



TRADE AND DEVELOPMENT REPORT UPDATE

Tapering in a Time of Conflict

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A. Introduction

The global economy is, literally and metaphorically, staring down the barrel of a gun. Stopping the war in Ukraine, rebuilding its economy and delivering a lasting peace settlement must be the priorities. But the international community will also need to deal with the widespread economic damage that the conflict is already causing in many parts of the developing world; damage that will only intensify as the conflict persists. Recalling George Marshall's response to the challenges of an earlier post-conflict world, the truth of the matter is that for a significant number of countries, the financial requirements for the next few years are so much greater than their present ability to pay that substantial additional help will be needed to mitigate economic, social, and political deterioration of a very grave character.¹

The year 2022 already appeared to be one of decelerating and uneven growth. The unprecedented policy measures that helped economies around the world recover from the paralysis of the covid pandemic have been asymmetric in their effects and short-term in scope, adding new challenges to an already testing policy environment. As we argued in September 2021 (*TDR 2021*), a return to pre-2020 conditions should not be the goal of policymakers. It would diminish the hope of achieving more inclusive and sustained growth and undermine the task of building economic resilience in the era of climate change. The threat of repeating the policy mistakes of the past is, however, rising as the fallout from the conflict in Ukraine spreads beyond its borders.

The economic, financial and political reverberations from the war are unfolding at a turning point in global policy discussions, as the supportive public policy stance necessitated by the pandemic gives way to fiscal and monetary tightening. In the advanced economies, central banks are beginning to raise interest rates from historic lows and selling some of the assets they purchased during the decade of quantitative easing. Budgetary authorities, having issued large volumes of government debt during the pandemic, are turning their focus to reducing primary balances by raising taxes and cutting spending.

In the face of long-standing structural problems and new geopolitical risks, macroeconomic tightening in the North, along with a general weakening of multilateral rules and practices, is set to stymie growth across developing economies, particularly those that are closely integrated into the global financial system. This will not only endanger their fragile recovery, but also undermine their long-term development.

Already in the closing months of 2021, inflationary and exchange rate pressures began to trigger monetary tightening in a number of developing countries, with expenditure cuts anticipated in upcoming budgets. A likely effect of the conflict in Ukraine is an acceleration and widening of these measures, with the purpose of retaining volatile foreign capital.

Two immediate impacts of the war in Ukraine have been exchange rate instability and surging commodity prices, particularly for food and fuel. The added pressure of price increases is

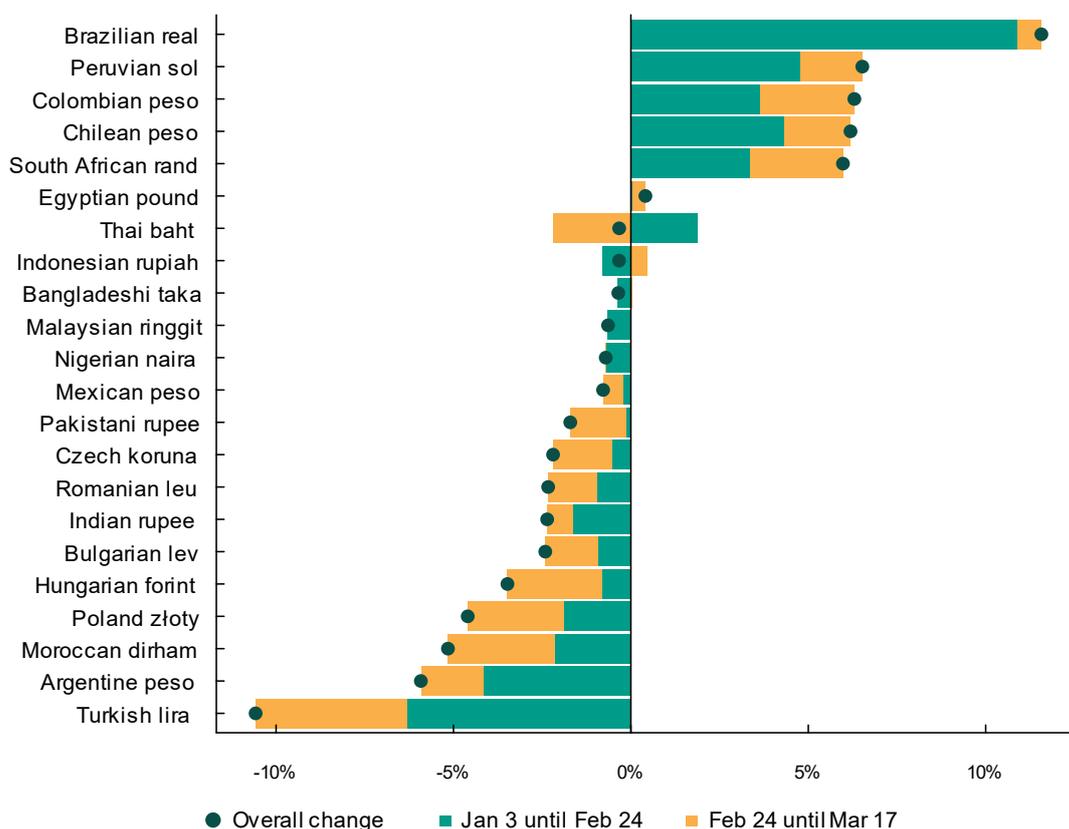
¹ The "Marshall Plan" speech at Harvard University, 5 June 1947, <https://www.oecd.org/general/themarshallplanspeechatharvarduniversity5june1947.htm>

intensifying calls for a policy response in advanced economies, including on the fiscal front, threatening a sharper than expected slowdown in growth.

The danger for many developing countries that are heavily reliant on food and fuel imports is more profound, as higher prices threaten livelihoods, discourage investment and raise the spectre of widening trade deficits. With elevated debt levels from the pandemic, sudden currency depreciation can quickly make debt service unsustainable and tip some countries into a downward spiral of insolvency, recession and arrested development. Whether this leads to unrest or not, a profound social malaise is already spreading.

As a result, the global economy, having entered 2022 on a “two-speed” recovery path, will not only shift down a gear in terms of growth, but will also see many developing countries lose ground to advanced countries, while their vulnerability to shocks is heightened by rising geopolitical tensions and deepening economic uncertainty.

Figure 1.1 Change in selected exchange rates against the dollar, early January–mid March 2022 (Per cent)



Source: UNCTAD secretariat calculations based on Refinitiv data.

Note: An increase refers to an appreciation of the domestic currency. Calculated using daily closing exchange rates. The rate for 17 March is calculated as the average of the closing rates for the three days from 15 March to 17 March.

As suggested in *TDR 2021*, the impressive growth of the world economy in 2021 notwithstanding, the post-pandemic world is looking increasingly fragile, with external shocks becoming more unpredictable and complex in nature. Even in peaceful times, unregulated and unbalanced

international financial markets have been the source of much of that fragility for many developing countries. At a time of international conflict and heightened geopolitical risks, finance is a central mechanism for transmission and amplification of these risks. While the immediate financial consequences of the war and sanctions on the Russian Federation have not immediately triggered an international financial crisis or contagion effects that would signal a crisis for emerging market economies, this cannot be discounted (Figure 1.1).

The risks to countries' financial systems are further amplified by the pressure to “rebuild fiscal buffers” by cutting non-military government spending. In fact, as discussed in previous *Trade and Development Reports*, attempts to create fiscal space through budget cuts are bound to backfire. Building resilience requires reinforcing aggregate demand through investment and social protection, in a framework of appropriate multilateral institutions.

The existing crisis management mechanisms of the global financial architecture leave the developing economies in a particularly vulnerable position. The liquidity stresses that are likely to emerge in these countries in the coming phase of post-pandemic reopening, international conflict and climate emergencies, will exceed the willingness of the Federal Reserve in its recently adopted role of unofficial lender-of-last resort. Globally, the issuance of \$650 billion of new SDRs in August 2021, of which around \$275 billion were allocated to developing economies was a welcome development, but well short of the amounts required.

In the current geopolitical context, given the ambiguous role of the Fed – pressed, on the one hand, by its national mandate and by its de facto global function, on the other – as well as coordination difficulties at the level of the IMF in times of complex crises, it is vital that governments agree to the establishment a rules-based system of multilateral policy-coordination in finance. Ad hoc, highly selective international initiatives, such as those that were deployed in 2008-09 and during the pandemic crises, cannot provide a reliable solution for all in the coming era of complex shocks that are global in impact.

As the war in Ukraine and its consequences have taken centre stage, the budding discussions on decarbonization and long-term development have been again put on hold. But the intertwining of finance, food and fuel shocks stemming from the war in Ukraine is likely to be a preview of what is in store in an overheating world. Indeed, as outlined in the latest report from the IPCC (2022), the threat from rising global temperatures is already causing serious economic damage and untold suffering across the developing world. Mitigating this threat will require a profound change in the way the multilateral order safeguards global economic resilience on the one hand, and its ability to develop new policy mechanisms to respond to increasingly complex external shocks, on the other.

B.1. Global macroeconomic outlook

Global growth prospects for 2022 will be affected by downside risks to both supply and demand, compounded by the war in Ukraine. On the supply side, persistent disruptions will continue to hamper economic activity. At the same time, macroeconomic tightening will weaken demand while rising prices will erode real incomes and dampen investor confidence. These pressures will only deepen the geographical, financial and socio-economic fractures that marked the recovery in 2021.

Table 1.1 World output growth, 2017–2022
(Annual percentage change)

	2017	2018	2019	2020	2021	TDR 2021 2022 ^a	Revised 2022 ^a	Rev. from TDR 2021 2022
World	3.4	3.2	2.6	-3.4	5.6	3.6	2.6	-1.0
Africa	3.3	3.5	2.8	-2.9	4.4	2.9	1.8	-1.1
North Africa (incl. South Sudan)	4.8	4.3	2.8	-4.7	6.4	3.1	2.2	-0.9
South Africa	1.2	1.5	0.1	-6.4	4.9	2.3	1.1	-1.2
Sub-Saharan Africa (excl. South Africa and South Sudan)	3.0	3.5	3.5	-1.1	3.2	2.9	1.8	-1.1
America	2.2	2.5	1.8	-4.3	5.7	2.9	2.4	-0.5
Latin America and the Caribbean	1.3	1.0	0.1	-7.2	6.2	2.6	2.3	-0.3
Central America (excl. Mexico) and Caribbean	3.1	3.1	2.3	-8.4	6.6	2.9	3.5	+0.6
Mexico	2.1	2.2	-0.2	-8.4	4.8	2.8	1.3	-1.6
South America	0.8	0.3	-0.2	-6.6	6.7	2.5	2.4	-0.1
of which:								
Argentina	2.8	-2.6	-2.0	-9.9	10.1	2.9	4.6	+1.7
Brazil	1.3	1.8	1.4	-4.1	4.6	1.8	1.3	-0.5
North America	2.4	2.9	2.3	-3.5	5.6	3.0	2.4	-0.6
of which:								
Canada	3.0	2.4	1.9	-5.2	4.6	2.9	3.0	+0.1
United States	2.3	2.9	2.3	-3.4	5.7	3.0	2.4	-0.6
Asia (excl. Cyprus)	5.1	4.7	3.8	-1.1	6.1	4.7	3.8	-0.9
Central Asia	4.5	4.8	5.1	-0.2	4.9	3.1	0.2	-2.9
East Asia	5.2	4.8	4.1	0.3	6.4	4.7	3.9	-0.8
of which:								
China	6.9	6.7	6.0	2.2	8.1	5.7	4.8	-0.9
Japan	1.7	0.6	-0.2	-4.5	1.6	2.1	2.0	-0.1
Republic of Korea	3.2	2.9	2.2	-0.9	4.0	2.8	1.7	-1.1
South Asia	6.2	5.4	3.3	-4.7	7.0	5.7	4.0	-1.7
of which:								
India	6.1	7.3	4.8	-7.0	8.3	6.7	4.6	-2.1
South-East Asia	5.3	5.1	4.4	-3.9	2.5	4.7	3.4	-1.3
of which:								
Indonesia	5.1	5.2	5.0	-2.1	3.7	4.9	4.4	-0.5
Western Asia (excl. Cyprus)	2.5	2.4	1.5	-3.5	6.0	3.2	3.4	+0.2
of which:								
Saudi Arabia	-0.7	2.5	0.3	-4.1	3.3	3.3	4.8	+1.5
Turkey	7.5	3.0	0.9	1.8	11.0	3.6	2.5	-1.2
Europe (incl. Cyprus)	2.6	2.1	1.8	-6.0	5.2	3.0	0.9	-2.1
of which:								
European Union (EU 27)	2.8	2.1	1.8	-6.0	4.9	3.3	1.6	-1.7
of which:								
Euro area	2.6	1.8	1.5	-6.4	5.0	3.4	1.7	-1.7
of which:								
France	2.3	1.8	1.8	-8.0	7.0	3.4	2.4	-1.0
Germany	2.7	1.1	1.1	-4.6	2.9	3.2	1.4	-1.8
Italy	1.7	0.9	0.4	-8.9	6.6	3.0	1.6	-1.4
Russian Federation	1.8	2.8	2.2	-2.7	4.7	2.3	-7.3	-9.6
United Kingdom	2.1	1.7	1.7	-9.4	7.5	2.1	1.3	-0.9
Oceania	2.7	2.9	2.1	-2.4	3.9	2.8	3.0	+0.2
of which:								
Australia	2.5	2.8	1.9	-2.5	4.6	2.8	3.3	+0.5
Memo items:								
Developed (M49, incl. Republic of Korea)	2.5	2.4	1.8	-4.5	5.0	2.9	1.8	-1.1
Developing (M49)	4.9	4.6	3.7	-1.7	6.7	4.7	3.7	-1.0

Source: UNCTAD secretariat calculations based on official data and estimates generated by United Nations Global Policy Model.

Note: Calculations for country aggregates are based on GDP at constant 2015 dollars.

a Forecasts.

Global growth in 2022 will, as a result, be slower, more uneven and more fragile than we expected in September 2021 (Table 1.1). Our estimates incorporate the two main new features of the world economic situation: the war in Ukraine and tightening macroeconomic policy in developed economies.

Before the outbreak of the war in Ukraine, global growth was already projected to slow in 2022, with the recovery from the pandemic shifting to more long-term rates, pandemic restrictions abating and supply pressures continuing.

The economic reverberations of the war have led to significant downward revisions to growth figures, as incomes are squeezed further by increased food and fuel prices, global trade is curtailed by sanctions, and confidence and financial instability issues re-emerge. As a result of the conflict, oil and gas prices have surged from already elevated levels, wheat prices have reached levels not seen since the late 2000s, and a wide range of other items including fertilizers, metals and manufacturing inputs are facing severe supply shortages.

As mentioned, the main advanced economies are in the process of reversing the stimuli enacted during the pandemic, by tightening policy rates, unwinding Central Bank asset purchases, and cutting furlough programmes, transfers and support to businesses and households. These shifts will dampen domestic economic activity and weaken global demand. By implication, economies in the Global South, which have incurred larger costs to cope with the pandemic, face additional constraints on demand and in the balance of payments at a time when their recovery is struggling to take off. The war in Ukraine compounds this situation, by adding restrictions on trade, financial risks and economic destruction.

Global growth, measured in constant United States dollars at market exchange rates, is expected to decelerate from 5.6 per cent in 2021 to 2.6 per cent in 2022. Of the 3-point drop, two percentage points are due to structural and policy factors pre-dating the war and one percentage point, amounting to approximately \$1 trillion in foregone income, is due to the war. This assumes that the sanctions and the supply chain disruptions will last through 2022, even if the war ends.

Hardly any country will be immune from the deterioration of global growth prospects, although a few may benefit from higher prices and demand for their commodity exports. Yet it is those developing economies that were in a precarious situation due to debt obligations, supply shocks and terms-of-trade and exchange rate swings, that will see their economic performance deteriorate even further.

The United States, while relatively isolated from current shocks, will see further pressure on consumption expenditure from higher fuel and food prices and may introduce a fiscal response in the form of fuel subsidies. Consumption expenditures in the United States have returned to pre-pandemic trends, but the inflationary pressures together with flagging confidence will impose a deceleration. Investment has recovered strongly since the pandemic compared to European countries but the new sources of instability will likely shift resources to safe asset allocations instead of productive ventures. These prospects will be made worse by monetary tightening. High energy prices are likely to stimulate some investment in extraction of hydrocarbons, likely crowding out any plans for a transition out of fossil fuels.

Europe will be harder hit by both high commodities prices and the conflict in Ukraine. Across Europe, higher food and fuel prices will constrain domestic expenditure, weakening aggregate

demand. The German economy is highly dependent on imports of natural gas from the Russian Federation, and on its own manufacturing exports which will be disrupted by sanctions and the war. Increased military expenditure will provide a moderate addition to aggregate demand. The French economy may be somewhat better prepared to weather the storm, given lower dependence on imported energy due to nuclear power, substantial food exports and the likelihood of some fiscal relaxation in response to the shocks. Pronouncements from the European Central Bank suggest that monetary tightening will proceed, further weakening consumption and investment growth.

Figure 1.2 Real gross domestic product, selected countries, first quarter 2019 to fourth quarter 2021
(Index numbers, Q1 2019 = 100)



Source: UNCTAD secretariat calculations based on Refinitiv data.

Eastern European and Central Asian economies too will be hit hard by the conflict. Higher food prices, falling remittances and large numbers of refugees will place these economies under strain. The picture for the region as a whole is mixed, with some economies directly or indirectly suffering severe losses from the conflict and trade restrictions (induced by sanctions or by inability to reach exporting hubs), and others being able to gain market access and at higher prices.

The Russian economy faces stringent external constraints imposed by the sanctions. While the Russian Federation is still exporting oil and gas, and will therefore see compensating increases of revenue due to high prices, sanctions severely limit the use of foreign exchange earnings for the purchase of imports or debt servicing. The Russian Federation will experience shortages of a wide range of imported goods, high inflation and a devalued currency. While the state will likely act to cushion the shock and limit unemployment and the fall of household incomes, its capacity is limited. Trade with China and some other partners will continue, but it will not be able to provide substitutes for the wide range of imported goods that the Russian Federation currently cannot access. Assuming the sanctions remain in place through 2022, even if the fighting in Ukraine ends, Russia will experience a severe recession (See Appendix A on Regional Trends for a fuller analysis).

Japan, already facing a weak recovery from the pandemic, and heavily dependent on energy and commodity imports, will be further constrained by high energy prices and disruption to export markets as a result of sanctions. The Chinese economy was expected to continue with their long-term adjustment towards higher household income and consumption spending, alongside slowing of other growth components. Yet, Chinese growth will not escape the effects of the supply shock, with high grain prices, disruption to exports and manufacturing and a resurgent pandemic, all contributing to lower growth. The authorities will be able to cushion negative external trends to an extent, through the usual channels of credit expansion and investment spending. Nonetheless, the earlier announced target of 5.5 per cent will challenge policymakers.

Other economies in Asia will experience headwinds resulting from the conflict. The Republic of Korea and other relatively strong economies of East Asia would have needed a sustained rebound of manufacturing and trade services to regain strong momentum, but these will be shaken by the gyrations of international trade resulting directly or indirectly from the war (including the milder growth prospects for China, Japan and Europe). On top of that, strains in access to primary commodities and energy will represent a shock, adding inflationary pressures and potentially tightening responses. Meanwhile, as some of the other economies in South and Western Asia may gain some benefits from fast growth of demand and prices of energy, they will be hampered by the adversities in primary commodity markets, especially food inflation, and will be further hit by inherent financial instabilities. India, in particular, will face restraints on several fronts: energy access and prices, primary commodity bottlenecks, reflexes from trade sanctions, food inflation, tightening policies and financial instability.

The picture is mixed in Latin American economies: consumption expenditures in Brazil, Argentina and Mexico remain below pre-pandemic levels, while Chile and Colombia have seen strong rebounds. Brazil, Argentina, Peru and Chile have seen strong recoveries in investment from the deep declines in 2020 and have benefitted from the sharp rebound of global commodity markets. But Brazil was already expecting a severe slowdown (with negative

growth in the second part of 2021) due to extreme tightening of monetary policy, and Argentina was expected to slow down, from a very rapid pace in 2021, under the weight of external debt pressures. At present, it is estimated that while Latin American growth figures will decline substantially from highs achieved during the pandemic rebound, the energy and commodity exporters of the group, which represents the bulk of regional output, will still see relatively strong growth compensations.

Economies of Africa will be affected in mixed ways, but growth expectations for 2022 of the region as a whole will be lower than estimated earlier in the year. The considerable weight of oil and gas exports of the region will stimulate growth through higher volume and prices, but commodities represent a mixed bag. Only few of the staples exported by Africa are likely to help circumvent the bottlenecks resulting from the conflict in Ukraine, but for the most part African economies are either food dependent or face supply bottlenecks of their own. And while minerals may see a rebound in prices and demand, some of these products face some investment and infrastructure bottlenecks. Overall, the global shock of commodities will imply a relatively negative shock for the region as a whole, especially through food prices and domestic consumption. On top of that, while the stresses resulting from a continuing pandemic in the region had earlier in the year started to draw some attention and policy gestures from advanced economies, these have unfortunately faded away in the context of the conflict.

Australia, New Zealand, Canada and other developed countries closely ‘allied’ with the United States and Europe in the current conflict will, on the one hand experience some of the headwinds that affect most of these countries (inflationary pressures leading to tightening policy responses, high international prices of commodities, supply shortages, etc.) but, on the other hand, will see some windfall gains through export markets of their commodities and energy products, which will trigger positive terms of trade effects on domestic spending (including government spending) and hence growth.

B.2. Policy tapering

In late 2021-early 2022, the shift to tighter macroeconomic policy in developed countries began. This turn was triggered by concerns for inflation, which rose sharply in many of these countries as economies reopened, driven by supply chain bottlenecks, the shifting composition of consumer demand and environmental degradation. Expectations that these effects would fade quickly were, unfortunately, not fulfilled.

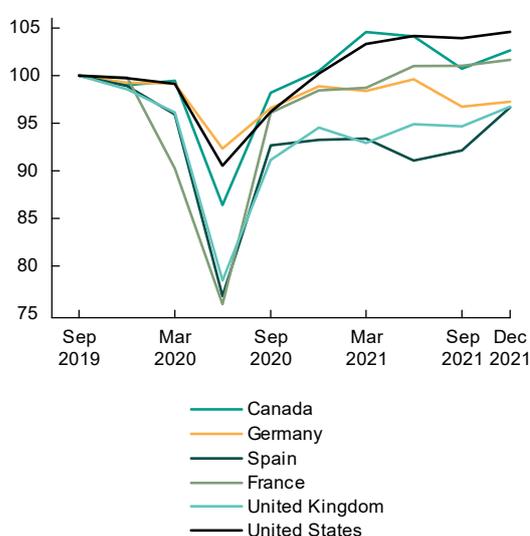
In the United States, consumer spending has returned to pre-pandemic trends, but with a significant switch to goods over services. Consumption expenditures in other rich nations have not recovered as strongly, likely reflecting less aggressive fiscal support measures. In Japan and many euro area countries, consumption expenditure remains below pre-pandemic levels. The picture is mixed in Latin American and Eastern European economies: consumption expenditures in Argentina, Brazil and Mexico remain below pre-pandemic levels, while Chile, Colombia and some Eastern European countries have seen consumption expand beyond pre-pandemic levels.

Investment expenditure has also recovered more strongly in the United States than in most of the euro area countries (Figure 2.1). Argentina, Brazil, Chile and Peru have also seen strong recoveries in investment from the deep declines in 2021, while other Latin American countries,

South Africa, and many Eastern European countries are experiencing weak or declining capital investment. Investment growth will be constrained further as fiscal support is withdrawn and economic activity slows down. Even for those developing economies where investment recovered strongly, trends may reverse over the course of 2022.

Relatively limited inflationary pressure in export-oriented Asian economies is likely to obviate calls for the policy tightening which is already happening in Latin American and African economies with higher inflation, particularly those economies which are dependent on commodity imports and external financing (the Republic of Korea is a partial exception). The

Figure 2.1 Gross fixed capital formation
(Index numbers, Q3 2019 = 100)



Source: UNCTAD secretariat calculations based on Refinitiv data.

resulting divergence in interest rates is likely to encourage carry trades and may add to the existing fragility in external financial positions. External constraints will likely grow tighter for many countries which are dependent on foreign exchange earnings to cover imports.

These constraints will be further tightened by dollar appreciation as the Fed hikes rates. Currency depreciation will increase the financing costs of debt denominated in foreign exchange. Even in the case of externally held debt issued in domestic currencies, depreciation places pressure on the balance sheets of overseas investors who fund their positions in United States dollars or other foreign currencies, raising the likelihood that positions will be unwound, or rollover costs

increased. As economies reopen and import demand recovers, global imbalances are likely to widen.

In this context, developing countries are in a particularly vulnerable position. The pandemic has led to a dramatic worsening of hunger and malnutrition (WHO, 2021). Rising prices of food and fuel will exacerbate the fall in real incomes for many. Poverty, which was only deepened during the pandemic with an estimated additional 80 million pushed into extreme poverty, has become an even bigger problem confronting most developing countries (World Bank, 2020).

The ability of developing countries to respond to these challenges is limited. Their policy space – already narrow due to balance of payments constraints – is being squeezed further by macroeconomic tightening in developed economies and the withdrawal of fiscal and monetary support. There are growing financial vulnerabilities: stocks of debt, particularly external debt, have risen in many developing economies, and deepening financial integration widens the socio-economic scope of the impact from the dynamics of the global financial cycle.

The war in Ukraine puts macroeconomic policymakers in developed economies in a conundrum. Higher inflation raises the pressure to tighten policy. Prior to the start of the conflict, the central banks of developed countries had been hawkish about the path of interest rates. Following the 25 basis point rise in interest rates on the 16 March 2022, the Federal Reserve is expected to raise rates to around 1.75 per cent over the next twelve months and up to 2.8 per cent in 2024.

Alongside rising policy rates, central banks have begun the process of unwinding the large increases in quantitative easing enacted during the pandemic. By lowering the cost of public borrowing, quantitative easing helped governments in high income countries to issue large amounts of debt, thus funding unprecedented fiscal deficits. As monetary support is withdrawn and interest rates rise, the governments of high-income countries are also shifting towards fiscal tightening.

It is not obvious, however, that tighter monetary and fiscal policies are the correct response to inflation driven by supply-side bottlenecks. In developed countries price controls and income support could help households cope with rising costs (see below). And while the shift to monetary tapering and contractionary fiscal policy in developed countries may turn out to be a policy error for them, it may have disastrous repercussions for developing countries if it triggers appreciation of the dollar.

In light of the dislocations caused by the war in Ukraine and the potential for financial disorder, central banks could still opt to postpone (or at least slow) tightening and instead, maintain or increase the provision of liquidity. A dual strategy of liquidity provision in the form of bond purchases, alongside higher interest rates, may emerge. It is also possible that we will see divergence in the policy stances of advanced economies with the United States, which is not directly affected by the conflict and is facing higher inflation than Europe, going ahead with tightening, and the European Central Bank keeping policy accommodative to offset the impact of the conflict.

Rate hikes in advanced economies, alongside disorderly movements in global financial markets, would be a devastating combination for developing economies. Volatility in commodity futures and bond markets alongside flights to safety would be reflected in higher risk premia on the financial liabilities of developing economies, in addition to the considerable pressures from rate hikes. Even in the absence of disorderly moves in financial markets, developing economies will face severe constraints on growth. During the pandemic, public and private debt stocks in developing countries have increased. Issues that receded from view during the pandemic, such as balance of payments constraints, high corporate leverage and rising household debt, will resurface as policy tightens.

While the outlook for lower- and middle-income economies has darkened substantially as a result of the enduring pandemic, the dynamics of the next phase of the economic recovery remain uncertain. Lessons from the experience of 2013 round of tapering point to a mixed picture: in 2013, the mere mention of monetary tapering by the Federal Reserve generated a major liquidity shock as investors withdrew funding from developing economies (Table 2.1). This put severe pressure on exchange rates, foreign reserves and funding costs.

Table 2.1 Average annual growth in developing regions, 2001–2008 and 2014–2019 (Per cent)

	Average annual growth 2001–2008	Average annual growth 2014–2019
Latin America and Caribbean	3.9	0.5
East Asia	5.8	4.8
South Asia	6.7	5.9
Western Asia	5.5	2.7
North Africa	5.4	2.8
Sub-Saharan Africa (excl. South Africa)	6.5	3.5

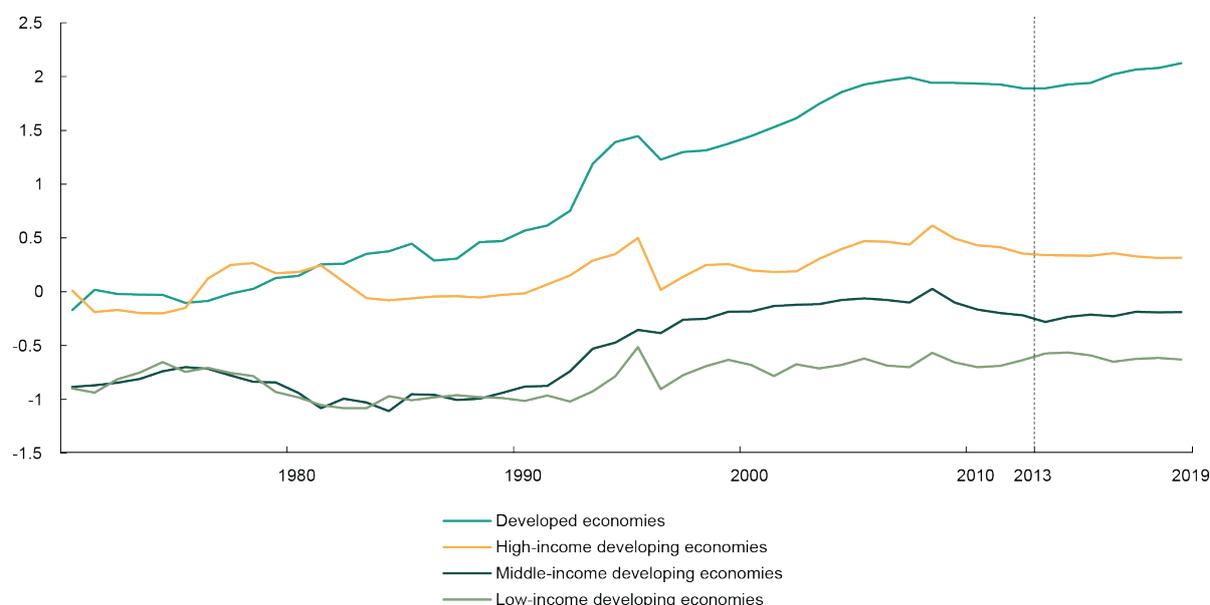
Source: UNCTAD, TDR 2021 table 1.1.

Today, the likelihood and timing of a similar episode in response to current policy tightening cannot be predicted with any confidence, given the role of volatile expectations, market sentiment and herd behaviour in such episodes. The ramifications of the conflict in Ukraine and sanctions imposed on the Russian economy further compound this uncertainty.

Today in many countries, current account deficits are smaller than in 2013, and thus external capital inflows, including volatile portfolio

inflows, appear to pose lower immediate risks. In several large developing economies, stocks of foreign exchange reserves have increased. Yet indicators such as current account positions and foreign reserves are limited in predicting vulnerability to short-run liquidity movements. Measures of financial integration provide a better gauge of potential exposures. On this measure, the picture is not substantially changed from 2013 – many large developing economies remain financially open and thus vulnerable to sudden reversals in financial flows (Figure 2.2).

Figure 2.2 Chinn-Ito financial openness by country income groups, 1970–2019



Source: UNCTAD secretariat calculations based on Chinn, Menzie D. and Hiro Ito (2006).

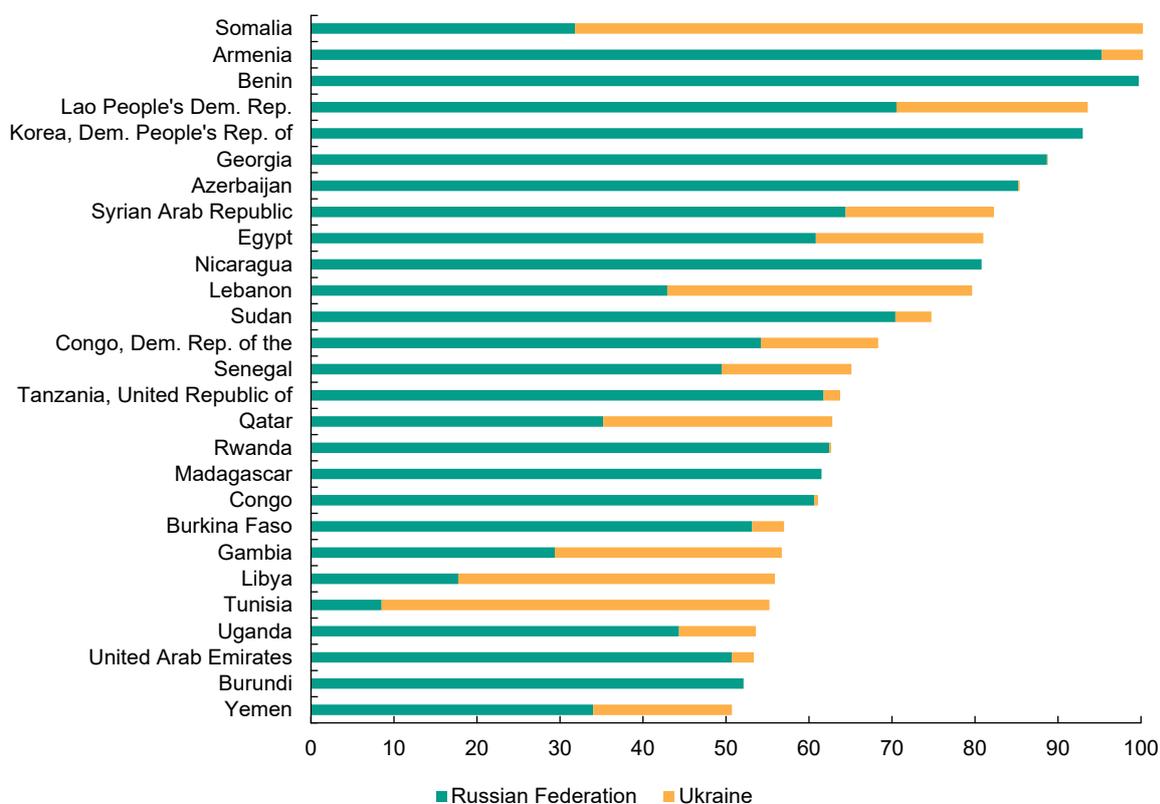
Note: Simple average of Chinn-Ito index for 36 developed economies, 48 high-income developing economies, 29 low-income developing economies and 48 middle-income developing economies.

Whether the coming period is characterized by volatile liquidity-driven cross-border financial flows, or by the slower grind of diminished policy space, fiscal and monetary tightening and squeezed incomes, it is people in the developing world who will be forced to take on a disproportionate share of the adjustment to the post-pandemic global economy. The crucial missing element from the international policy-making framework is a financial system that enables developing countries to invest for the long term, to introduce the changes needed to mitigate the enormous costs of climate change, and to avoid externally imposed austerity in response to dynamics in advanced economies and external shocks.

C. Trade

The war in Ukraine has caused immediate disruptions to global trade and is likely to have longer-term effects on its structure too. In the short-term, price effects and scarcity are spilling over onto economies more dependent on Ukrainian and Russian exports, especially of commodities, ranging from oil to minerals and food.

Figure 3.1 Wheat imports from the Russian Federation and Ukraine to selected developing countries (Per cent of total wheat imports)



Source: UNCTAD secretariat calculations based on UNCTADstat and FAOSTAT.

Note: Data refer to the 2018–2020 average for 'wheat (including spelt) and meslin, unmilled' product. The selection of developing countries is based on two criteria: (i) a ratio of net imports of wheat over domestic production exceeding 20 per cent; and (ii) a ratio of imports from the Russian Federation and Ukraine over the total imports of wheat exceeding 50 per cent.

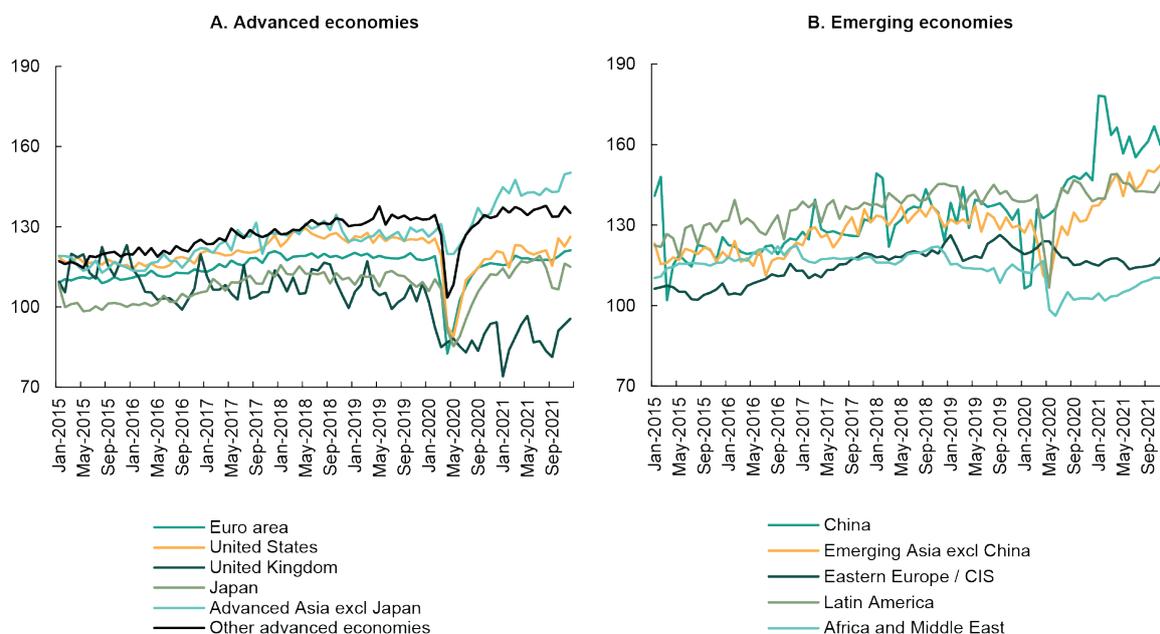
Preliminary data point to special vulnerabilities in Africa. In 2018–2020, Africa imported \$3.7 billion of Russian wheat (32 per cent of the total) and another \$1.4 billion from Ukraine (12 per cent). In the case of Least Developed Countries (LDCs) the corresponding imports were respectively \$1.4 billion (29 per cent of the total) and \$0.5 billion (10 per cent). The dependence of individual African and LDC countries on wheat imports from the Russian Federation and Ukraine is in many cases, far higher (Figure 3.1).

In the medium term, fear of ongoing geopolitical instability is likely to lead to reorganization of value chains to reduce dependency on imports from countries that may be subject to sanctions. As disruptions to value chains are being eased in the wake of the pandemic, calls have arisen for closer further trade integration across the Atlantic and the South Pacific. Some strategically important production processes, like military equipment, are likely to be ‘re-shored’.

In 2021, global trade of goods and services rebounded markedly and reached a record high of \$28.5 trillion, 13 per cent higher than its pre-pandemic peak. Greater merchandise trade volumes – as demand has shifted sharply from services (travel, leisure and entertainment) to durable goods since March 2020 – and higher unitary prices for some key commodities supported this outcome.

The dollar value of merchandise trade grew 26.5 per cent in 2021. Netting out the price effect, it is estimated that this segment of world trade grew 9 per cent in 2021 in real terms, after being almost flat in 2019 and contracting more than 5 per cent in 2020, putting it about 3 per cent higher than its pre-pandemic peak.

Figure 3.2 World merchandise exports, January 2015–Dec 2021
(Index numbers, average 2010 = 100)



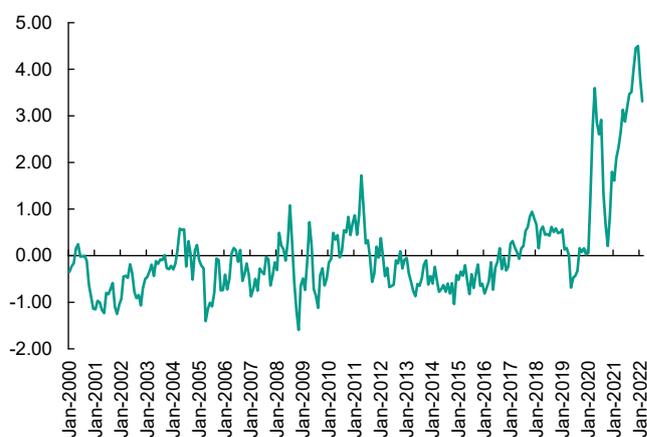
Source: CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor database.

Note: Country group classification relies on Ebrecht (2020).

Overall, the rebound of merchandise trade was broad-based, both in terms of products and exporting economies. Asian exporters led the recovery in terms of volumes since the region is skewed towards manufactured goods such as automobile, electronics, furniture and machinery. Meanwhile, large commodity-exporters benefitted from elevated export prices, though their volumes are little changed from their pre-pandemic levels (Figure 3.2).

By contrast, the value of trade in *services* remained slightly below its 2019 figure, though it rose about 17 per cent in 2021. The composition has, however, changed since the outbreak of the pandemic. Digitally deliverable services such as computer, financial and business services, together with air freight transport, have registered robust performances while other sectors like the ones relating to travel and tourism are still severely depressed.

Figure 3.3 Global Supply Chain Pressure Index (GSCPI), January 2000–January 2022
(Standard deviations from average value)



Source: Benigno et al. (2022).

Note: The index is normalized such that a zero indicates that the index is at its average value with positive values representing how many standard deviations the index are above this average value (and negative values representing the opposite).

Among the sectors that have more effectively navigated the Covid-19 pandemic, air cargo registered a stellar year in 2021, after it increased by 7 per cent compared to 2019 owing to cost advantages compared to the still-disrupted sea-container shipping.

The pandemic and the 2021 recovery created unprecedented challenges for international trade. Logistical disruptions of all kinds, semiconductor and electrical steel shortages and rising commodity prices led to broad-based shortages of products, delays in delivery and soaring shipping costs in the face of strong demand and health-related measures to contain the pandemic. At the time of publication, global supply

chain pressures remain high, and many observers believe that the ‘Great Supply Chain Disruption’ will continue in 2022, though the Global Supply Chain Pressure Index,² albeit still extremely high, suggests that pressures may have begun to moderate (Figure 3.3).

Business surveys also suggest that supply chain difficulties have somewhat eased at the beginning of 2022 even though a return to normal will take time.³ Overall, this situation could well have long-term repercussions as large firms consider shortening their supply chains and diversifying away from current suppliers. The war and the rising geopolitical tension compounds this situation as many supply chains take on renewed strategic-military roles.

² See Benigno et al. (2022).

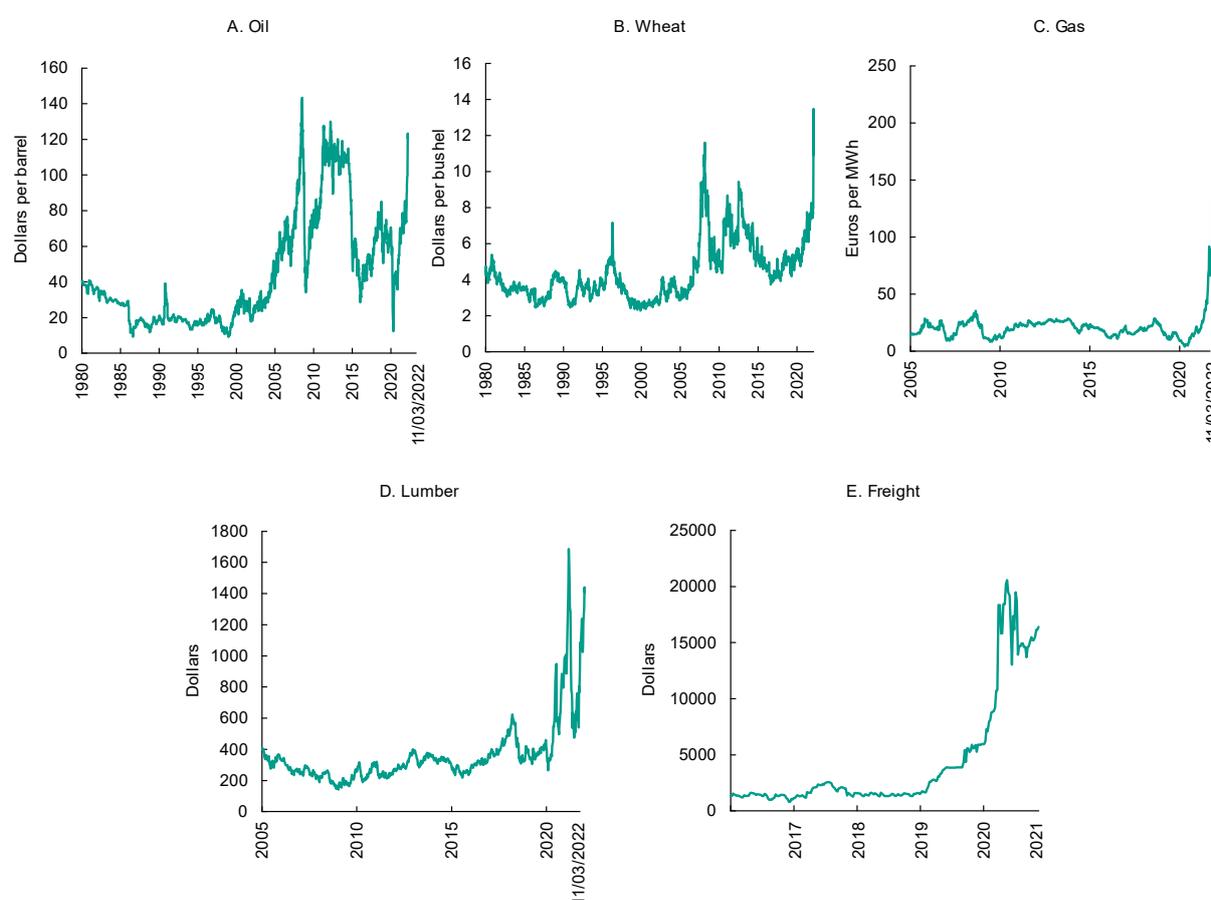
³ IHS Markit. Why the Great Supply Chain Disruption Will Continue in 2022. News Release. 20 January 2022.

D. Supply shocks, conflict and inflation

1. The return of high inflation

As consumer price inflation moved sharply up from the mid-2021 onwards in the United States and elsewhere, debate has continued over its causes, likely duration, and the appropriate policy response. The debate has entered a new phase with the added set of price shocks from the war in Ukraine.

Figure 4.1 Commodities and shipping prices, 1980–2022



Source: UNCTAD secretariat calculations based on Refinitiv data.

Note: Weekly data. The indicator for oil refers to Brent crude; the one for wheat to the price of CBOT Composite; the one for Gas to gas in the European market; the one for lumber to the price of CME Random Length Lumber; the one for shipping to Freightos Container Index China/East Asia To North America West Coast.

On the supply side, a range of factors have combined to produce shortages and bottlenecks. Global production and distribution were unable to adjust rapidly to the sudden surge in expenditure, particularly for durable goods, as economies reopened. Supplies of energy and raw materials, such as timber and metals, were unable to keep up with surging demand, and saw sharp price increases towards the end of 2021. Global energy supplies were placed under pressure by

high demand in Asia, shortfalls of natural gas and reduced wind generation. War in Ukraine has pushed some energy prices to ten-year highs along with the prices of some key commodities such as wheat and corn. Global freight transport saw severe bottlenecks, with prices of container shipping rising to record highs. Commodities prices have moderated somewhat since the start of the conflict but remain substantially above pre-conflict levels (Figure 4.1).

Although raw materials supply and shipping recovered quickly, effects further down the supply chain were more persistent: the long-standing trend toward inventory reduction made supply chains more vulnerable, while fears of shortages led to hoarding of inputs in short supply.

Bottlenecks and supply shortages are caused not only by supply-side issues: demand has played an important role, driven in, particular, by the shift in consumption from services to goods. Driven by direct cash transfers, demand for goods rose sharply in the United States, exceeding previous trends and spilling over onto global value chains. Production of key manufacturing intermediate inputs such as semiconductors remained relatively constant during the pandemic, but was unable to keep pace with surging demand for microchips in the production of vehicles and consumer goods.

Also on the demand side, some have pointed to the unprecedented rise in fiscal deficits during the pandemic, and rapid expansion of household savings and monetary aggregates in developed countries as drivers of spending. While fiscal measures effectively supported incomes for populations under lockdowns and pandemic restrictions, with the exception of the United States, these did not lead to substantial increases in demand relative to pre-pandemic supply. Prior to the outbreak of the war in Ukraine, it was expected that as supply adjusted, price pressures would abate over the course of 2022.

Claims that excess growth in household savings and monetary aggregates are driving inflation are not compelling either. Accumulation of cash balances in developed economies during the pandemic is a reflection of the unequal distribution of income and work-related risks as those in professional jobs were able to shift to working from home, while lower-paid workers in sectors such as hospitality and personal services were faced with business closures and furlough schemes. With hospitality sectors closed, those with protected incomes accumulated savings, while those on lower incomes dis-saved.

Attempts to resurrect monetarist narratives about inflation driven by increases in the money supply are not coherent. The issuance of large liabilities by the public sector in developed countries was driven by the government deficits required to respond to the pandemic. Central bank support in the form of bond purchase programmes converted these liabilities from bonds paying very low nominal rates of interest into bank deposits paying zero interest. The mix between low yield debt and zero yield deposits in the hands of the private sector may affect spending decisions marginally, but at most this will account for a small fraction of current inflationary pressures.

The suggestion of an incipient wage-price spiral also lacks clear evidence. More hawkish analysts point to record quit rates and widespread shortages of workers across a range of sectors in rich countries. However, employment to prime age population ratios remain well below pre-pandemic levels, suggesting substantial potential slack in labour forces. Beyond the current period of post-pandemic upheaval, it is likely that unemployment rates will rise across much of Europe and the United States by the end of 2022. There is little compelling evidence of wage pressures in rich countries. In much of the euro area nominal pay increases are running at

around 2 per cent. In Italy and Japan, the figure is below 1 per cent. In the United Kingdom, wage growth is higher, at around 5 per cent, but this comes after a decade of falling real wages; profits margins are largely unchanged since before the pandemic. Finally, in the United States, where household incomes have not taken the hit seen elsewhere and inflation is rising more rapidly, nominal wage increases are running at around 5 per cent.⁴ It seems more likely that a greater part of the increase in consumer prices since 2019 can be attributed to corporations raising their mark-ups to effectively protect the higher profits that have become a hallmark of the current era rather than to wage costs per se.⁵

For many developing countries, currency devaluation against the dollar is an important driver of inflation: domestic currency depreciation raises the domestic price of imported goods and therefore headline inflation measures. As the Fed and other central banks in developed countries central banks tighten, the currencies of developing countries are likely to devalue further. Policy tightening in the North, in response to supply-side bottlenecks, thus worsens the problem of rising prices in developing countries.

2. How to respond?

Many developing economies have already raised interest rates from the lows reached during the pandemic (Figure 4.2). Policy rates in Brazil, Chile and Paraguay have risen by at least five percentage points and many countries in Eastern Europe and Western Asia have introduced significant rate hikes. Even in those developing countries that have not raised rates during the pandemic, policy rates are substantially higher than in developed countries.

High and rising interest rates are justified by policymakers as a response to inflation. But for developing economies with open financial markets an important implication of rate hikes is offering higher financial returns than advanced economies. As policy tightens in these countries, policy makers in developing economies will be placed under pressure to tighten domestic policy in an attempt to prevent capital outflow.

Policy options for responding to current inflation can be divided into three main categories. Some advocates of orthodox inflation targeting argue that the imbalance between supply and demand as a result of pandemic reopening will persist for sufficiently long that inflationary expectations become embedded or “unanchored” and risk triggering a wage-price spiral. Monetary policy should therefore be tightened rapidly to tame expectations and wage demands and avoid the need for more aggressive action in the future. There is little evidence to support this view. The claim that expectations drive inflation is driven more by the needs of mathematical modelling than by evidence.

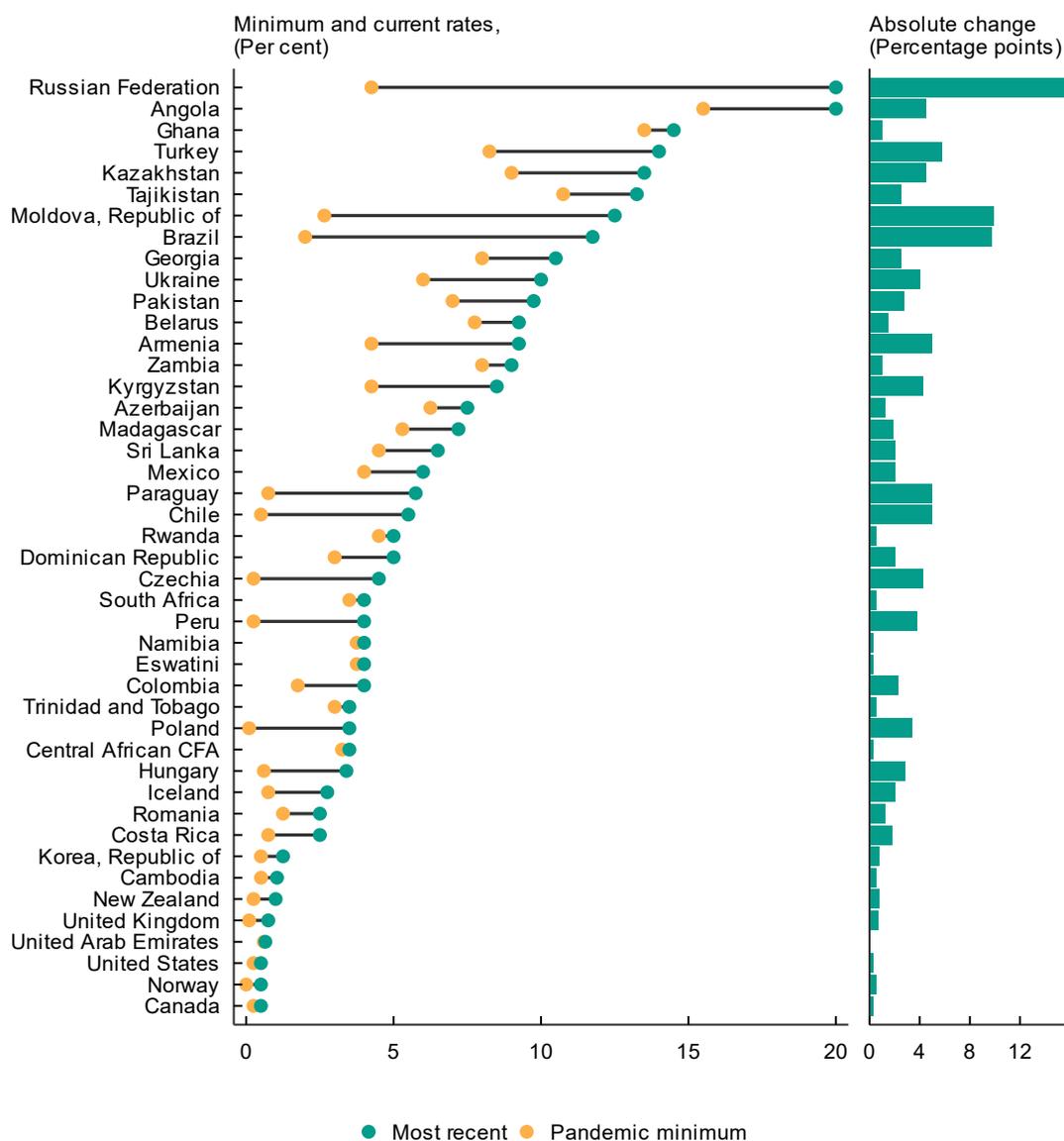
The second possible response is advocated by those who favour orthodox inflation targeting but who regard inflation as driven by transitory supply-side factors. This was the dominant view in central banking circles until the recent shift to a more hawkish stance. The problem

⁴ *The Economist* (2022). “Labour v capital in the post-lockdown economy”, 19 February.

⁵ *The Economist* (2021). “How America Inc is coping with rising inflation”, 12 June.

with this “wait and see” approach is that it offers nothing to support those who face lower real incomes as a result of rising food and fuel prices.

Figure 4.2 Policy interest rates
(Pandemic minimum and current rates)



Source: UNCTAD secretariat calculations based on Refinitiv data.

Note: Policy rates as of 17 March 2022.

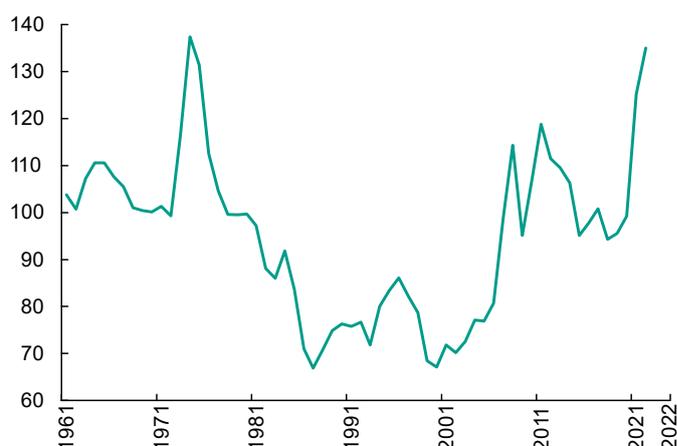
The third approach is to recognize that interest rates are not the appropriate tool to use in response to sharp supply-side shocks. Higher interest rates will reduce the real incomes of those on variable rate mortgages, and raise borrowing costs for firms, particularly smaller firms with lower profit margins. In order to generate significant reductions in total expenditure in developed countries, monetary policy would likely need to be tightened sufficiently that an

economic “hard landing” results. As described above, the costs of this outcome would be borne mostly by lower income households in rich countries and possibly in developing countries

The appropriate response is, instead, to use fiscal and administrative tools to manage the distributional impact of higher costs of essential goods and commodities. Policy makers should recognize that, particularly in situations of extreme stress such as the current moment, the basic consumption needs outweigh the importance of what is, ultimately, an arbitrary price target. Consumer price inflation indices can and should be allowed to remain historically high for the short term, while policy tools should be deployed to minimize the costs to the most vulnerable.

In real terms, the FAO food price index reached levels in early 2022 which have only been surpassed in the aftermath of the 1973 oil shock (Figure 4.3). Cereals, including maize and wheat jumped sharply in the last year, and have moved higher again as a result of war in Ukraine: together, the Russian Federation and Ukraine account for over a quarter of global wheat exports, on which many countries in Africa and the Middle East are heavily dependent. Natural gas and oil prices have increased. In both rich countries and lower and middle-income countries, it is entirely reasonable to use a combination of price caps, quotas and subsidies to assist with the provision of basic needs.

Figure 4.3 FAO real food price index, 1961–2022
(Index numbers, average 2014–2016 = 100)



Source: Food and Agriculture Organization (FAO).

Note: The Food and Agriculture Organization annual average for 2022 is based on monthly data for January and February only.

Price controls are already widely used in many developing countries, particularly low-income countries, on food and fuels. Many advanced economies implement price caps on a range of items, particularly utilities and energy. While such interventions cannot mitigate supply-side shortages and falling real incomes, they can affect the distribution of costs among the population so those better able to afford reductions in income and consumption take a greater share of the burden.

Over the longer run, the only effective response to recurrent supply-side shortages driven by increasingly frequent climate-related disasters such as droughts, floods and wildfires is to substantially raise investment in climate mitigation and

adaptation. As discussed in previous Reports, this will require fundamental restructuring of the international financial system to enable developing countries to devote significant resources to long-run investment in infrastructure, clean energy and technological upgrading.

E. Developing countries: common constraints, different vulnerabilities

1. The fiscal squeeze in developing countries

In most developing countries, fiscal support in response to the pandemic amounted to a substantially lower proportion of GDP than in developed countries. Still, developing countries are now facing the prospect of global macroeconomic tightening in a particularly perilous position, given substantial debt vulnerabilities. Many support schemes introduced during the pandemic will be withdrawn just as rising food and fuel costs consume household budgets and new pressures from the conflict in Ukraine arise, including on exchange rates and balance of payments.

The pandemic capped a decade of growing external debt in developing countries: external debt almost doubled from \$6.5 trillion to \$11.7 trillion between 2011 and 2020, rising from 41 to 69.5 per cent of GDP.⁶ In 2020 alone, external debt increased by \$678 billion and developing countries transferred almost \$1 trillion in debt servicing to external creditors.⁷ In combination with GDP declines and weak exports from developing countries, this accounted for an increase of the aggregate external debt to GDP ratio of developing countries from 57.4 to 69.5 per cent, and of the external debt to exports ratio from 176.2 to 252.6 in 2020.⁸

These aggregate figures mostly relate to high-income developing countries, since these countries accounted for 78 per cent of the developing countries' total external debt in 2020. Yet, this sharp increase took place across the board. The group of low-income countries, for instance, experienced the sharpest relative increase between 2011 and 2020, as their external debt more than doubled during this period, to reach 44 per cent of GDP in 2020. Meanwhile, middle-income countries' external debt reached 64 per cent of their aggregate GDP.

Developing countries' capacity to service their external debt deteriorated during the first year of the pandemic. The external-debt-to-export ratio increased in 121 out of 127 developing countries for which data exist between 2019 and 2020, while in 51 countries this indicator stood above 250 percent in 2020, which lies above the risk threshold of 240 per cent used by the IMF for the low-income countries in its Debt Sustainability Framework (DSF).

Default episodes have so far remained confined to four countries.⁹ This can be explained by a favourable turn in external conditions following the sharp deterioration in the early months of the pandemic, with a rapid rebound of exports, high commodity prices and renewed access to

⁶ UNCTAD secretariat calculations based on UNCTAD country classification.

⁷ Debt service payments to external creditors from developing countries excluding China and Singapore totaled \$944 billion. This total rises to \$1.8 trillion if China and Singapore are included.

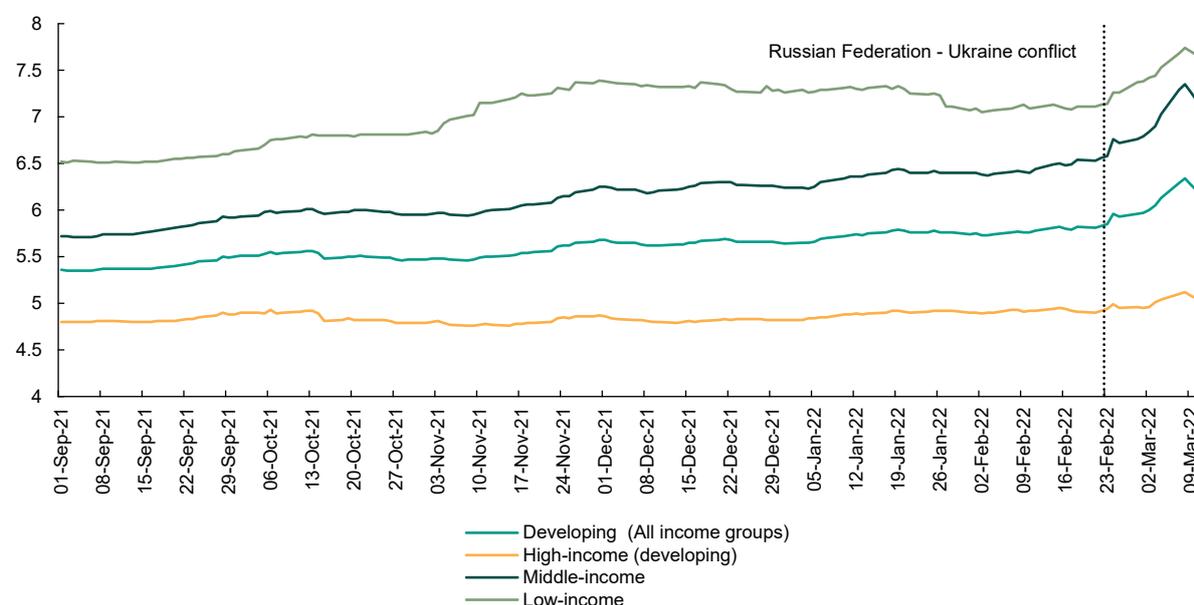
⁸ These ratios are driven partly by the slowdowns or falls in GDP and exports in 2020. The sharp deterioration in the debt to exports ratio is partially explained by a small number of outliers. This group includes two countries in debt distress (Lebanon and Bolivarian Republic of Venezuela), five Small Island Developing States (SIDS) (Cabo Verde, Mauritius, Sao Tome and Principe, Jamaica and Samoa) and three low-income countries (Nepal, Sierra Leone and Gambia). These countries experienced the largest deterioration in the debt to exports ratio amongst developing countries due to a substantial reduction of exports. Excluding this group, the average debt to exports ratio of developing countries reached 211.4 per cent in 2020.

⁹ This group includes two countries which defaulted before 2020 (Bolivarian Republic of Venezuela and Lebanon) and two countries with defaults in the aftermath of Covid-19 (Suriname and Zambia).

global capital markets (*TDR 2021*). Available data point to a decline in debt to exports ratios.¹⁰ However, the combination of geopolitical and financial instability along with the slowdown of growth in developed economies may set this process in reverse starting in 2022.

Data for private sector external debt is limited but, where available, these data suggest that a high proportion of private debt in total external debt is found in a relatively small group of mostly high-income and middle-income developing countries.¹¹ While the average proportion of private debt in total external debt was 25.9 per cent for those developing countries where data are available, for 10 countries this ratio exceeds 50 per cent in 2010.¹² Narrowing the focus to countries with both a high share of private sector debt and leverage reduces this group to four: Chile, Kazakhstan, Mongolia and Zambia.

Figure 5.1 Sovereign bond yield in developing countries by income classification, 1 September 2021–11 March 2022 (Per cent)



Source: UNCTAD secretariat calculations based on Refinitiv.

Note: Data for 524 sovereign bonds issued by 68 countries classified as developing countries by UNCTAD. The bonds covered are denominated in either dollars or euro and under New York and England law with maturities set after 1 March 2022. The average yield is estimated as the simple average of bonds per country (at the country level) and income groups (yield by country).

Timing also matters: even countries with low levels of external private leverage may face trouble in the event of a shock which prevents firms from rolling over debts. For at least 10 countries, projected rollover and interest payments in 2022 represent more than a quarter of their total stock of debt.¹³ Countries in which the private sector could be particularly vulnerable are those with a large debt service to export ratio, including Kazakhstan, Mongolia, and Zambia.

¹⁰ For an overview of the rapid recovery of exports in developing countries see, UNCTAD (2022). *Global Trade Update - February 2022*.

¹¹ The stock of external debt is separated in four components: short-term debt; use of IMF credits; long-term debt stocks of the private sector; and public and publicly guaranteed debt. See World Bank (2021).

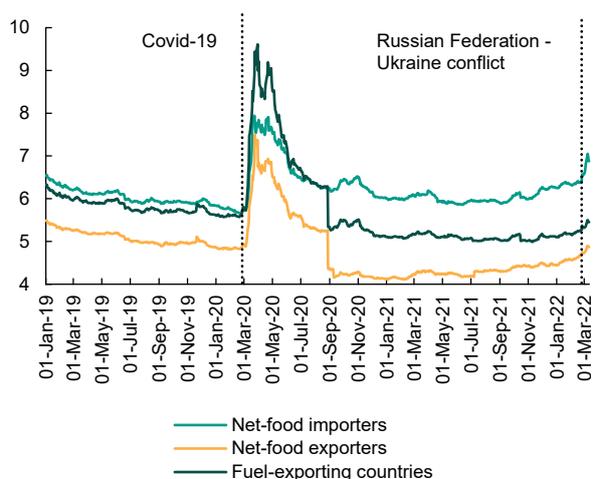
¹² These countries are Brazil, Chile, Kazakhstan, Malaysia, Mongolia, Mauritius, Republic of Korea, Solomon Islands, Papua New Guinea and Zambia.

¹³ This group includes Botswana, Cameroon, Congo, Egypt, Guyana, Lebanon, Maldives, Myanmar, Nepal and Pakistan.

Public sector external debt vulnerabilities are substantial, especially in low-income countries. The average proportion of public and publicly guaranteed (PPG) debt in the external debt of developing countries was 64.4 per cent in 2020. This figure increases to 76.2 per cent in the case of low-income countries. High and middle-income developing countries with substantial nominal amounts of debt in combination with a large share of PPG and a high degree of external leverage relative to exports include, amongst others, Pakistan, Sri Lanka, Egypt, Angola and Colombia.

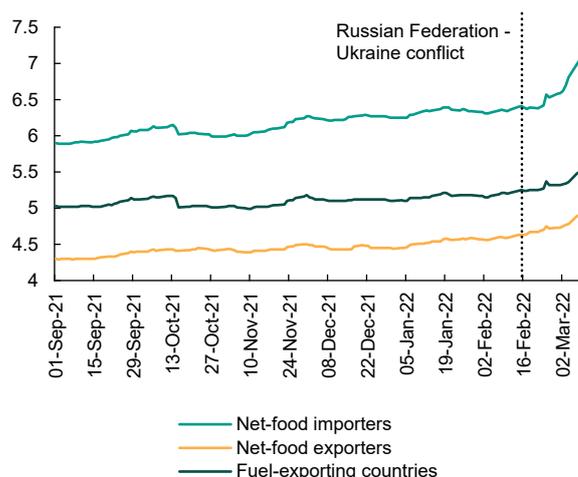
Short-term PPG debt servicing needs are concerning (Figure 5.1). Developing countries are projected to require \$310 billion to meet external public debt service requirements in 2022 – equivalent to 9.2 per cent of the outstanding stock of external public debt at the end of 2020. Countries which appear vulnerable to a sudden stop due to a combination of large rollover pressures and a large debt service to export ratio include Pakistan, Mongolia, Sri Lanka,¹⁴ Egypt and Angola. Three of these, Pakistan, Egypt and Angola, already have long-term IMF programme in place.

Figure 5.2 Sovereign bond yield in developing countries by trade group classification, 1 January 2019–11 March 2022 (Per cent)



Source: UNCTAD secretariat calculations based on Refinitiv.
Note: See Figure 5.1.

Figure 5.3 Sovereign bond yield in developing countries by trade group classification, 1 September 2021–11 March 2022 (Per cent)



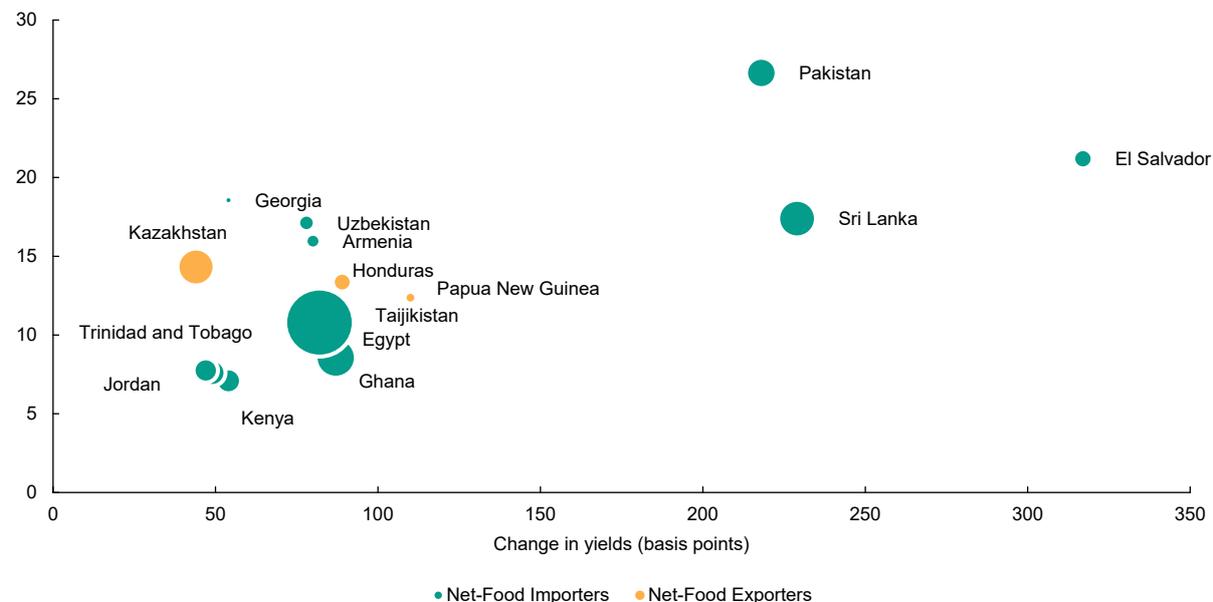
Source: UNCTAD secretariat calculations based on Refinitiv.
Note: See Figure 5.1.

Developing country bond yields have been on the rise since September 2021 (Figures 5.2 and 5.3). The increase is widespread and is a clear signal of tighter financial conditions. Since the breakout of the conflict in Ukraine yields have further increased for developing countries by 36 basis points, on average, with countries heavily dependent on food imports experiencing higher increases (Figure 5.4).

¹⁴ In March 2022, facing fiscal crisis, Sri Lanka's Central Bank floated the national currency, which led to its devaluation by 36 per cent and a further sharp rise in prices.

A total of 104 countries are net food importers. These countries had a total of \$1.4 trillion in external public debt at the end of 2020 and they face \$153 billion in projected debt service payments in 2022, which can be jeopardized if international food prices continue to rise.

Figure 5.4 Developing countries with the highest increase in bond yields, absolute and relative changes since 23 February 2022 (Per cent)



Source: UNCTAD secretariat calculations based on Refinitiv.

Note: Size of the bubble denotes the outstanding nominal value of sovereign bonds in dollars. The change in yields is measured over the period from 22 February 2022 to 11 March 2022.

Box 1 Unequal access to international finance

Bond market size

As states across the world resorted to increased bond issuance in response to the pandemic, terms differed greatly for developed and developing countries. Between January 2020 to February 2021, the yields on developed countries government bonds hovered between -0.5 per cent and 1 per cent while for developing countries they ranged from China's 3.2 per cent to over 15 per cent for smaller economies.¹⁵

Important factors in these disparities are the size and depth of stock and bond markets in different countries and regions, that is the amount of securities that are issued and traded in each country. Countries with smaller and shallower markets can be more easily hit by capital flight or deliberate speculative attacks. But large and deep financial markets are no insurance against disastrous market swings, as shown by the 1997 crisis in Asia and the 2008–2012 crises in the United States and Europe.

Difference in currency strength is another critical factor, which compounds market depth. Few currency areas host large enough securities markets as to give them a substantive presence in the global financial landscape alongside the dollar. These include the euro, yen, pound sterling areas but most other currency areas as measured from this standpoint shrink to fragments.

These asymmetries have a bearing on the costs of financing for corporations and states although the major determinants of these costs may well relate to risk factors specific to borrowing organizations.

United States securities markets are by far the largest and deepest in the world, and as such they are highly attractive to portfolio investors. Not only is there an abundance of securities in which to park their funds, but also a wide choice of securities with different risk, return and structuring characteristics. Investors' appetite for securities of the United States keeps their returns down: they will earn no currency risk premium; low credit risk premiums; low liquidity risk premiums (due to the depth of the United States securities markets); and a low sovereign risk premium.

In contrast, investors require higher returns from assets located in smaller markets, especially if denominated in peripheral currencies.

The events in the markets in March 2020 illustrated the degree to which international portfolio flows enforce the inverse correlation between regional market size and financing costs. Portfolio investors withdrew funds from developing countries' equities and bonds on a scale and with a speed without recent historical precedent. These funds were redirected to the safety of developed country government securities, the chief beneficiary being the United States government. When in the course of 2020 the United States outstanding treasury bonds increased by approximately \$4 trillion, yields fell precipitously also thanks to demand from outside the United States.¹⁶

¹⁵ International Capital Market Association, ICMA (2021). Covid-19 Market Update, June.

¹⁶ SIFMA (2021). Capital Markets Fact Book, July.

2. A new liquidity shock?

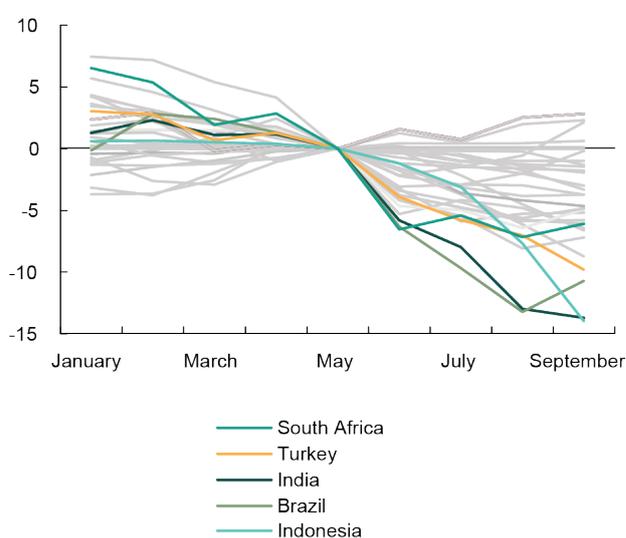
As the consequences of tapering and the conflict in Ukraine unfold, a key question is whether they will lead to a ‘tantrum’ of the kind seen in 2013. The consequences for developing country governments would be severely damaging.

Heavy portfolio inflows into the United States attracted by Federal Reserve tightening would strengthen the dollar, making it extremely difficult for non-bank corporations in developing economies to service their dollar-denominated bonds (these instruments having become one of the preferred forms of developing countries corporate financing since the financial crisis of 2007-8). This would leave developing economy central banks in a dilemma. On the one hand, if they do not tighten monetary policy to prevent currency depreciation against the dollar, this depreciation would seriously harm their heavily dollar-indebted corporations. On the other hand, if they do tighten this will threaten the already fragile post-covid recovery.

I. The 2013 taper tantrum

Central banks in advanced economies responded to the 2008 financial crisis with multiple rounds of quantitative easing, as interest rates fell to their effective lower bound. Large increases in financial flows, especially portfolio flows, to developing countries are widely accepted to be major consequence of the policy.¹⁷ These effects can work in both directions,

Figure 5.5 Emerging market exchange rates during the taper tantrum, 2013
(Change in dollar exchange rate, per cent)



Source: UNCTAD secretariat calculation based on IMF data.

with a variety of potential negative spillovers resulting from the withdrawal of unconventional policy. The first major example was the ‘taper tantrum’ of 2013, triggered by a statement made to the Joint Economic Committee of the United States Congress by the chairman of the Federal Reserve, Ben Bernanke, on 22 May 2013 that the pace of asset purchases could soon ease.¹⁸

The statement led to an immediate sell-off of Treasuries of the United States, with the yield on 10-year Treasuries rising from around 2 per cent in May to around 3 per cent by the start of September, an immediate depreciation of several developing country currencies against the dollar, and a sharp decrease in capital flows, as shown in Figure 5.5. Five

¹⁷ See, for example, Lim J and Mohapatra S (2016). Quantitative easing and the post-crisis surge in financial flows to developing countries. *Journal of International Money and Finance*, 68, pp. 331-357.

¹⁸ da Costa P and Bull A (2013). Bernanke: Decision to reduce stimulus may come in next meetings. *Thomson Reuters Economic News*. 23 May. <https://www.reuters.com/article/usa-fed-bernanke-idINDEE94L09Y20130523>.

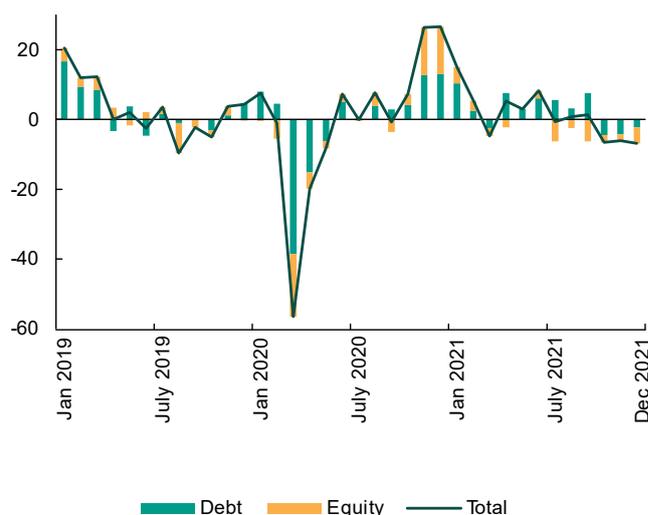
countries – the so-called “fragile five” – were particularly affected by the taper tantrum: Brazil, India, Indonesia, South Africa and Turkey. Aside from Indonesia and Brazil, very few of the central banks in these countries increased their policy rates in response to the market moves.¹⁹

The subsequent turbulence on capital, currency and commodity markets hit developing countries hard, contributing to subdued growth in many, particularly in Africa and Latin America, over the remainder of the decade.

II. Capital markets since 2013

Since 2013, most developing countries’ capital markets have not decreased in size or liquidity. On the contrary, some developing countries have experienced continued capital market expansion and activity over the past decade. With the exception of Indonesia, the ‘fragile five’ continue to be outliers in the value of stocks traded in their domestic exchanges, with a sharp increase seen between 2019 and 2020. Of the other measures of capital market liquidity, South

Figure 5.6 Net portfolio flows to emerging markets, January 2019 to December 2021 (Billions of dollars)



Source: UNCTAD secretariat calculation based on IMF Balance of Payments and Koepke and Paetzold (2020) data updated on March 11, 2022.

Note: Monthly aggregate portfolio flows for Brazil, India, Indonesia, Mexico, Pakistan, Peru, South Africa and Turkey.

Africa and Turkey have seen particularly rapid increases in the size and liquidity of their capital markets since 2013.

On these measures, therefore, at least some of the ‘fragile five’ remain exposed to monetary tightening in the United States. Turkey has since experienced an unstable growth path and is currently suffering from stagflationary conditions which are compounded by its particularly high exposure to the conflict in Ukraine. The sudden stop at the beginning of the pandemic is clearly visible. Figure 5.6 shows recent portfolio flows to eight emerging market economies (including the ‘fragile five’).

Portfolio flows to emerging markets have slowed since the start of 2022

and have turned negative for the countries shown in Figure 5.6, which may be due, at least in

¹⁹ The countries in Figure 5.5 are middle-income and high-income developing countries with a population of at least 10,000,000 (which removes offshore financial centres such as Hong Kong (SAR) and Singapore from the analysis). We also remove Egypt, Iran (Islamic Republic of) and Venezuela (Bolivarian Republic of), which are significant outliers in exchange rate dynamics and/or reserve movements. Bolivia (Plurinational State of), Ecuador, Iraq and Saudi Arabia are also excluded, as these countries’ domestic currencies are pegged to the dollar, and a small number of other countries are excluded due to lack of data (including Zimbabwe and Cuba). This leaves a sample of 36 countries.

part, to the signalled tapering of quantitative easing and rising bond rates in the United States. These trends are likely to be intensified by the conflict in Ukraine.

3. Tackling debt vulnerabilities: the need for an ambitious policy agenda

I. Reforming the debt architecture

Even before the war in Ukraine, there was a growing consensus on the need to revise support measures provided to developing countries. Current tensions underline the urgency for provision of assistance beyond the current G20 Common Framework for Debt Treatments Beyond the Debt Service Suspension Initiative.²⁰ Uptake and implementation of this framework has been disappointing despite the fact that the DSSI expired at the end of 2021. Only 47 of the 72 DSSI-eligible countries participated in the initiative, receiving \$10.3 billion in debt servicing suspension between 2020 and 2021.²¹ Deferred payments under the DSSI in 2020 must be repaid between 2022 and 2024. These will add to existing debt servicing obligations. DSSI-participant countries are estimated require \$42.2 billion per year to meet external public debt service over the initial three-year DSSI repayment period.²²

As discussed extensively in previous Reports, the existing sovereign debt architecture is ill-suited to address a systemic crisis.²³ An enhanced G20 Common Framework can be considered a step towards, but not a substitute of, a permanent and comprehensive debt restructuring mechanism.²⁴ Progress in this area is pertinent for developing countries at high risk of debt distress which are currently excluded from multilateral support due to their income status. For these high and middle-income developing countries, a Paris Club-centred approach to debt relief based on official bilateral debt treatments does not appear an effective way to address debt challenges.

The composition of the public debt of these countries is characterized by a larger share of domestic debt and a substantial role of commercial creditors in public external debt.²⁵ The revitalization of a multilateral debt resolution framework in line with the United Nations General Assembly resolution on “Basic Principles for Sovereign Debt Restructuring Processes” is required.²⁶ The framework should be designed around a definition of debt sustainability that incorporates the financing requirements for developing countries to recover

²⁰ G20 (2020). Statement Extraordinary G20 Finance Ministers and Central Bank Governors' Meeting, 13 November. Annex I: Common Framework for Debt Treatments beyond the DSSI. <https://bit.ly/3o5iPUu>.

²¹ Debt service relief through the second phase of the DSSI ending in June 2021. It is expected that there will be additional debt service suspension as a result of the final DSSI extension until end 2021. IMF-WBG. (2021). *Joint IMF-WBG Staff Note: DSSI Fiscal Monitoring Update*. <https://bit.ly/3E1QQtl>.

²² Deferred payments under the second and third phase of the DSSI in 2021 are to be repaid after a one-year grace period over a five-year window. UNCTAD secretariat calculations based on World Bank. (2021). *International Debt Statistics 2022*. <https://bit.ly/3ITTZj6>.

²³ UNCTAD (2020). From the Great Lockdown to the Great Meltdown: Developing Country Debt in the Time of Covid-19. <https://bit.ly/2Nt6U3p>; IMF (2020). The International Architecture for Resolving Sovereign Debt Involving Private-Sector

Creditors — Recent Developments, Challenges, And Reform Options. <https://bit.ly/3up9GHI>.

²⁴ United Nations (2022). *World Economic Situation and Prospects 2022*. <https://bit.ly/34Qej5i>.

²⁵ IMF (2021). *Issues in Restructuring of Sovereign Domestic Debt*. <https://bit.ly/3tBellx>; UNCTAD (2019). *Trade and Development Report 2019*. <https://bit.ly/30t51qO>.

²⁶ United Nations General Assembly (2015). *Basic Principles on Sovereign Debt Restructuring Processes*. UN A/RES/69/319. <https://bit.ly/3fzIXTL>.

from the pandemic, achieve the 2030 Agenda and successfully implement climate mitigation and adaptation strategies.²⁷

II. Central banking and dollar access

Across both developed and developing economies, central banks reacted to the onset of the pandemic with interest rate cuts. With rates already close to zero in advanced economies, developing economies had more space for rate cuts: cumulative rate cuts were greater in Latin American, African and other developing economies.²⁸

A number of developing country central banks also engaged in quantitative easing: active purchasing of bonds in the open market. A small number of developing country central banks engaged in private sector bond purchases, but public bond buying was more widespread: the central banks of India, Thailand, Colombia and South Africa, among others, engaged in public bond purchases. Latin American central banks were more cautious: although the central banks of Brazil and Chile made legal preparations for bond buying, these mechanisms were not utilized. Where bond purchase programmes were implemented, they were on significantly smaller scale than those of developed economies.

Against this background, the ability of developing economy central banks to manage the negative spill-over effects of United States monetary tightening will depend in part on access to dollars in order to manage exchange rates. Many developing countries have increased their stocks of foreign exchange reserves in recent years. Dollar access has also been enhanced by the Federal Reserve's decision in 2021 to establish a new Foreign and International Monetary Authorities (FIMA) repo facility, which provides dollar liquidity to other foreign central banks in exchange for United States Treasury securities as collateral. The central banks of developing nations typically hold stocks of Treasuries which can be sold to obtain dollars when needed. Yet in times of market stress, the Treasury market can seize up, leaving central banks unable to access dollars. The FIMA repo facility is intended to enable central banks to access dollars, even in such times of stress.

However, many developing country central banks simply do not have dollar collateral and are thus in more urgent need of access to the Federal Reserve's central bank currency swaps. During the financial turmoil of the 2008-09, and the global run for dollar liquidity, the Federal Reserve re-established dollar swap lines with other central banks that had either been previously terminated or had lain dormant since the 1990s.

At the start of the pandemic in 2020, these lines were again drawn upon. In addition to five central banks of rich countries, which were given permanent swap access in 2013, the Federal Reserve provided temporary swap access to several other central banks including Brazil, Mexico and the Republic of Korea. From March 2020, these lines were drawn upon by eleven central banks, for total amounts in excess of \$450 billion. These swaps were dominated by the

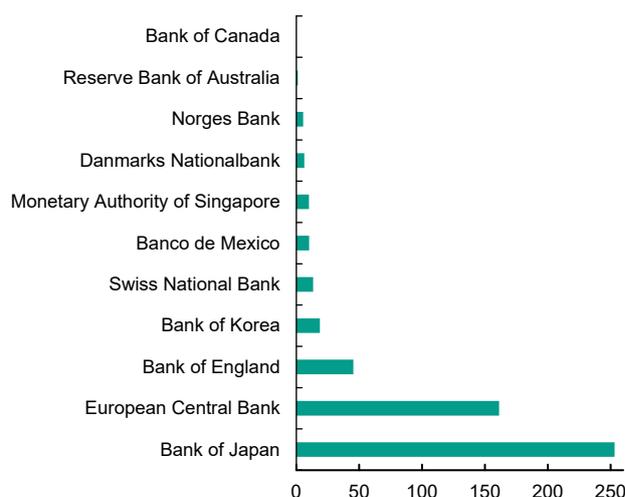
²⁷ UNCTAD. (2019). *Trade and Development Report 2019*.

²⁸ Emerging market economies also raised liquidity by reducing reserve requirements: Brazil reduced reserve requirements on time deposits from 25 per cent to 17 per cent, for example. In some countries, the definition of reserve assets was broadened, to increase effective available liquidity. Access to liquidity facilities was broadened in many countries by increasing the range of eligible collateral. Several Latin American and Asian central banks introduced facilities aimed at provision of credit and guarantees to the private sector, SMEs in particular.

central banks of high income nations with financial systems with substantial dollar funding needs, such as Japan, and in jurisdictions with substantial foreign exchange and derivatives trading such as the United Kingdom and the euro area (Figure 6.1). Of developing economies, only Banco de Mexico accessed swap lines – Brazil did not utilize the facility.²⁹

One direct consequence of the Federal Reserve’s selective stance on currency swaps has been the proliferation of bilateral currency swap arrangements between developing country central

Figure 6.1 Maximum amounts drawn on Federal Reserve swap lines, selected central banks, 2020
(Billions of dollars)



Source: UNCTAD secretariat calculations based on Federal Reserve Bank of New York data.

banks, a notable example of such arrangements being the People’s Bank of China’s yuan-denominated currency swap agreements with over 30 other developing country central banks. There are over 400 bilateral swap lines in place globally. While such arrangements do have some positive advantages, they nevertheless remain limited in scope, given the comparatively small positions that all developing country currencies occupy in the global foreign exchange markets. Only the Federal Reserve has the capacity to create dollars.

In the global monetary hierarchy, the place of a national currency today is determined less by the size of its domestic production base than by the

size of its domestic financial sector. As shows in Figure 6.2, together, the currencies of Brazil, the Russian Federation, India and China account for no more than 3.5 per cent of the \$6.6 trillion daily turnover in the forex markets, a ratio barely one-tenth of the United States dollar’s 44 per cent share of that daily turnover.³⁰

In sum, the current reality is that any initiatives on the part of developing countries and their central banks aimed at containing the negative spill-over effects of United States monetary tightening must include the participation of the United States Federal Reserve itself. Since 2008, a system in which the Federal Reserve acts as unofficial dollar lender-swapper of last resort has emerged.

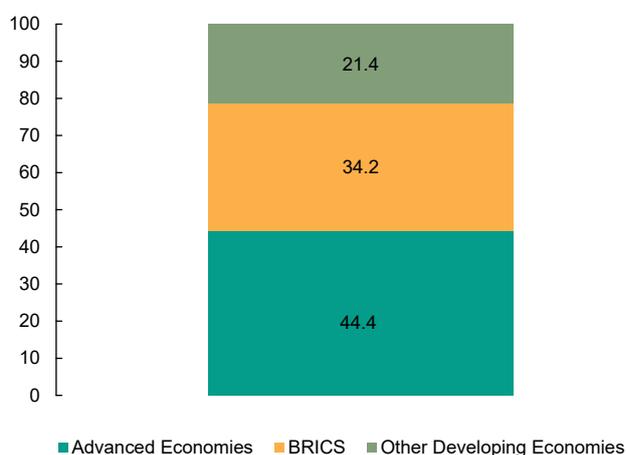
This system is unsatisfactory from the point of view of much of the developing world. The two-tier system of swaps for a small number of counter-parties unilaterally selected by the Federal Reserve, alongside repo access for others, reinforces the hierarchical nature of global dollar access, and requires those without direct swap access to maintain inventories of

²⁹ Gislén M, Hansson L and Melander O (2021). Dollar liquidity from the Federal Reserve to other central banks, *Severiges Riksbank Economic Review*, 2021 (1).

³⁰ Bank for International Settlements (2019). Triennial Central Bank Survey of Foreign Exchange and Over the counter (OTC) Derivatives Markets, December.

Treasuries of the United States, with the additional indirect effect of generating global demand for United States government debt.

Figure 6.2 Share of global dollar holdings, 2020
(Per cent)



Source: UNCTAD secretariat calculations based on IMF International Financial Statistics (IFS) data.

Given the Fed’s reluctance to extend swap lines to all central banks, an alternative option is for it to agree to the establishment of a rules-based system of multilateral policy-coordination. Such initiatives have been a key element in repeated calls for the establishment of a wider global financial safety net³¹ and increasingly are of direct relevance for developing country central banks. While there is no sign of any willingness on the part of the Federal Reserve to move in this direction, there may be a chance that it will do so if there is a repeat of the taper tantrum of 2013.

The beginning of 2022 has shown just how unpredictable the global political-economic environment has become. It will continue to bring up new, complex external shocks, which are bound to generate structural challenges and new financial constraints for all economies, but especially to the most economically and financially vulnerable countries.

To withstand these shocks and address these challenges, while safeguarding global economic resilience, the multilateral system of global governance needs to be reformed. It is increasingly clear that we cannot rely on ad hoc, selective international initiatives, such as those that were deployed in 2008-09 and during the pandemic crises. They cannot provide a reliable solution for all in the coming era of complex shocks that are global in impact.

³¹ Bordo M (2021). Monetary Policy Cooperation/Coordination and Global Financial Crises in Historical Perspective, *Open Economies Review*, 32, 587-611.

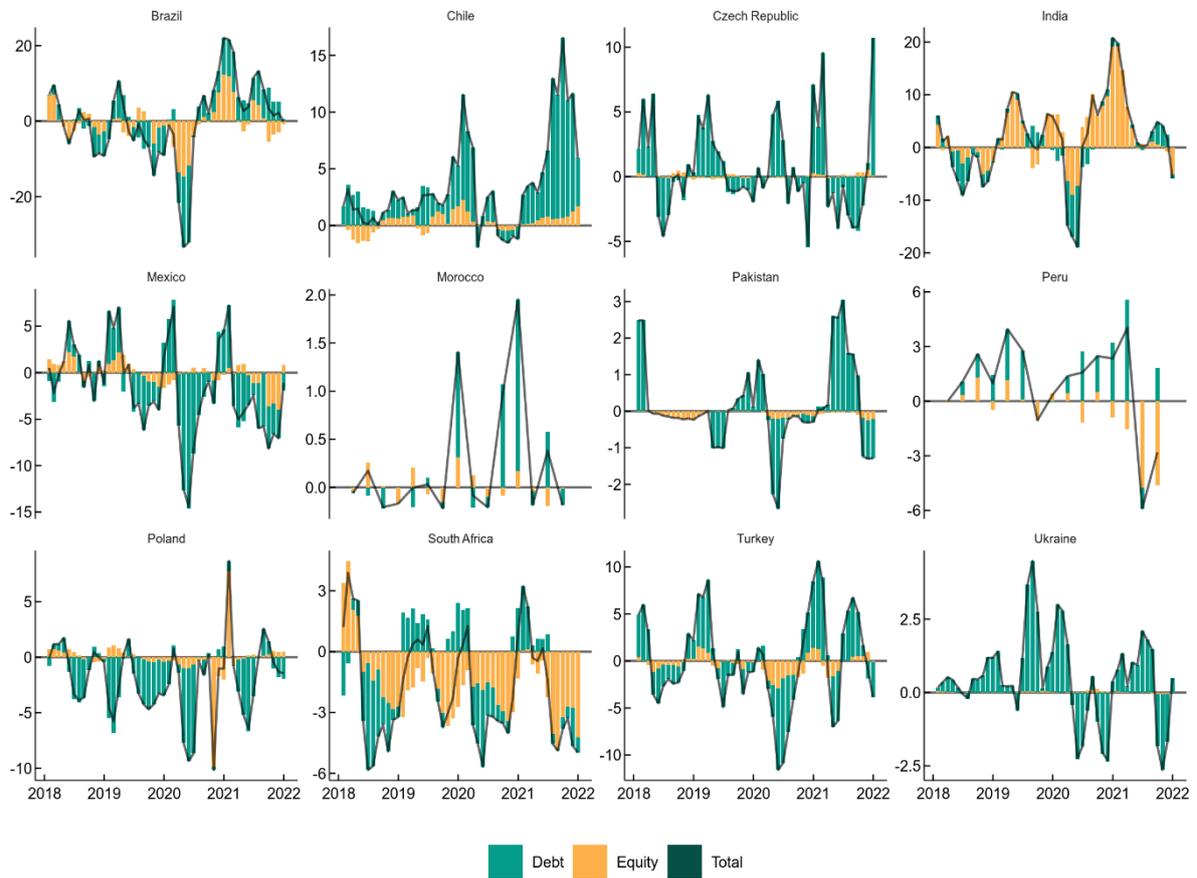
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Annex

Figure A.1 Portfolio flows to selected emerging markets
(Billions of dollars)



Source: See Figure 5.6.

Note: Quarterly data for Peru and Morocco. Three month moving averages for others.