pick up slightly in 2016, mostly as a result of increased exports and heightened foreign investment.

Latin America is heading towards a second consecutive year of economic stagnation and a risk of negative growth in 2016 (ECLAC, 2016). This is due mainly to weak economic performance in South America, where several countries have experienced falling levels of consumption and fixed capital formation. Tighter external conditions (including losses from the terms of trade) in 2015 led to fiscal retrenchment and exchange rate depreciation. To check the resulting threat of inflation, some countries, such as Brazil and Colombia, responded by raising interest rates, causing further growth deceleration. Furthermore, economic contraction in Brazil is likely to continue, given the tight monetary conditions, the Government's intention to further tighten fiscal policy and political uncertainty that is affecting investment. Similarly, growth in Argentina is forecast to be negative as a result of high interest rates, lower real wages due to inflation acceleration and cuts in public investment, all of which are affecting private consumption and fixed capital formation; while the downward spiral in the Bolivarian Republic of Venezuela continues. Other primary exporters (e.g. the Plurinational State of Bolivia, Chile and Peru) that managed the windfall revenues during the bonanza years with a longer term approach have been able to maintain positive growth rates. The prospects might improve marginally in the near future if the partial recovery in commodity prices since the second quarter of 2016 does not reverse (see subsection B.3 below) and some positive shifts in capital flows are confirmed.

Mexico and the economies of Central America and the Caribbean are more closely linked to the United States' economic cycle through manufacturing production networks, remittances and tourism. For most of these economies, growth in 2016 is expected to be slightly slower than in 2015, partly reflecting growth deceleration in the United States. In Mexico, the weaker currency (with the peso losing nearly 25 per cent against the dollar during 2015 and the first half of 2016) could provide some stimulus to growth by boosting manufacturing exports but the emphasis on fiscal consolidation will continue to dampen public investment.

Slower growth is forecast for Africa in 2016, due to weaker performance in North Africa and southern Africa. In the former, political instability and insecurity will continue to hinder economic recovery. In southern Africa, activity is expected to decelerate further because of depressed commodity prices, severe droughts and electricity shortages as well as lower dynamism in South Africa, which is an important export destination for neighbouring countries.

East Africa is projected to continue its growth momentum in 2016, boosted by strong domestic investment including large public investment programmes, and lower oil prices. Similarly, most West African countries (Benin, Côte d'Ivoire, Mali, Senegal and Togo) are expected to record high growth rates generally, supported by increases in public investment, improving agricultural productivity and a dynamic private sector. Besides, as the Ebola epidemic abates, growth is forecast to recover gradually in Guinea, Liberia and Sierra Leone. By contrast, prospects remain challenging in Nigeria where authorities continue to enforce tight monetary and fiscal policies in order to contain rising inflation and the currency crisis stemming from the slump in global oil prices. Falling oil and copper revenues, which in the past have led governments to cut infrastructure investment, as well as political tensions, are expected to continue to put strains on the economies of most countries in Central Africa. The fall in commodity prices has also led to deteriorating external debt situations in a number of countries, including Angola, Ghana, Mozambique and Zambia.

Developing Asia remains the fastest growing region, with an expected growth rate similar to that of 2015, around 5 per cent. China grew 6.7 per cent year-on-year in the first half of 2016, a marginal slowdown in relation to 2015 (6.9 per cent) that nevertheless corroborates the shift towards more moderated growth. This is the result of several factors, including weakness in external demand, efforts to reduce overcapacity in some sectors and a strategic reorientation towards consumption-led growth, with a larger place for services. Gradually, these goals seem to be progressing, as services outpaced the secondary sector as the main engine of growth, and the real contribution of private consumption to GDP growth currently exceeds that of investment. However, while recent expansionary fiscal and monetary policies have led to the recovery of the property market and a surge in State-led investment spending, this may be postponing the needed resizing of some industrial sectors and the deleveraging process. Hence, the aspiration of averting financial risks and consolidating a more balanced growth contrasts with the more immediate motivation of the Government to keep the economy growing by an average of 6.5 per cent, as defined in the 13th five-year plan (2016–2020).

India's growth rate is projected to remain strong, at 7.5 per cent in 2016, further cementing the rather large terms-of-trade gains of 2015 (over 2 per cent of GDP). Growth is primarily driven by rapidly expanding domestic consumption, supported by the low prices of commodities (particularly fuel), a rise in real incomes (including public sector wages) and lower inflation (OECD, 2016b). Export demand declined in 2015, and gross fixed capital formation weakened in late 2015 and early 2016; however, investment (private and public) is expected to expand, which would support a solid growth performance through to 2017. Despite these trends, high public debt and current rates of inflation may limit the room for supportive fiscal policies. The stalled manufacturing share in GDP, as also reflected in the limited capacity of the sector to create jobs with higher wages, will need to be addressed to ensure India's growth in the longer term.

South-East Asia is likely to maintain a growth rate above 4 per cent in 2016, largely based on domestic consumption and investment demand. International trade has been sluggish, although the negative impact of falling exports was partially compensated in some countries by the positive contribution to growth of declining imports. Lower oil prices (and related energy subsidies) and low inflation rates have given room for more supportive fiscal and monetary policies in several countries of the region; domestic demand should remain the main driver for growth (ESCAP, 2016).

Finally, West Asia is expected to grow at around 2 per cent in 2016, down from 2.9 per cent in 2015. Downward adjustment will hit the major oil exporters of the region including Kuwait, Qatar, Saudi Arabia and the United Arab Emirates, whose export revenues fell on average by 6.1 per cent in 2014 and by 34.1 per cent in 2015. Even though these countries have benefited from the modest recovery of oil prices in the first half of 2016, they need to adjust their expenditure given the significant deterioration in current account and fiscal balances (fiscal deficit amounted to 15 per

cent of GDP in Saudi Arabia, 13.6 per cent in Kuwait and 3.7 per cent in the United Arab Emirates in 2015). Policies aimed at fiscal consolidation will severely constrain government consumption and public investment, which contributed significantly to GDP growth in recent years, while the introduction of value-added tax (VAT) and privatization projects aim at improving fiscal revenues (Sommer et al., 2016). Such measures of fiscal austerity may hinder recent attempts in these countries to diversify away from oil.

GDP growth in the non-oil exporting countries in the region (Jordan, Lebanon, Turkey) is likely to decelerate in 2016; it relies mostly on domestic consumption growth, as exports contracted already in 2015 and investment ratios either remained constant (in Turkey) or declined. In Turkey, it will be difficult to sustain domestic consumption demand at 2015 levels, which was stimulated by credit availability and the additional demand created by Syrian refugees. In 2016, the country faces additional economic instability due to recent political frictions; the depreciation pressures on the lira in July 2016 demanded a strong intervention by the central bank. Falling revenues from tourism exports, the challenges posed by a large refugee population and increased financial market volatility necessitate continuous vigilance by policymakers.

2. International trade

(a) Goods

International trade slowed down further in 2015. This poor performance was primarily due to the lacklustre development of merchandise trade, which increased by only around 1.5 per cent in real terms (table 1.2). After the roller-coaster episode of 2009–2011, in the aftermath of the global financial and economic crisis, the growth of international merchandise trade was more or less in line with global output growth for about three years. In 2015, merchandise trade grew at a rate below that of global output, a situation that may worsen in 2016, as the first quarter of the year showed a further deceleration vis-à-vis 2015.[4]

When measured in current dollars, which matters more for revenues, expenditures and ultimately balance sheets, merchandise trade dropped by an estimated 12.7 per cent in 2015. This resulted from the continuing primary commodity price declines (particularly for oil) as well as the depreciation of several key currencies against the dollar. In fact, as several major economies – like most of those of the European Union, Japan and to a lesser extent China – trade in their own currencies, their depreciation reduces the value of exports denominated in dollars, even if they may register positive values when denominated in the domestic currencies.

The slowdown in volumes of merchandise trade in 2015 (table 1.2) reflects the contraction of import demand in some large economies, especially in Asia, Latin America and the transition economies. In Japan, imports fell in volume by 2.8 per cent, and by 1.6 per cent in the rest of East Asia – which includes China, the largest trading economy. In Latin America and the Caribbean, imports contracted by 1.8 per cent, while in the transition economies, imports plunged by 19.4 per cent after contracting already the previous two years.

The 2014–2015 period also marked a shift in the driving forces of international trade. After the global financial crisis, it had been supported primarily by developing economies and the economies in transition, whose trade flows – particularly imports – had grown much faster than those of developed countries, so that they contributed about three quarters of the increase in global imports over 2011–2013. However, since 2014, developing countries' aggregate import growth has slowed down considerably, from about 6 per cent per year in 2012–2013 to only 0.4 per cent in 2015. As a result, developed countries' imports contributed 91 per cent to the growth of global imports over 2014–2015, compared with 28 per cent for developing economies and -19 per cent for the economies in transition. However, in early 2016 developed countries' imports (in volume) were only 3 per cent higher than their pre-crisis peak, compared with 20 per cent for developing economies (chart 1.1).

In developed economies, exports of the United States were held back in 2015 by slow foreign growth and the appreciation of the dollar. Meanwhile, imports increased owing to rising household consumption. In Europe, exports increased with the acceleration of trade within the continent, which accounts for roughly two thirds of European total trade. European exports to the United States were also robust. By contrast, exports to China and other

Table 1.2

EXPORT AND IMPORT VOLUMES OF GOODS, SELECTED REGIONS AND COUNTRIES, 2012–2015

(Annual percentage change)

	Volume of exports				Volume of imports			
Region/country	*2012*	*2013*	*2014*	*2015*	*2012*	*2013*	*2014*	*2015*
World	**3.2**	**3.3**	**2.3**	**1.4**	**3.0**	**2.7**	**2.4**	**1.6**
Developed countries	**1.6**	**2.2**	**1.9**	**2.2**	**1.0**	**0.0**	**2.8**	**3.3**
of which:								
Japan	-4.8	-1.5	0.6	-1.0	2.4	0.3	0.6	-2.8
United States	3.6	2.8	4.4	-0.2	2.1	1.0	4.3	4.8
European Union	-0.1	1.8	1.7	3.2	-2.3	-0.9	3.3	3.6
Transition economies	**0.9**	**2.3**	**0.5**	**0.9**	**6.4**	**-0.5**	**-7.6**	**-19.4**
Developing countries	**5.2**	**4.6**	**3.1**	**0.4**	**5.6**	**6.3**	**2.5**	**0.4**
Africa	19.5	-0.7	0.0	2.1	17.8	6.5	5.7	1.5
Sub-Saharan Africa	2.0	2.7	1.5	0.6	9.2	8.4	4.6	1.6
Latin America and the Caribbean	4.1	1.9	3.3	2.9	2.4	3.6	0.2	-1.8
East Asia	5.0	6.7	4.9	-0.5	3.2	8.9	2.8	-1.6
of which:								
China	6.2	7.7	6.8	-0.9	3.6	9.9	3.9	-2.2
South-East Asia	1.8	4.7	3.5	-0.3	5.4	4.3	1.7	2.8
South Asia	-6.1	4.1	5.2	-0.2	4.1	-0.4	4.6	7.2
of which:								
India	-1.8	8.5	3.5	-2.1	5.7	-0.3	3.2	10.1
West Asia	6.8	3.8	-2.3	2.0	11.4	7.4	1.8	2.0

Source: UNCTAD secretariat calculations, based on *UNCTADstat* and national sources.

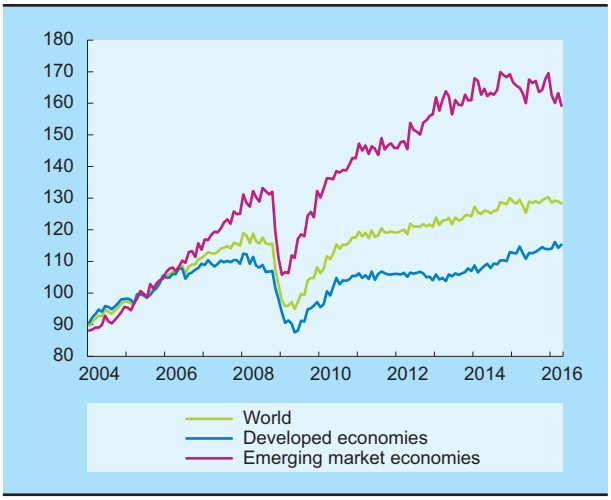
large developing countries and economies in transition appeared to be subdued. In Japan, by contrast, both imports and exports declined in real terms, with imports showing the effects of domestic factors while exports faced headwinds from the weak demand emanating from developing Asia.

Likewise, in developing Asia, all the subregions except West Asia, registered declines in real exports. The contraction in both exports and imports in East Asia had adverse effects on the trade dynamics of many manufacturing export-dependent economies of the region. In particular, China's declining trade weighed on regional trade flows. Real imports by China declined by 2.2 per cent in 2015 – the first negative figure in decades – due to slower growth in manufacturing (affected by weak external demand) and private investment, as well as internal rebalancing. In addition to depressed demand from developed economies, increasing competition from other lower cost producers further affected China's exports, leading to a decline of 0.9 per cent in 2015. This decline in Chinese international trade affected the entire region: China is the largest export market for some of the key manufacturing economies of developing Asia, such as

Chart 1.1

IMPORT VOLUME, SELECTED COUNTRY GROUPS, JANUARY 2004–APRIL 2016

(Index numbers, 2005 = 100)



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

Note: Emerging market economies excludes Central and Eastern Europe.

the Republic of Korea, Singapore, Taiwan Province of China and Thailand, and the second largest market for Japan and Viet Nam. Some smaller economies in the region are very dependent on exporting to China, such as Mongolia (with 90 per cent of exports going to China), Lao People's Democratic Republic, Turkmenistan and Viet Nam (ESCAP, 2016).

In South-East Asia, while exports declined, imports remained subdued owing to domestic factors such as slower job creation in Indonesia and high household debt levels in Malaysia and Thailand. In South Asia, by contrast, import growth accelerated as lower energy and other commodity prices improved economic prospects in India and other economies of the subregion. International trade in several transition economies in North and Central Asia registered a marked deterioration in 2015, as the deep plunge in the global prices of oil, gas and minerals slashed export earnings and led to steep currency depreciations, inflation and recession. All these factors greatly affected the volume of imports (almost -20 per cent in 2015) without improving that of exports (ESCAP, 2016).

In Africa, many countries have been hard hit by the decline in commodity prices and negative spillovers from developing Asia. Major oil exporters like Angola and Nigeria have been severely affected. Meanwhile, for oil-importing African countries which rely on exporting other commodities, the benefits of cheaper energy imports were offset by the general decline in other commodity prices in a context of depressed foreign demand. In South Africa, the largest trading partner for most other African countries, slower growth in export volumes despite the depreciation of the currency, along with the decline in commodity prices, have meant only marginal growth in the nominal value of merchandise exports.

In Latin America and the Caribbean, plunging commodity prices have also had major impacts on the region's average export revenues in 2015, after the region registered its worst terms-of-trade deterioration since 1986 (ECLAC, 2016). Countries whose exports are concentrated mainly in hydrocarbons, such as the Plurinational State of Bolivia, Colombia, Ecuador, Trinidad and Tobago, and the Bolivarian Republic of Venezuela, were among the hardest hit, followed by countries whose main exports are minerals and metals and agro-industrial products, since these countries benefited to some extent from the lower oil prices. By contrast, many Central American and Caribbean countries enjoyed improved terms of trade. In the region as a whole, the drop in the value of exports (-15 per cent) was the result of falling prices. In real terms, export volumes increased 2.9 per cent, with, for instance, Mexico's manufacturing exports improving markedly owing to currency depreciation and robust demand from the United States. On the import side, many countries registered a decline in real imports. In Brazil, for instance, imports declined in all major trade categories, including fuel, durable consumer goods, capital goods, intermediate goods and non-durable consumer goods. Meanwhile, imports fell sharply in the Bolivarian Republic of Venezuela owing to the shortage of foreign currency. Also, in Ecuador, balance-of-payment safeguard policies and the economic slowdown reduced imports (ECLAC, 2016).

(b) Services

Trade in services declined by 6.1 per cent in 2015 in terms of current dollars. Developing economies were less affected by the trade slowdown (-2.7 per cent) than developed ones (-7.3 per cent) or transition countries (-15.4 per cent), while least developed countries (LDCs) showed an increase in services exports of 1.3 per cent in 2015. However, just as for goods trade, this decline was partly due to the dollar appreciation: at constant prices, trade in services performed significantly better. Indeed, quantity indicators for two of its main subcomponents, travel and transport – which account for 25 per cent and 20 per cent of services trade, respectively – continued to expand in 2015.

International tourism receipts grew by 4.4 per cent in 2015 in real terms (taking into account exchange rate fluctuations and inflation). This was in line with a 4.6 per cent increase in international arrivals in 2015, reaching a total of almost 1.2 billion. These receipts grew in all main regions, led by the Americas (7.8 per cent), Middle East (4.3 per cent) and Asia and the Pacific (4 per cent); they are followed by Europe (3 per cent) and Africa (2 per cent). At the country level, Japan and Thailand reaffirmed their place as major international destinations, with tourist arrivals up by 47 and 20 per cent compared with 2014, while Nepal and Tunisia registered sharp declines in arrivals (UNWTO, 2016a).

A few leading economies, in particular China, the United Kingdom and the United States, led outbound tourism last year. The number of outbound travellers from China rose 10 per cent to 128 million, benefiting Asian destinations such as Japan and Thailand as well as the United States and various European destinations. China's outbound tourism expenditure has been expanding at double-digit rates every year since 2004; it further increased by 25 per cent in 2015 to reach $292 billion. The number of residents travelling abroad from the United States and the United Kingdom (the world's second and fourth largest source countries) increased by 8 per cent and 9 per cent respectively in 2015 (UNWTO, 2016b).

The second largest category of commercial services relates to international transport. World seaborne trade volumes expanded by 2.1 per cent in 2015, surpassing 10 billion tons for the first time in history. But growth was notably slower than the expansion of the last decade: international seaborne trade volumes expanded at an even slower rate of 1.7 per cent, down from 5.6 per cent recorded in 2014. A key reason for this slowdown was weaker Chinese merchandise trade (UNCTAD, 2016).

3. Recent developments in commodity markets

(a) General evolution of commodity prices

Commodity prices continued to plunge in 2015. All commodity groups experienced even larger price declines than in 2014, with crude oil prices falling the most (table 1.3). Plummeting oil prices explain the contraction of almost 37 per cent in the commodity prices index, which was even larger than the 29 per cent decline seen in 2009 after the global financial crisis erupted (non-oil commodities prices contracted by 17 per cent, as in 2009). Since March 2016, the downward trend in commodity prices appears to have been arrested, and in some cases reversed (see chart 1.2).

The main factors behind the relatively low levels for most commodity prices throughout 2015 were persistent oversupply, and associated levels of inventories. Since 2011 and continuing to 2015, supply increases have been larger than demand growth for most commodities, with weak demand in the context of slow global growth. This may change as a result of supply adjustments following low price levels. But on the demand side, slower growth in emerging economies is likely to continue to have a significant negative impact on prices. China's rebalancing towards domestic consumption and services could alter its commodity demand patterns and have a large impact on global markets, although such concerns may be overstated. In general, Chinese demand for commodities has remained robust in recent years (see table 1.4). Thus, in 2015 Chinese copper imports increased by 8.7 per cent, by volume, while those of crude oil increased by 8.8 per cent.[5]

Despite some recent changes, the financialization of commodity markets remains a major factor in determining prices (see *TDR 2015*, annex to chapter I). Since 2011, major transnational banks that were earlier active in commodities retreated from this market in response to regulatory changes in the United States and the European Union, as well as the declining profitability of financial investment in commodities because of lower prices. However, this gap was to some extent filled by banks from other countries and other agents like major trading companies (Jégourel, 2015a and 2015b), as well as the growing importance of commodity exchanges in Asia, and particularly in China. Recent increases in commodity prices in the first half of 2016 have been associated with a revival of financial market interest in commodities, as reflected in the 29 per cent increase (since December 2015) in commodity assets under management to reach $220 billion by the end of April 2016, a level similar to that of 2008.[6] Commodity prices also rallied in early 2016 due to the surge in Chinese speculative commodities trading, which was especially evident for iron ore, steel, coal and cotton until regulatory measures in China led to some correction.[7]

(b) Specific market developments by major commodity group

In the energy commodities group, crude oil prices declined by 47.2 per cent in 2015. The price of Brent crude oil reached a low of $30.8 a barrel for its monthly average of January 2016. It recovered in the subsequent months to levels of around $50 per barrel in May–June 2016 (*UNCTADstat*).

Table 1.3

WORLD PRIMARY COMMODITY PRICES, 2010–2016

(Percentage change over previous year, unless otherwise indicated)

Commodity groups	2010	2011	2012	2013	2014	2015	2016[a]	2015-2016 versus 2003-2008[b]
All commodities[c]	**24.6**	**26.4**	**-2.0**	**-3.2**	**-7.1**	**-36.7**	**-14.5**	**-4.9**
Non-fuel commodities[d]	**20.4**	**17.9**	**-8.3**	**-6.7**	**-6.1**	**-16.9**	**-4.2**	**17.3**
Non-fuel commodities (in SDRs)[d]	**21.7**	**14.1**	**-5.5**	**-6.0**	**-6.1**	**-9.7**	**-4.2**	**26.2**
All food	**7.4**	**17.8**	**-1.4**	**-7.4**	**-4.1**	**-14.8**	**-0.7**	**33.8**
Food and tropical beverages	**5.6**	**16.5**	**-0.4**	**-6.7**	**-3.8**	**-14.2**	**-1.6**	**37.0**
Tropical beverages	17.5	26.8	-21.5	-18.3	23.5	-8.1	-7.3	47.8
Coffee	27.3	42.9	-25.7	-23.6	29.9	-19.7	-5.7	38.1
Cocoa	8.5	-4.9	-19.7	2.0	25.6	2.3	-3.0	69.8
Tea	-1.0	11.4	0.8	-23.9	-10.4	43.1	-20.4	42.9
Food	4.4	15.4	2.0	-5.7	-5.9	-14.8	-1.0	35.9
Sugar	17.3	22.2	-17.1	-17.9	-3.9	-21.0	17.2	37.9
Beef	27.5	20.0	2.6	-2.3	22.1	-10.5	-13.2	68.0
Maize	13.2	50.1	2.6	-12.1	-22.2	-14.7	-2.7	24.3
Wheat	3.3	35.1	-0.1	-1.9	-6.1	-23.1	-12.8	4.1
Rice	-11.5	5.9	5.1	-10.6	-17.8	-10.9	1.1	10.6
Bananas	3.7	10.8	0.9	-5.9	0.6	2.9	5.9	59.4
Vegetable oilseeds and oils	**22.7**	**27.2**	**-7.6**	**-12.6**	**-5.8**	**-19.8**	**6.8**	**12.8**
Soybeans	3.1	20.2	9.4	-7.9	-9.7	-20.6	1.7	16.6
Agricultural raw materials	**38.3**	**28.1**	**-23.0**	**-7.4**	**-9.9**	**-13.6**	**-4.7**	**8.5**
Hides and skins	60.5	14.0	1.4	13.9	16.5	-20.6	-20.1	20.7
Cotton	65.3	47.5	-41.8	1.5	-8.8	-14.7	-1.9	13.1
Tobacco	1.8	3.8	-3.9	6.3	9.1	-1.7	-4.8	60.4
Rubber	90.3	32.0	-30.5	-16.7	-30.0	-20.3	-4.9	-14.0
Tropical logs	1.8	13.4	-7.1	2.6	0.4	-16.5	0.5	7.3
Minerals, ores and metals	**41.3**	**14.7**	**-14.1**	**-5.1**	**-8.5**	**-22.0**	**-11.4**	**-5.4**
Aluminium	30.5	10.4	-15.8	-8.6	1.1	-10.9	-7.2	-24.1
Phosphate rock	1.1	50.3	0.5	-20.3	-25.6	6.5	-1.7	20.5
Iron ore	82.4	15.0	-23.4	5.3	-28.4	-42.4	-6.6	-32.2
Tin	50.4	28.0	-19.2	5.7	-1.8	-26.6	0.8	54.5
Copper	47.0	17.1	-9.9	-7.8	-6.4	-19.8	-14.6	7.9
Nickel	48.9	5.0	-23.4	-14.3	12.3	-29.8	-26.8	-46.5
Lead	25.0	11.8	-14.2	3.9	-2.2	-14.8	-3.1	27.3
Zinc	30.5	1.5	-11.2	-1.9	13.2	-10.6	-7.1	-2.8
Gold	26.1	27.8	6.4	-15.4	-10.3	-8.4	5.2	108.9
Crude petroleum[e]	**28.0**	**31.4**	**1.0**	**-0.9**	**-7.5**	**-47.2**	**-23.6**	**-20.3**
Memo item:								
Manufactures[f]	**3.0**	**8.9**	**-1.7**	**3.6**	**-1.3**	**-9.8**	**..**	**..**

Source: UNCTAD secretariat calculations, based on *UNCTADstat*; 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 June 2016 and the average for 2015.

b Percentage change between the 2003–2008 average and the 2015–2016 average.

c Including crude oil and gold.

d Excluding crude oil and gold. SDRs = special drawing rights.

e Average of Brent, Dubai and West Texas Intermediate, equally weighted.

f Unit value of exports of manufactured goods of developed countries.

The world oil market moved from a balanced situation in 2012–2013 to excess supply in 2014 and 2015 (*TDR 2015*). World oil demand expanded from 90.7 million barrels per day (mbd) in 2012 to 94.7 mbd in 2015. Non-OECD countries accounted for 96 per cent of this increase, with 68 per cent coming from China, India and other Asian countries.[8] Meanwhile, world oil supply increased from 90.9 mbd in 2012 to 96.4 mbd in 2015. A number of OPEC countries have continued to pump oil at high levels in 2016;[9] in particular, the Islamic Republic of Iran has been significantly increasing its oil production after its return to world markets, at an even faster rate than expected, in order to reach its pre-sanction levels.

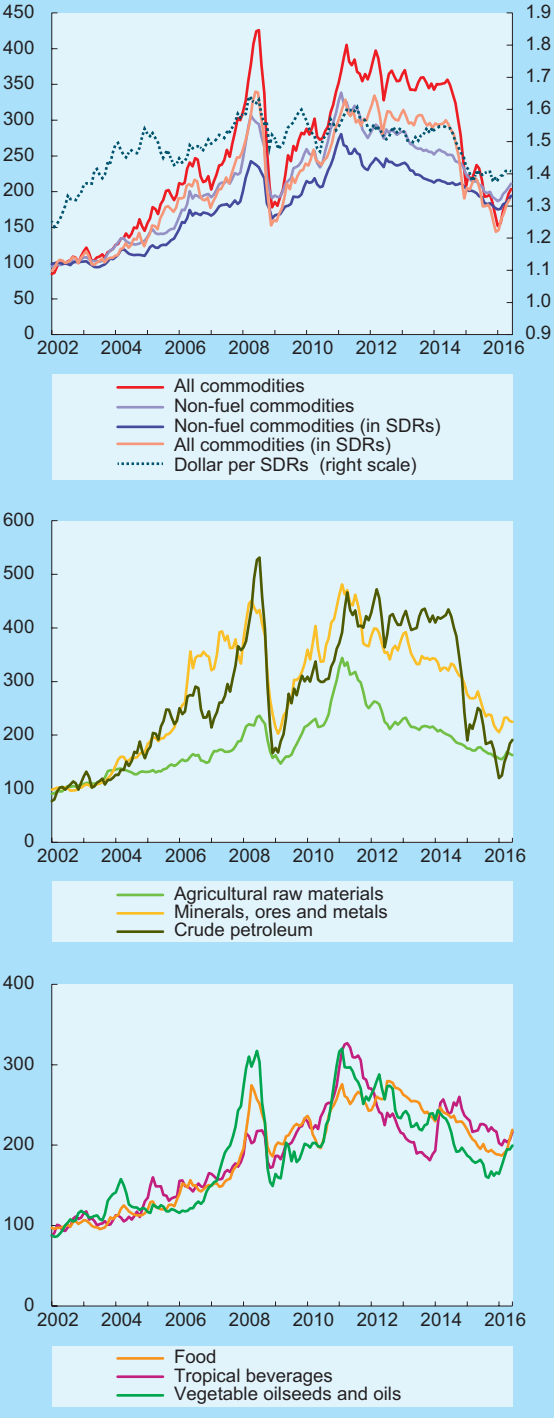
By contrast, in the United States, oil supply has been falling in response to lower oil prices: crude oil production fell from an average of 9.4 mbd in 2015 to 8.7 mbd in May 2016, and is forecast to decline further to 8.2 mbd in 2017 (EIA, 2016).[10] The capacity of oil production to rapidly recover if oil prices rise again is uncertain, due to financial reasons. Many oil producers in the United States had increased their production based on substantial borrowing, and so low prices have led to financial difficulties and increased bankruptcies in this sector. In addition to reduced oil production in the United States, unplanned supply disruptions in Canada, Ghana and Nigeria meant that world oil supply declined slightly in the first quarter of 2016.

Modest growth in the global economy and slower demand growth in emerging markets negatively affected prices of the minerals, ores and metals group, which tend to be highly correlated with global industrial activity. In 2015, many metal markets continued to register production overcapacity, with iron ore and nickel being the worst performing. In some cases, oversupply was exacerbated by big mining companies increasing their production despite lower prices, in order to drive less profitable producers out of the market; in general, mining companies initially responded to lower prices by trying to curb costs but maintain volumes, so inventories remained high. Nevertheless, the market seems finally to be reacting to the price drop, with cuts in production or announcements to do so for some minerals, ores and metals such as lead and zinc, and to a lesser extent aluminium and copper.[11] Actual and planned production cuts in oil production, as well as in the minerals and metals sectors, suggest that supply adjustment

Chart 1.2

MONTHLY COMMODITY PRICE INDICES BY COMMODITY GROUP, JANUARY 2002–JUNE 2016

(Index numbers, 2002 = 100)



Source: UNCTAD secretariat calculations, based on *UNCTADstat*.
Note: Crude oil price is the average of Brent, Dubai and West Texas Intermediate, equally weighted. Index numbers are based on prices in current dollars, unless otherwise specified.

Table 1.4

COMMODITY CONSUMPTION IN CHINA, SELECTED COMMODITIES, 2002–2015

	Consumption volume		*Share in world consumption (Per cent)*		*Annual growth rate (Per cent)*					
	2002	*2015*	*2002*	*2015*	*2003–2008*	*2009–2011*	*2012*	*2013*	*2014*	*2015*
Aluminium (refined)	4 115	31 068	16.2	54.4	21.3	12.4	14.4	8.4	23.9	14.2
Copper (refined)	2 737	11 353	18.2	50.2	10.8	14.1	12.9	10.5	15.0	0.4
Nickel (refined)	84	964	7.1	50.3	26.0	22.7	4.4	3.6	-6.2	13.8
Coffee	0	2 463	0.0	1.7	128.2	109.9	-1.3	55.1	35.4	12.2
Cotton	28 950	32 500	29.6	29.9	8.6	-4.3	-5.3	-4.2	-4.3	-1.5
Corn	125 900	217 500	20.1	22.2	3.6	7.3	6.4	4.0	-2.9	7.7
Rice	135 700	146 000	33.4	30.6	-0.6	1.5	1.0	1.4	1.0	1.0
Wheat	105 200	112 000	17.5	15.9	0.1	4.9	2.0	-6.8	0.0	-3.9
Soybeans	35 290	95 250	18.5	30.0	7.3	11.9	5.7	5.8	8.2	9.2
Oil	248	560	6.8	12.9	7.1	7.8	4.8	4.3	3.9	6.3

Source: UNCTAD secretariat calculations, based on *World Metal Statistics Yearbook*, various issues; *BP Statistical Review of World Energy 2016*; and United States Department of Agriculture, *Production, Supply and Distribution* online database.

Note: Data for the volume of consumption are in thousand tons for metals, cereals and soybeans, in million tons for oil, in thousand 48 lb. bales for cotton and in thousand 60 kilogram bags for coffee.

has already begun. This is likely to continue over the next few years as oil and mining companies cut their exploration and investment expenditures.

Gold prices tend to be delinked from those of other minerals, ores and metals because of its role as a store of value. Gold prices experienced the lowest average decline in 2015 and have risen in the first half of 2016, in response to increasing investor demand. This suggests continued concerns about the prospects of the global economy and the effects of the delayed decision by the United States Federal Reserve to increase interest rates.

Price changes in the agricultural commodities group have been more diverse in 2015 and the first half of 2016. Prices in this group have been mostly determined by weather conditions but producers have also benefited from the lower price of oil. In the subgroup of food commodities, cereal prices remained subdued as a result of abundant crops in major producing countries for several years and high inventory levels. The El Niño meteorological phenomenon has affected crop conditions in some food commodities, particularly in Africa and Asia, and raised concerns about food prices and food insecurity in affected regions, but the comfortable level of inventories has prevented much of an impact on international prices in 2015.

Like minerals, oils and metals, price movements of agricultural raw materials follow the industrial production cycle. After several years of decline, cotton prices remained relatively stable at low levels as production was lower than consumption, but levels of stocks remained high. Natural rubber prices continued to decline in 2015, but have rebounded in the first half of 2016, pointing to the success of the export quota scheme agreed by the International Tripartite Rubber Council (World Bank, 2016), which includes the three major producing countries, Indonesia, Malaysia and Thailand.

4. International capital flows to developing economies

In the past half century, developing economies received three main waves of net capital flows, in 1975–1981, 1991–1997 and 2004–2011; in each case these were followed by periods of steep reductions or reversals. Net capital flows are the difference between net capital inflows (increases minus reductions of liabilities towards non-residents) and net capital outflows (changes in net foreign assets earned by residents). During the 1970s and 1980s, capital outflows from developing economies were modest, and overall net capital flows to these economies resulted almost exclusively from foreign investor decisions, as reflected in net inflows. By the mid-1990s, emerging economies also started to be a source of capital outflows, and some of them gained relevance as international financial centres. This explains the simultaneous increase or decrease of net inflows to and outflows from emerging economies at moments of great expansion (as in 2007) or retraction (as in 2009) of capital flows.

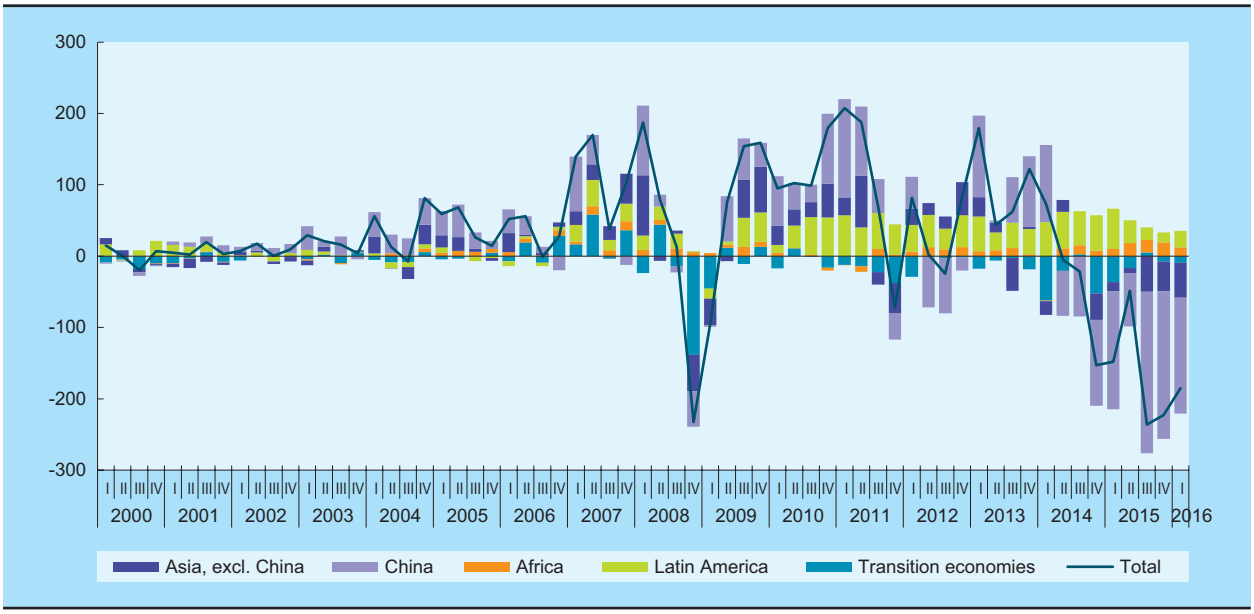
Since the onset of the global financial crisis, and in the wider context of their fast integration into international financial markets, developing countries, and in particular emerging market economies, have been exposed to highly volatile capital flows. Strong surges in capital flows have alternated with repeated dips in rapid succession.

The surge in capital flows to developing and emerging economies between 2010 and the first quarter of 2014 (see chart 1.3) took place in the context of monetary expansion in some major economies, led by the asset purchasing programmes (or quantitative easing policy) of the United States Federal Reserve. These dramatically lowered the yields of financial

Chart 1.3

NET CAPITAL FLOWS FOR SELECTED COUNTRY GROUPS, 2000–2016

(Billions of dollars)



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

Note: The samples of economies by country group are as follows: *Transition economies*: Kazakhstan, Kyrgyzstan, the Russian Federation and Ukraine. *Africa*: Botswana, Republic of Cabo Verde, Egypt, Ghana, Mauritius, Morocco, Mozambique, Namibia, Nigeria, South Africa, the Sudan and Uganda. *Latin America*: Argentina, the Plurinational State of Bolivia, Brazil, Chile, Colombia, Ecuador, El Salvador, Mexico, Nicaragua, Paraguay, Uruguay and the Bolivarian Republic of Venezuela. *Asia excluding China*: Hong Kong (China), India, Indonesia, Jordan, Lebanon, Malaysia, Mongolia, Pakistan, Philippines, the Republic of Korea, Saudi Arabia, Singapore, Sri Lanka, Thailand, Turkey and Viet Nam.

assets in major financial centres, prompting a change in investors' portfolio allocation decisions in favour of the (riskier) emerging market "asset class". The perception that these economies had "decoupled" from the developed world to deliver self-sustaining high growth rates further strengthened this direction of flows. The end of the Federal Reserve's asset purchasing programme in 2014 clearly had an impact on the reversal of flows, but the most relevant factors were the protracted slowdown in developed-country growth, combined with steep falls in commodity prices, both of which adversely affected developing country exports and growth prospects. Changing prospects reinforced capital outflows, as the "carry trade" positions began to make losses and were rapidly unwound. This said, capital flow movements had proved highly volatile throughout this period, with the eventual turning point of 2014 having been preceded by a series of shorter dips in capital flows to developing economies since 2008.[12]

The pronounced decline in net inflows since mid-2014 and in particular throughout 2015 drove aggregate net capital flows into negative territory, for the first time since the Latin American debt crisis in the second half of the 1980s. Foreign investors exited large developing and transition economies, especially in the fourth quarter of 2015 when withdrawals of capital of non-residents became larger than inflows. In the aggregate, overall capital net flows were negative by about $656 billion in 2015;[13] about 2.7 per cent of the total GDP of these countries. The turnaround of 4.4 percentage points of GDP from a surplus of 1.7 per cent in 2013 is much larger than the "sudden stops" of 1981–1983 (a decline in net flows from 2.8 per cent of GDP to 0.6 per cent), 1996–1998 (from 2.8 to 0) and 2007–2008 (from 3.1 to 0.2 per cent of GDP). The recent drop in net capital inflows into emerging economies was due to a reversal in "other investment liabilities" (from 1.4 in 2014 to -1.2 per cent of GDP in 2015) and a decline in portfolio flows (from 1.4 to 0.1 per cent of GDP), which more than offset the marginal rise in foreign direct investment (FDI), from 3 to 3.3 per cent of GDP.[14]

The reversal in net capital flows was most pronounced in Asia, especially in China (in fact, the bulk of the negative net capital flows since 2014 is explained by China alone), but also hit emerging economies in Eastern Europe and the Russian Federation. By contrast, Latin America and countries such as India and South Africa continued to receive positive net capital flows. China's net capital flow deficit in 2015 amounted to around 4.5 per cent of GDP, driven by external debt repayments by non-financial corporates, the unwinding of carry trade operations, a decline in offshore convertible renminbi deposits,[15] and outward FDI that increased to 1.8 per cent of GDP, approaching the level of inward FDI flows (2.4 per cent of GDP). The gradual recovery in net inflows to developing economies observed in the first quarter of 2016 continued to be offset by outflows from residents, which maintained net capital flows in negative territory.

Recently there has been a revival of risk appetite in global financial markets that once again attracted investors to emerging economies. In the first half of 2016, the currencies of large emerging market economies strengthened against the dollar, and the prices of both financial assets and commodities rose. As in previous financial cycles, there is a significant correlation in the direction and the intensity of capital flows across large developing economies, which suggests that common factors like developed country policies and risk perceptions largely determine capital movements (*TDR 2013; TDR 2014*).[16] With financial globalization, economists have stressed the importance of "push factors" – mainly changes to global liquidity and risk – as the main determinants of surges and reversals in capital flows, giving "pull factors", i.e. country-specific factors and demand, only a secondary role. Global factors act as "gatekeepers", whereas "pull factors" – in particular the foreign exchange regime – explain different degrees of exposure to changes in global conditions and the final magnitude of the surge in particular countries (Fernández-Arias, 1996; Cerutti et al., 2015).

The cyclical nature of these cross-border capital flow movements, as opposed to their mere volatility, is worth emphasizing, not least because these financial cycles are at the heart of growing challenges to developing country debt sustainability and the increased likelihood of substantial sovereign debt crises. Easy access to cheap credit in boom times has led to growing debt levels across the developing world. Developing country external debt stocks alone rose from $2.1 trillion in 2000 to $6.8 trillion in 2015, while overall debt levels (foreign and domestic, excluding financial sector debt) rose by over $31 trillion between 2000 and 2014, with total debt-to-GDP ratios in many developing countries reaching over 120 per cent, and in some emerging economies

over 200 per cent.[17] Only a couple of years ago, the amount of debt low-income developing countries could have sold to keen investors seemed almost limitless. International sovereign bond issuances in these economies rose from a mere $2 billion in 2009 to almost $18 billion by 2014.

But with the tide turning and access to cheap credit beginning to dry up, the risks of fast integration into international financial markets have become apparent. Developing countries have expanded and opened up their domestic financial markets to non-resident investors, foreign commercial banks and financial institutions; they have allowed their citizens to invest abroad and, as mentioned, many developing country governments engaged in raising finance in developed country financial markets. Against the backdrop of falling commodity prices and weakening growth in developed economies, borrowing costs have been driven up very quickly, turning what seemed reasonable debt burdens under favourable conditions into largely unsustainable debt. But the procyclical nature of capital flows – cheap during a boom and expensive during downturns – is not the only drawback. Once a crisis looms, currency devaluations to improve export prospects simultaneously increase the value of foreign-currency denominated debt. For commodity exporters, the need to meet rising debt servicing requirements also generates pressures to continue to produce, potentially worsening excess supply constraints and downward pressures on commodity prices (Akyüz, 2016).

More generally, additional factors add to the market risks, such as high maturity risks in particular in domestic bond markets and interest rate risks. Finally, growing contingent liabilities – whether stemming from public-private partnership contracts or from the need to transfer high and systemically important corporate debt onto public balance sheets – tend to become more visible once things go wrong. Thus, in the current circumstances, the many downsides of excessive financial and capital account liberalization may well mean that the international community should prepare for managing debt workouts in a faster, fairer and more orderly manner than is currently the case. Already, several countries have turned to multilateral lending institutions, such as the IMF and the World Bank, in order to obtain financial assistance: Angola, Azerbaijan, Ghana, Kenya, Mozambique, Nigeria, Zambia and Zimbabwe have already asked for bailouts or are in talks to do so.

C. The slowdown of global trade

The growth of global merchandise trade volume slowed to around 1.5 per cent in 2015, from 2.3 per cent in 2014, and the slow pace has continued through the first half of 2016. This trend, which began in 2012, has been more pronounced than for world output.

To many observers this prolonged period of sluggish trade – the longest since the early 1980s – is a principal reason for the weakness in global growth since the financial crisis, just as its revival is seen as the best hope for recovery, overcoming other aggregate demand constraints. Accordingly, measures to increase external competitiveness and facilitate trade have become a policy priority, especially in developed economies. Despite their adoption, the fact that trade has continued to slow down suggests limits to such measures and raises the possibility that they may even be self-defeating.

First, domestic demand, on which trade depends, is not an exogenous outcome for policymakers; many of the measures adopted to boost export market shares tend to weaken aggregate demand (*TDR 2012; TDR 2013*). Second, by limiting the role of the public sector and accelerating the pace of financial liberalization, the policy space to manage a sustained recovery is significantly narrowed (*TDR 2014; TDR 2015*). Third, what may appear sensible from the perspective of a single country or group of countries, like aiming at net export gains, runs into a "fallacy of

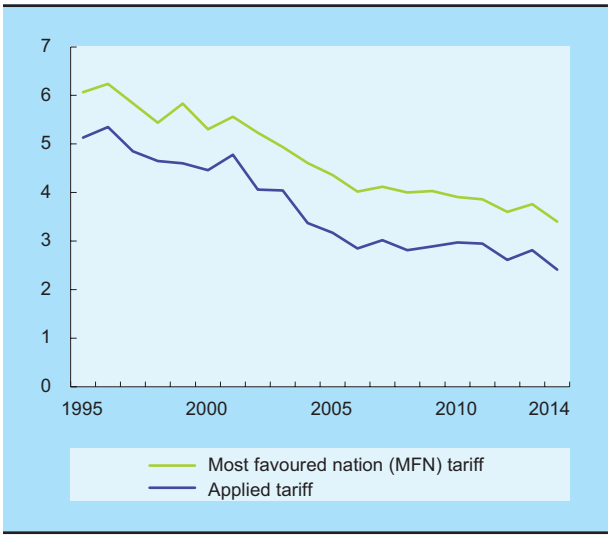
composition" at the global level (not all countries can be net exporters) and can exacerbate a "race to the bottom" that worsens the sustainability of global demand (*TDR 2014*).

Yet, despite the fact that the measures to increase competitiveness have contributed to, or at least preceded, the global trade slowdown, policy-makers in many countries continue to see them as the only route to the recovery of trade, and, by implication, economic growth. Indeed, governments in both developed and developing countries have been pursuing mega regional trade and investment agreements, as a more comprehensive and workable approach to boosting trade and advancing economic integration than through discussions at the multilateral level. The prominent place that such agreements have taken in official policy discussions, and even electoral campaigns, calls for full and careful scrutiny. This is not the aim of this section. Rather, the focus is more narrow on whether the current deceleration of global trade can be attributed to obstacles that would be lifted by enacting such trade and investment agreements.

Chart 1.4

AVERAGE GLOBAL TARIFFS, 1995–2014

(Per cent)



Source: UNCTAD secretariat calculations, based on UNCTAD, *TRAINS*; and WTO, *I-TIP* databases.

1. *Preliminary observations on the causes of the trade slowdown*

It has been argued that trade has slowed because of rising protectionism since the global crisis (Evenett, 2014). However, apart from isolated cases concerning a few products (such as some metal products), there is little evidence that tariff changes explain the prolonged sluggishness of global trade. Average tariff figures have been declining steadily since the establishment of the World Trade Organization (WTO), and are currently at historic lows (chart 1.4). Moreover, any partial tariff increases were certainly not on a scale that could explain the sharp slowdown in trade.

Global averages could, of course, be misleading given the uneven geographical distribution of trade. For a detailed analysis of import tariffs by region over the period 2008–2012, the period of trade slowdown, see UNCTAD (2015a). It shows trade restrictiveness measures from the perspective of importers as well as exporters, confirming that while the group of developed countries has broadly maintained the same level of tariff restrictions over these years, most developing regions have reduced such restrictions (with the partial exception of South Asia, showing a negligible increase of less than half a percentage point). In terms of market access defined by the levels of import tariffs faced by exports from different regions, a similar conclusion can be reached: developed countries faced lower tariff restrictions in 2014 than in 2011 or 2008, as did countries in South Asia, West Asia and Africa. Meanwhile, East Asia, Latin America and economies in transition faced similar or higher tariffs for their exports to developed countries than in 2008. In sum, while the aggregate picture confirms small changes in tariffs since the financial crisis, developing countries overall have made more concessions than developed countries in recent years.

On a bilateral basis, the same indices of restrictiveness suggest that even though many developing countries still have higher levels of applied tariffs than developed countries, these have declined since 2008 in most regions, especially within regions (see table 1.5).

This empirical evidence suggests that neither the current level of average tariffs nor their trend in

Table 1.5

AVERAGE LEVELS OF TARIFFS BETWEEN COUNTRY GROUPS IN 2014 AND CHANGES BETWEEN 2008 AND 2014

(Per cent and percentage points)

		Exporting group						
		East Asia	Latin America	South Asia	Sub-Saharan Africa	Transition economies	West Asia and North Africa	Developed countries
Importing group	East Asia	2.6 [-0.7]	4.5 [-0.2]	3.2 [-0.9]	1.9 [0.1]	2.6 [0.0]	1.6 [-0.2]	5.2 [-0.6]
	Latin America	9.2 [-0.4]	1.1 [-0.6]	9.7 [-0.5]	1.5 [-0.3]	2.1 [0.5]	2.9 [-0.2]	3.8 [-0.3]
	South Asia	13.2 [0.8]	10.2 [-3.7]	7.1 [-0.7]	4.5 [-2.0]	7.4 [0.4]	5.2 [-2.9]	10.6 [0.8]
	Sub-Saharan Africa	11.4 [-0.2]	9.1 [0.0]	8.1 [0.3]	3.9 [-0.7]	6.9 [-0.4]	5.1 [-0.3]	7.5 [-0.7]
	Transition economies	6.7 [-2.4]	9.0 [-2.7]	6.7 [-2.5]	1.7 [-1.2]	0.4 [0.3]	6.2 [-1.4]	4.6 [-2.0]
	West Asia and North Africa	5.6 [-0.3]	5.4 [-1.3]	4.0 [0.1]	3.5 [-0.4]	6.9 [3.0]	1.6 [-0.3]	3.7 [-0.7]
	Developed countries	2.7 [0.3]	1.1 [0.3]	2.9 [0.0]	0.3 [-0.2]	1.1 [0.2]	0.4 [-0.1]	1.8 [-0.3]

Source: UNCTAD, 2015a.

Note: The cells in the matrix show the tariff trade restrictiveness index (TTRI) calculated for the imports of the regions in the rows which are experienced by the exporting regions of the columns. Numbers in brackets show the percentage change of the TTRI from 2008 to 2014.

recent years can be seen as an explanation for the slow growth of global trade or an obstacle to future recovery. Moreover, given that the level of "applied tariffs" by countries, aggregated at the global level, has remained considerably and consistently below the corresponding level of most favoured nation tariffs (chart 1.4), the claims of increased tariff protectionism would appear to be at least exaggerated.

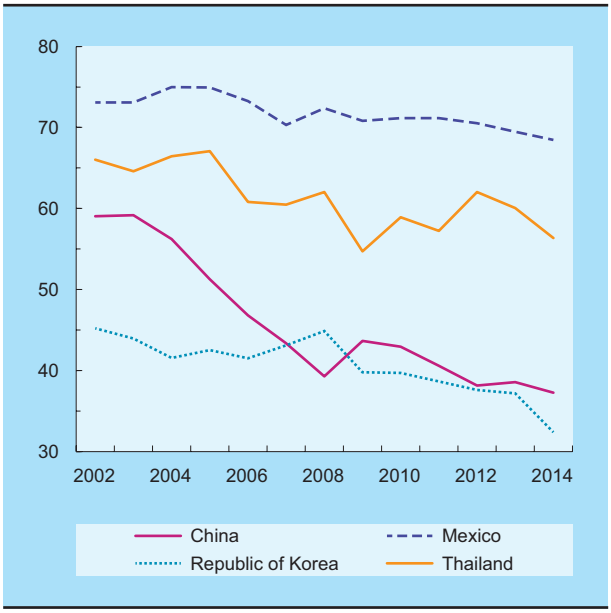
Concerns have also been raised about a possible surge of hidden or "murky" protectionism since the global financial crisis, to the extent that the trade slowdown has been attributed to rising "non-tariff measures" (NTMs) applied, in particular, to specific product lines. This is a more nuanced (and more difficult to measure) aspect of trade policy, since NTMs cover a wide array of regulatory issues, standards, technical requirements, environmental and health conditions, etc. As noted in *TDR 2014*: 91, the association of these measures with a "murky" form of protectionism "is problematic, since it also includes several measures that have an important public policy purpose, not only for promoting financial stability and preventing drastic declines in employment, but also for building domestic productive capacity and protecting consumers". Moreover, "the assessments of the impact of these measures rely entirely on subjective judgement".

UNCTAD has made progress in generating indices of NTMs but the indicators are still quite fragmentary. They measure the number of NTMs and because of their qualitative nature they are not comparable across countries. A proper assessment of these measures requires in most instances a case-by-case analysis and may even involve following up litigation processes in some depth (UNCTAD, 2015b). Aside from the difficulty of measuring NTMs, what

Chart 1.5

DEGREE OF IMPORT DEPENDENCY OF EXPORTING INDUSTRIES IN SELECTED COUNTRIES, 2002–2014

(Per cent)



Source: UNCTAD secretariat calculations, based on *UN Comtrade*; and *UNCTADstat*.

is even more difficult is to quantify their impact on global trade volumes (Raza et al., 2014). Needless to say, a number of NTMs, particularly in relation to standards (quality of products, production processes) and also in relation to compliance with patents and other regulations, have historically contributed to constrain market access of developing countries to developed countries. Yet, this is not an emergent problem explaining the slowdown in recent years.[18]

Beyond issues of trade policy, another possible factor explaining the observed trade deceleration is the changing structure of demand, particularly in systemically important economies. A shift in the composition of demand towards services or away from investment goods might offer an explanation, but neither the timing of the trade surge or its subsequent decline would seem consistent with such shifts in the structure of global demand. A more compelling explanation is based on the evolution of international production networks (Constantinescu et al., 2015). The rise of global value chains, given their heavy reliance on imported parts and components for processing and re-export, and the very high elasticity of trade between the mid-1980s and the early 2000s, can be explained by the establishment of the first stages of these chains. As developing countries participating in such chains diversify their economies and develop additional skills and technologies, it is possible that a greater proportion of the inputs used in their tradeable sectors could be produced domestically, leading to a reduction of global trade elasticity.

If a sufficiently large trade partner, or a large group, evolves rapidly from one stage to the other (a phenomenon characterized as "shrinking chains") then there is likely to be an immediate impact on the volume of global trade. Chart 1.5 shows that this was apparently the case for China, which managed to reduce the import dependence indicator of its manufacturing exports from about 60 per cent in 2002 to 40 per cent in 2008.[19] The ratios for other countries have remained flat over the same period.[20] However, the dramatic reduction of import content of the exporting industries of China should have translated into a decline or slowdown of global trade during 2002 to 2008, which was the period of very fast growth of trade, and not during 2012 to the present, when the production structure of China's exporting industries, as well as those of most other economies with heavy value chain participation, declined marginally or remained flat.[21] Other aspects of global production networks seem more relevant than the import-export structure per se; they are examined in more detail below.

2. Global trade in the context of international production networks

(a) Diffusion of activities and the global decline in wage shares

The rapid pace of global trade since the mid-1980s has been closely linked to the internationalization of manufacturing through cross-border production networks. "Lead" corporations, which outsource selected activities to specific locations and manage the assembly, branding and marketing of the final product, play the central role. In the production of standardized goods, a mix of vertical specialization and economies of scale has enabled these corporations to increase profits by choosing

locations with desirable combinations of relatively high labour productivity, low wage and infrastructure costs and favourable tax conditions. However, much of this discussion has been delinked from the global macroeconomic context in which these chains have emerged.

From a global perspective, outsourcing and the diffusion of activities can lead to ambiguous employment outcomes, with a mixture of both job creation and destruction.[22] The internationalization of production and trade competition may, as discussed further in chapter IV, enhance or erode the scope for industrialization via export-led strategies. There are, however, potentially more unequivocal distributional consequences at the global level associated with this relocation of activities.

The growth of wages in most developed economies has been weak or stagnant for a considerable time, with the result that the share of wages in national income has been on a downward trend since the 1980s (*TDR 2012; TDR 2014*). A number of factors explain this trend: the general shift in bargaining power away from labour, partly due to the greater mobility of capital (Stockhammer, 2013); outsourcing and de-industrialization (Jaumotte and Osorio Buitron, 2015); the lower costs of the consumer basket resulting from the ability of MNEs to import back cheaper goods outsourced elsewhere (Seguino, 2014); and the compensating ability of households to borrow on the back of the holding gains derived from the ownership of equity in a context of asset bubbles (Turner, 2008; UN DESA, 2013, chap. 3).

The pressures on wage shares in developed countries have not been offset by a trend in the opposite direction in developing countries. As discussed in previous *TDRs*, competition on world markets for labour-intensive manufactures among firms located in developing countries tends to become competition among labour located in different countries (*TDR 2002*). Wage growth is likely to be constrained even as employment increases, not only because reserve labour pools remain large, but also because the potential of MNEs to shift production to *other* developing countries can act as a constraint on wage demands (Burke and Epstein, 2003).

Chart 1.6 provides evidence of how such patterns of production and labour income have played out in a selected group of industrializing developing countries since the mid-1980s.[23] The usual comparison is between the growth of exports ("trading more") and the significantly slower growth of value added ("earning less").[24] To highlight the impact of the diffusion of activities on income distribution, the charts show the evolution of relative wage incomes of these "industrializing" countries as they gain export market share. They also include a measure of the country's share in global product.

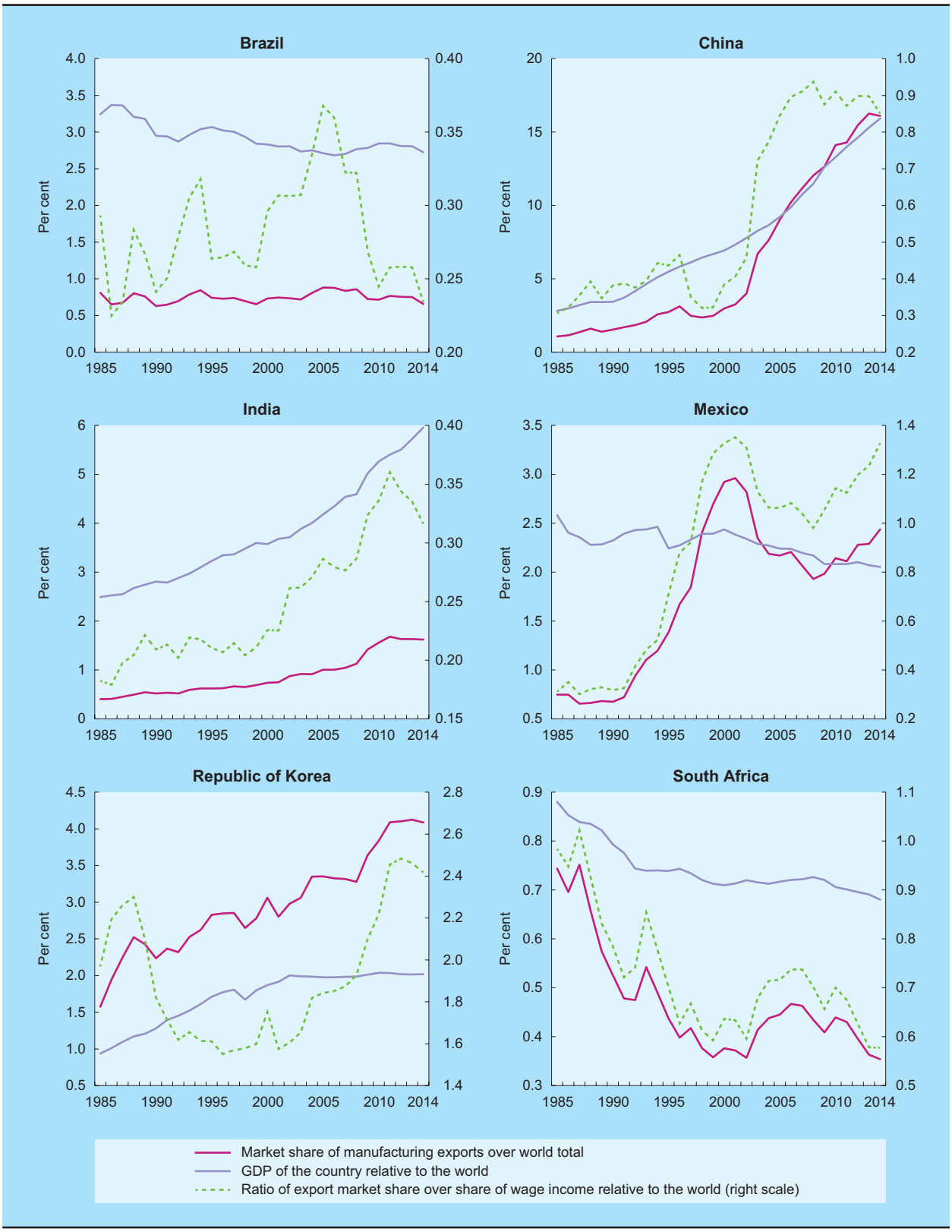
This indicates that those countries that did exhibit increases in their global share of manufacturing exports did not show similar increases in wage shares of national income relative to the global average. In periods of export success, shares of global manufacturing exports rose faster than relative shares of wage income, such that the ratio also increased. This suggests that increased access to global markets has typically been associated with a relative deterioration of national wage income compared with the world level.

Exceptions to this general pattern are few. The Republic of Korea succeeded in supporting wage compensation, particularly during the early 1990s, without significantly affecting competition for export market shares. Although it took up to 1993 to regain the market shares enjoyed in 1988, up until the East Asian crisis the model allowed a pace of export performance on a par with the pace of wage compensation relative to that of the world as a whole. From the 1997 crisis on, the Republic of Korea conformed more closely to the general pattern of "exporting more" but "earning less".[25] Another unusual case is represented by the patterns in China after the global financial crisis. From 2008 onwards, policymakers managed to sustain increases in the wage share without significantly affecting the pace of increase in export market shares. As discussed in earlier *Report*s, this may reflect the efforts to support income generation at the household level in order to allow faster increases in consumption than in investment and exports.

As discussed in other chapters of this *Report*, the usual justification for greater trade and financial liberalization is that the promotion of exports, even if at the cost of a relative deterioration of wage income, ensures a faster catch-up in terms of national income. However, for the selected countries in these charts, the patterns of convergence or divergence (the variable showing national income relative to

Chart 1.6

MANUFACTURING EXPORTS, WAGE EARNINGS AND GDP OF SELECTED COUNTRIES RELATIVE TO THOSE OF THE WORLD, 1985–2014



Source: UN Global Policy Model using historical data compiled from *UN Comtrade*, *UNCTADstat* and UNSD.

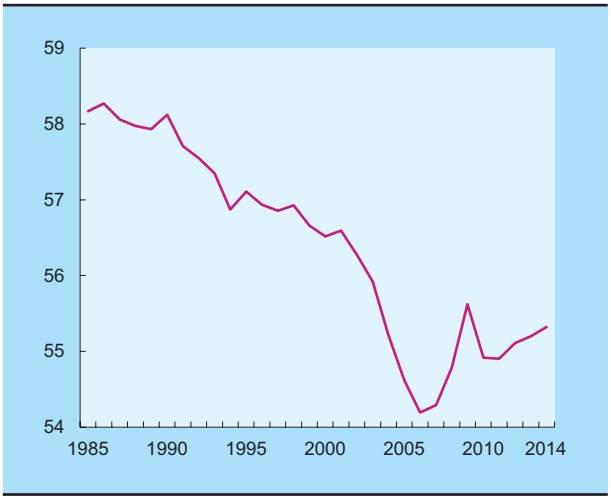
world income, in percentage terms) have little connection with whether export manufacturing shares were falling, stable or rising. In the light of the above discussion, part of the reason is that strategies based on gaining a greater share of world manufacturing exports through relative compression of wage shares, tend to reduce the potential for growth in domestic demand.

Together, the trends of developed and developing countries discussed above help explain the decline of the global wage share, and, in particular, the very sharp drop in 2002–2007 during the boom years for trade and output (chart 1.7). The sharp turnaround during 2008–2009 reflects the typical adjustment in deep crises, as profits tend to take the first hit until unemployment surges or workers' contracts are revised. The fact that the global wage share did not fall in 2010–2011 to pre-crisis levels, and rose mildly subsequently, is partly due to more active labour market policies in a number of developing countries, and some developed countries.[26]

Chart 1.7

GLOBAL WAGE SHARE, 1985–2014

(Per cent of global income)



Source: UN Global Policy Model using historical data compiled from UNSD and national sources.

(b) Under-consumption and trade acceleration: The role of deficits and lending

Given the relevance of labour income to sustaining consumption, it could be expected that the observed long-term decline in wage share in global income should translate into a tendency towards under-consumption for the world as a whole.[27] If consumption demand for the world as whole was too low, the likely outcome would have been a steady and prolonged deceleration of investment *and* of global trade (as import demand in all countries individually depends ultimately on consumption and investment demand). Thus, the real puzzle is how global trade showed such dynamism while the global wage share was on a steadily declining trend.

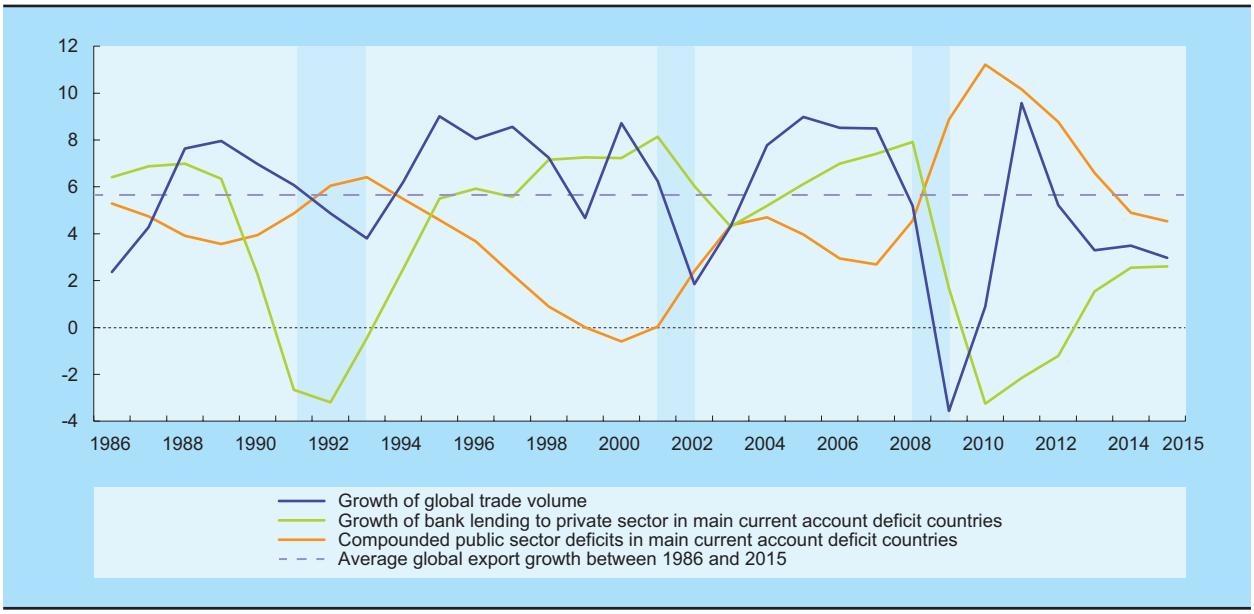
For the majority of developing economies, under-consumption is a direct effect of the fact that wage growth lags behind productivity with a concomitant rise in the share of non-wage income. One consequence is that the aggregate savings propensity increases, as the propensity to consume out of wage income is typically far higher than that out of profits (see *TDR 2013*). Under-consumption can also result from the fact that labour and social protection tend to be weak in developing countries and households put aside a portion of their wage income as a buffer (Akyüz, 2012). In any event, households in developing countries are earning insufficient incomes to absorb the increased output of manufactured goods they are producing, which is consistent with the export specialization strategy.

Meanwhile, for developed countries as a group, during the years of fast growth of global trade, and especially in the period of global imbalances prior to the financial crisis, there is no clear indication of under-consumption. The major current account deficit countries followed a different model that allowed a rise of consumption (public and private) despite the wage share contraction.[28] Indeed, in instances of sluggish activity (which could be expected to result from a persistent decline of the wage share) fiscal levers would bridge the demand gap until the momentum for a new boom developed. More significantly still, the suppression of wage incomes was compensated for by the increase in household debt, enabled by financial deregulation and relatively low interest rates. This generated a debt spiral among households, as well as a boom in asset markets such as housing and stock markets, which in turn had positive effects on consumption and investment. Such credit-driven bubbles are not sustainable and eventually end, often with a hard landing, as in 2008–2009.

Chart 1.8

GLOBAL TRADE GROWTH, CREDIT EXPANSION AND FISCAL DEFICITS IN THE MAIN CURRENT ACCOUNT DEFICIT COUNTRIES, 1986–2015

(Per cent, two-year moving average)



Source: UN Global Policy Model; using historical data compiled from *UNCTADstat*, UNSD and IMF.

Note: Main current account deficit countries are Australia, Canada, the United Kingdom and the United States. Variables correspond to weighted averages. Shaded areas denote years of significant deceleration in growth of global exports below the average for the period.

Under such "exceptional" conditions of credit booms or intermittent fiscal expansion in a significant subset of countries, fast growth of demand and global trade can be consistent with a declining global wage share.

Chart 1.8 adds to the evidence presented above, completing the global picture, by comparing the growth of trade, bank lending and fiscal deficits. The average annual growth of trade during this period was 5.5 per cent. Only during three sub-periods did global trade experience a marked deceleration significantly below the average, or a contraction: the crisis of early 1990s affecting Japan, the United Kingdom, the United States and a few north European countries; the "dot-com" crisis in the United States in 2001; and the global financial crisis of 2008–2009.[29] The recent period since 2012 represents an unusual pattern and will be discussed further below. Periods of weak fiscal stances in the major deficit countries exerted a negative influence on global trade. Declining and low fiscal deficits preceded global trade decelerations. Also, periods of trade slowdown or contraction have coincided with sharp decelerations in the pace of (real) bank credit expansion in such (current account deficit) countries. Conversely, only after a relatively sustained period of fiscal expansion and credit creation, did trade growth resume a fast pace. In brief, along with a decline in the global wage share, the patterns of global trade responded to a significant degree to the interactions between fiscal stances and credit creation in major deficit economies.

3. *Summing up and implications for the global outlook*

The fast pace of global trade between the mid-1980s and the financial crisis was, in part, encouraged by an increased pace of trade liberalization, but it was also heavily dependent on a series of global macro-imbalances that eventually led to that crisis. The

drastic correction of bank lending in deficit countries which occurred with the global crisis of 2008–2009 led to a contraction and subsequent weak recovery of trade despite the rise of public sector deficits. The persistence of the most critical of imbalances, that relating to wage shares, however, shows why a recovery in trade is proving difficult. More precisely, as long as the global wage share continues to decline because of efforts to increase competitiveness, including by shifting production from high-cost to low-cost locations, global trade growth will rely on the accumulation of deficits by a subset of economies. For such patterns of trade growth to continue, however, either fiscal deficits or credit bubbles have to help revive domestic demand, and therefore imports, which otherwise would remain inadequate in the face of the continuing weak growth of household income.

The unsatisfactory growth of trade from 2012 onwards, which was left unexplained above, can thus be clarified. Chart 1.9 replicates the variables shown above in charts 1.7 and 1.8, in conjunction with a conditional five-year projection. Reviewing the historic period, the chart shows that recourse to either rising fiscal deficits or credit bubbles to compensate weak wage growth is proving increasingly difficult. In particular, fiscal deficits in the major current account deficit countries are, instead of rising, contracting from unprecedentedly high levels. In 2015 these were still higher than in most other periods, above 4 per cent of GDP on average. Policymakers in these countries and in most of the developed economies are not considering further fiscal expansion. Meanwhile, even if fiscal deficits have been quite high in recent years, bank credit expansion to the private sector, at about 2.5 per cent, remains weak in comparison with earlier periods. And this is despite extraordinary "quantitative easing" experiments by central banks. Businesses are not increasing spending and, rather, continue to earn profits through cost-optimization and financial operations (see chapter V of this *Report*). Households are not significantly taking on greater debt burdens (with the exception of the United Kingdom, where the housing bubble has rapidly recovered from the global crisis and credit demand has picked up). The slow growth of global trade under these circumstances is not an anomaly, but is perfectly consistent with the underlying structure of income generation, demand and policy choice.

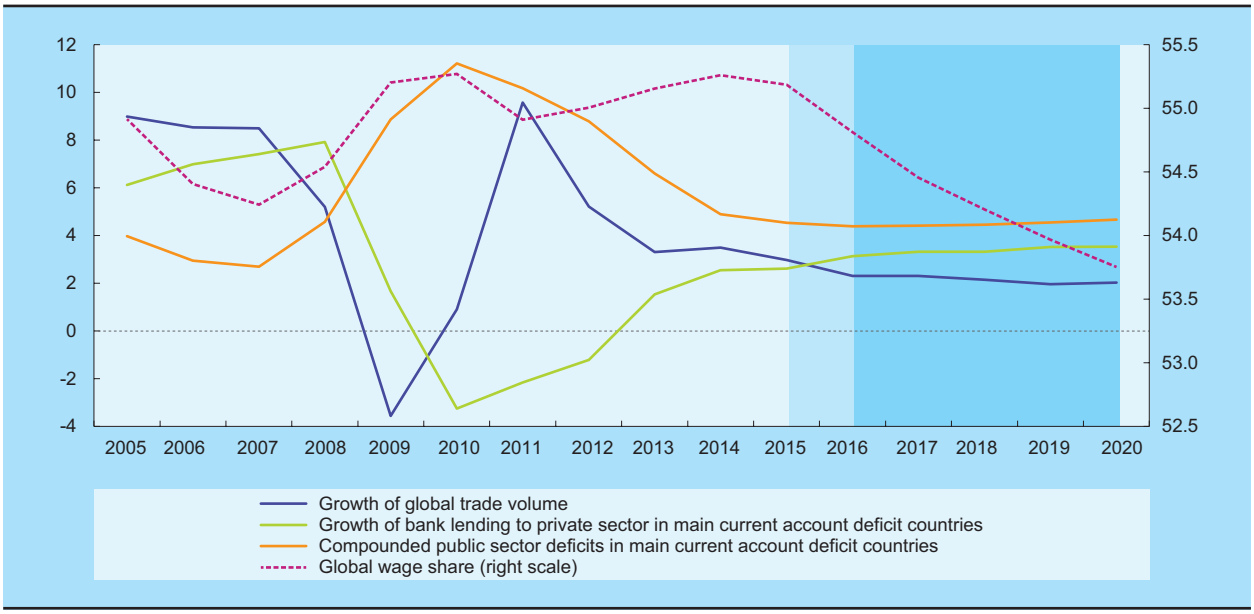
Chart 1.9 shows how the current configuration could play out over the course of a projection generated with the UN Global Policy Model.[30] The projection encompasses a vast set of conditions regarding the mid-term and is not in any way a forecast. In essence, it assumes that most developed economies, along with a few major developing economies, will press ahead moderately in their efforts at fiscal consolidation, even if this continues to weaken growth in demand and does not manage to improve the financial position of their public sectors, as tax revenues will also remain weak. Likewise, in the context of weak global demand, moves towards greater product-market and external liberalization will continue to constrain the growth of wage incomes, including through the spread of international production networks. Finally, even if monetary policy is expected to remain accommodative in most countries, effective credit creation for the private sector will continue to be sluggish. Under these circumstances, a conservative estimate is that during the coming years there will be a deterioration of the global wage share somewhat greater than 1 per cent of the projected global GDP. At the end of the five-year projection the wage share will reach a slightly lower level than in the pre-crisis period. The pace of bank credit expansion and the level of public sector deficits in the major current account deficit countries will remain around the current figures, with perhaps a slow acceleration of bank credit. The combination of these global conditions and patterns of the main current account deficit countries will not help trigger a revival of global trade, which may stay hovering around 2 per cent per annum.

In sum, under current structural conditions and policy stances, assuming that no significant changes in the direction of policies are implemented, trade growth will continue to be sluggish as the global wage share will continue to decline. Of course, a number of variations to this scenario are possible. Most notably, it remains plausible that surplus countries may increase spending in a way that will exert a positive net contribution to global demand. In this case the contributions to accelerate the pace of global trade will be from surplus countries and not from the countries now in deficit. What is more, such an acceleration of demand from surplus countries does not require credit bubbles, as the private sector in these countries enjoys large net financial surpluses. Similarly, such acceleration of domestic demand does not require that these surplus countries engage in excessively large public deficits, as at present they enjoy relatively well balanced fiscal positions. But for current surplus countries to succeed in exercising

Chart 1.9

CONDITIONAL PROJECTIONS OF GLOBAL TRADE GROWTH AND RELATED VARIABLES IN THE MAIN CURRENT ACCOUNT DEFICIT COUNTRIES, 2005–2020

(Per cent, two-year moving average)



Source: UN Global Policy Model; using historical data compiled from *UNCTADstat*, UNSD and IMF.
Note: Main current account deficit countries are Australia, Canada, the United Kingdom and the United States. Variables correspond to weighted averages. 2015–2016: preliminary; 2017–2020: conditional projections.

a meaningful contribution to the growth of global demand and trade, either the wage share or the public sector deficit has to increase ex-ante. This is equally true in other countries, and this seems to be a pre-condition to achieving faster growth of global trade and GDP from the current low levels.

This analysis suggests why trade and inequality have become closely associated in recent public discussions on globalization, but also why conventional policy proposals are inadequate to counter a dangerous backlash against closer economic integration. There are strong connections between the long-term deterioration of global wage shares and both the trade surge in the 1990s and 2000s and the slowdown of trade and economic activity since 2011. If these trends persist or worsen, then the threat of more determined protectionist responses could become real. However, like the boy who cried wolf in Aesop's fable, blaming protectionism for current trends runs the danger of not only distracting policymakers from making inclusive growth the axis of a globally coordinated programme but, as in the 1930s, of being ignored when a real protectionist threat emerges.

Notes

1 In an uncharacteristically harsh criticism of the IMF's role during the Greek crisis, the Independent Evaluation Office of the IMF criticized the IMF for having ignored the need for a standstill provision and for early and orderly debt restructuring, thereby contributing to the deepening of the country's debt and economic crisis (IMF/IEO, 2016).

2 Participation rate for men aged 20 or more fell from 72.7 per cent between 2000 and 2007 to 68.8 per cent in the first half of 2016; in the case of women aged 20 or more, the rate of participation declined from 57.8 to 55.6 per cent in the same period (United States Bureau of Labor Statistics).

3 Between 1973 and 2014, inflation-adjusted hourly compensation for the median worker rose by a total of 8.7 per cent, just 0.2 per cent per year. Conversely, net productivity (defined as the output of goods and services minus depreciation per hour worked) grew by a total of 72.2 per cent, or 1.3 per cent per year in the same period (Bivens and Mishel, 2015).

4 UNCTAD and WTO, 2016 news items: World trade weakens in first quarter as imports decline in Asia, 15 June 2016.

5 *World Metal Statistics Yearbook 2016* (World Bureau of Metal Statistics, 2016). See: *Got any copper to spare? Please send it to China*, Andy Home, Reuters, 23 February 2016; *China's first-quarter metal imports say more about supply than demand*, Andy Home, Reuters, 25 April 2016; and *China, India see oil imports grow, showing demand remains strong*, OPEC Bulletin 3/16.

6 See Hansen (2016) and Aelbrecht (2016).

7 See *China: A liquidity perspective on the onshore commodity boom*, JP Morgan Economic Research Note, 13 May 2016 and Citi (2016a).

8 International Energy Agency (IEA, 2016a); annual data for India from BP (2016).

9 Talks in April 2016 among leading world oil-producing countries, including some non-OPEC countries, failed to agree on a production freeze.

10 IEA (2016a) reports that by early May 2016 the number of active oil drilling rigs in the United States had fallen to a seven-year low of only 328, compared with 668 a year earlier and the peak of 1,600 in October 2014. Furthermore, upstream investment in oil is drying up as reflected in the expected fall in exploration and production capital (capex) expenditures of 17 per cent in 2016, after a reduction of 24 per cent in 2015. This would represent the first time that such investment has fallen for two consecutive years since 1986 (IEA, 2016b).

11 For a more detailed information on mine closures and production cuts by metal, see World Bank (2016), Citi (2016b) and HSBC (2016).

12 For more detail, see UNCTAD (2015a). Policy Brief No. 40, "When the Tide Goes Out: Capital Flows and Financial Shocks in Emerging Markets", 9 December 2015.

13 Overall capital flows include here net errors and omissions, which have been persistently negative since the second quarter 2014. This might be overestimating the size of net negative capital flows, because part of these errors and omissions may correspond to current account transactions. Without errors and omissions, the negative balance for capital flows was $525 billion in 2015.

14 It is noteworthy that, despite its intensity, the capital flow reversal of 2015 did not result in severe financial crises and collapses in GDP growth, as similar episodes had in the past. Greater resilience has resulted in levels of international reserves that remain relatively high in several developing economies and from managed (rather than fixed) exchange rate regimes, which have helped cushion the effect of capital outflows on individual economies through nominal adjustments (IMF, 2016). In particular, the country that experienced the largest negative net capital flows (China) is also the country with the largest international reserves.

15 Offshore renminbi accounts are opened by Chinese banks in jurisdictions outside mainland China (e.g. Hong Kong (China), Macao (China), Taiwan Province of China and Singapore) and available for non-residents wishing to constitute renminbi-denominated deposits. Thus, a reduction of such deposits accounts for a negative capital inflow.

16 Cross-correlations for net capital inflows (from non-residents) in 25 large emerging market countries averaged 60 per cent in the period 2005–2015.

17 UNCTAD secretariat calculations and McKinsey Global Institute (2015).

18 Stating that mounting protectionism cannot be blamed as the cause for slowing global trade does not logically imply that improving the international trade framework and rules would have no impact on global trade. For instance, advancing in multilateral trade negotiations (particularly in agriculture) or in some preferential trade agreements may benefit employment and income in developing countries, generating a demand stimulus that would also stimulate global trade.

19 See also Setser (2016), making similar observations based on country reports of the International Monetary Fund (IMF).

20 The empirical examination has been carried out for around 40 developing countries and China emerged as the only manufacturing exporter which showed an apparent lowering of imported manufacturing inputs for the exporting sector. A more specific study comparing the import-export structures of assembly operations between China and Mexico from the early 1980s to 2006, confirms that China's most noticeable improvement in value-added exports of manufactures took place between 2000 and 2006, while in Mexico processing zones did not manage to reduce import dependency at all during that period (see Shafaeddin and Pizarro, 2010).

21 Moreover, a more granular picture suggests that in several significant cases for the global volume of intra-industry trade, like the motor vehicles and the machinery subsectors, fragmentation (as measured by trade of intermediates over total trade) is on a somewhat increasing trend in recent years, rather than declining (UNCTAD, 2015c).

22 See Patnaik (2010), which explains the diffusion of activities by extending the Arthur Lewis model of "unlimited supply of labour" to a global scale. Core to this analysis are two observations. First, part of the labour creation mediated by MNEs is at the expense of shifting productive activities previously undertaken in the core countries. Thus, some of this is labour-displacing rather than labour-creating. Second, the combination of high productivity of the new jobs created in the developing country where the new activities are undertaken, with the increases in labour supply as workers from informal activities aim at accessing the new jobs, may not contribute to reduce labour reserves. Critically, for the pool of labour reserves to shrink, the growth of aggregate demand has to be significantly faster than the growth of labour productivity (see Taylor and Vos, 2002, for an analytical exposé).

23 The developing countries that managed to gain a significant share of world exports during this period are only a few in the East Asia region. For the sake of completeness other semi-industrialized economies in other regions (Africa, Latin America and South Asia) are included even if their export market shares are smaller than 2 per cent.

24 See, for example, Kozul-Wright (2007).

25 It should be clear from this discussion that "exporting more" but "earning less" does not refer to levels. Generally, over time, the levels of both exports and wage bills tend to increase but if export gains relative to the world grow faster than wage earnings relative to the world, the difference suggests a process of faster profit accumulation.

26 A few countries managed to introduce labour protection and wage protection policies and averted a fall of wage shares that would have resulted from the distributional adjustments after the crisis. Between 2010 and 2014 recoveries of the wage share were experienced in Argentina (equal to about 11 percentage points of GDP), Brazil (half of a percentage point of GDP), China (2 percentage points of GDP), Germany and South Africa (1 percentage point of GDP).

27 Under-consumption should be understood in the macroeconomic sense of a low share of consumption in national income, not in level terms. As Keynes (1936) puts it: "social practices and a distribution of wealth which result in a propensity to consume which is unduly low".

28 See Patnaik (2010).

29 The South-East Asian crisis of 1997–1998 did not contributed to a significant global trade slowdown and is therefore not considered here.

30 See Cripps and Izurieta (2014).

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