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1. A year of cascading crises

After a rapid but uneven recovery in 2021, the world economy is in the midst of cascading and multiplying crises. With incomes still below 2019 levels in many major economies, growth is slowing everywhere. The cost-of-living crisis is hurting the majority of households in advanced and developing countries. Damaged supply chains remain fragile in key sectors. Government budgets are under pressure from fiscal rules and highly volatile bond markets. Debt-distressed countries, including over half of low-income countries and about a third of middle-income countries, are edging ever closer to default. Financial markets are jittery, as questions mount about the reliability of some asset classes. The vaccine roll-out has stalled, leaving vulnerable countries and communities exposed to new outbreaks of the pandemic. Against this troubling backdrop, climate stress is intensifying, with mounting loss and damage in vulnerable countries who lack the fiscal space to deal with disasters, let alone invest in their own long-term development. In some countries, the economic hardship resulting from these compounding crises is already triggering social unrest that can quickly escalate into political instability and conflict.

Consequently, the great divergence witnessed over the course of the COVID-19 pandemic is now becoming entrenched, with only a select group of countries able to properly cope with the current cost-of-living crisis, and plan for and invest in the future. This great divergence is a direct consequence of an unfair global financial system which structurally favours advanced over developing countries.

In the last quarter, policymakers' attention has become overly focused on dampening inflationary pressures through restrictive monetary policies, with the hope that Central Banks can pilot the economy to a soft landing avoiding a full-blown recession. This policy stance carries short and long-term risks, especially for developing countries as a result of an ever-stronger dollar. Indeed, not only is there a real danger that the policy remedy could prove worse than the economic disease, in terms of declining wages, employment and government revenues, but the road taken would reverse the pandemic pledges to build a more sustainable, resilient and inclusive world.

The origins of this latest wave of inflation are rather unique. The successful roll-out of the vaccine in advanced countries and the easing of Covid restrictions combined with continued government support for households and firms, saw demand pressures running ahead of supply responses during the first half of 2021, creating bottlenecks, including in some key markets such as automobiles. The evidence does not suggest that this surge has come from a further loosening of fiscal policy or wage pressure but instead derives largely from cost increases, particularly for energy and sluggish supply response due to a prolonged history of weak investment growth. Businesses with substantial market power have made the problem worse by raising their mark-ups to capitalize on two rare opportunities – the 2021 demand surge and the 2022 surge in speculative commodity trades. Wages have actually decreased in real terms in the leading economies, and the unit cost of labour has fallen, early data indicate.

Under these circumstances, continued monetary tightening will have little direct impact on the principal sources of inflation and will, instead, work indirectly by further reducing investment demand, easing any incipient labour market pressures and slowing economic growth.

A more immediate impact could be a sharp correction in asset and commodity prices, from crypto currencies to housing and metals. Additional financial risk comes from the high leverage of non-financial businesses. Rising borrowing costs could cause a steep increase in non-performing loans (NPLs) and trigger a chain of bankruptcies. In this situation, accelerating fiscal tightening would only help precipitate a sharper global recession.

The impact of central bank tightening in systemically important economies will be more severe for vulnerable emerging economies with high public and private debt, substantial foreign exchange exposure, a high dependence on food and fuel imports and higher current-account deficits.

Compared to early 2021, when economic policy debates revolved around an ambitious policy agenda of inclusive recovery and building resilience to future shocks, the prospect of coordinated policy programmes that would make the global economy fairer and more sustainable have dimmed.

A path to overcome the current economic setbacks and achieve the SDGs is still available. It requires simultaneously dealing with the urgency of the cost-of-living crisis and the necessity of advancing structural transformation towards a more sustainable economy, while addressing a deteriorating growth outlook by boosting productive investment and expanding redistributive measures to bolster local markets and boost the confidence of firms and households.

2. **Global growth and inflation outlook**

Our projections indicate that the world economy will grow 2.6% in 2022, 0.9 percentage points below the rate we expected a year ago.

Further increases in real interest rates are expected to reduce world output growth in 2023, compounded, in advanced economies, by political divisions that continue to block compensatory fiscal action and, in developing economies, by foreign exchange constraints. UNCTAD expects the world economy to grow just 2.2 per cent next year but with risks of a further drop if financial conditions deteriorate.

On the downside, a lasting war in Ukraine, persistently high inflation, more monetary tightening and heightened financial turbulence could push the world economy into a deep recession, followed by a long stagnation, with macro-financial implications in many developing countries and some developed ones, especially in Europe, where the combination of currency union and fiscal disunion magnifies the risk premium paid by some governments in times of crisis.

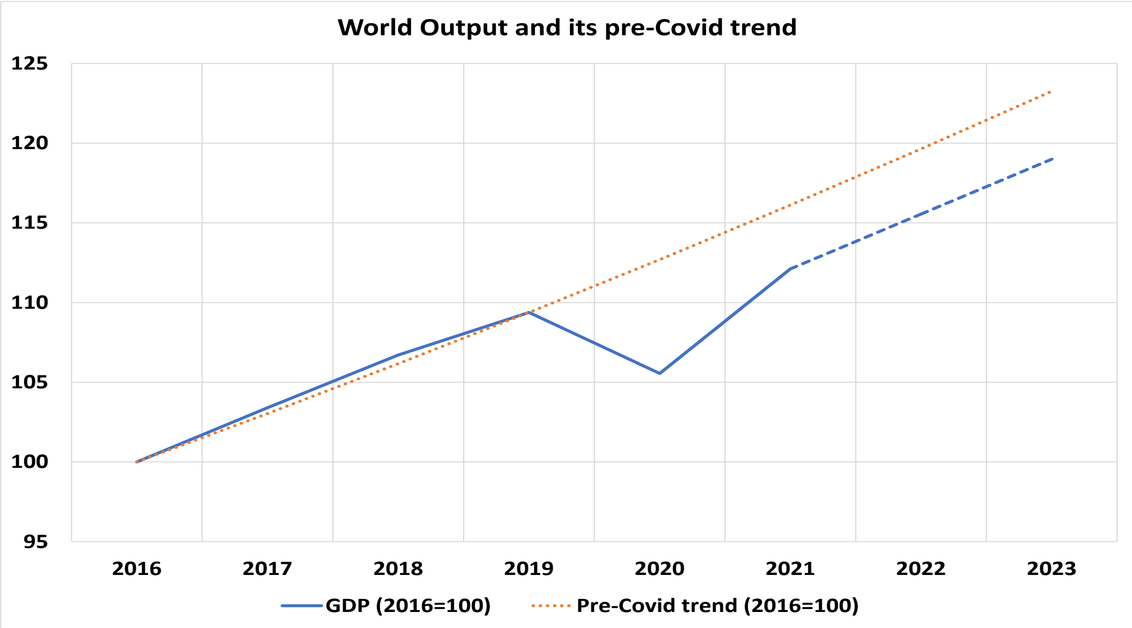
The deceleration is particularly alarming for developing economies. Excluding China, the group is projected to grow 3.0 per cent this year, below the pre-covid average of 3.5, diminishing the room for rising *per capita* incomes. In the early 2000s, the group grew at 5 percent per year on average. China will slow down too, an estimated 4 percentage points compared to 2021, although it is projected to continue growing faster than other countries, at approximately 4 percent in 2022, and to accelerate in 2023, one of the few countries expected to do so.

The current macroeconomic and financial conditions place developing economies in a vulnerable position, as they are exposed to ever more frequent shocks in commodity markets, capital flows, inflationary bursts, exchange rate instability and debt distress. Meanwhile, south-south trade has weakened, and geopolitical trade disruptions, increased market concentration, reduced policy space and the lack of truly global climate policy weaken developing countries' position in global value chains.

Developed economies are projected to grow 1.7 percent in 2022 and 1.1 in 2023. On average, this is 0.5 percentage points below the mean of the pre-covid period and 0.9 per cent below the pre-GFC. As we have remarked in the past, those growth rates were already insufficient to ensure full employment, a reduction of inequalities, and the energy transition. The slowdown is particularly marked in the United Kingdom and in the European Union, and particularly in France, Germany and Italy.

While the global increase in inflation has sparked concerns about economic overheating in some economies, in most G20 economies real GDP is still expected to be below its pre-Covid trend by the end of 2023. Our projections indicate that the world economy will still be over 3 percentage points below its pre-Covid trend in 2023 (**Figure 1**), and with no sign of the gap closing soon.

Figure 1 Covid recovery compared to pre-Covid trend



Source: UNCTAD

This outlook can be affected by domestic political decisions and international coordination (or lack thereof). Progressive and coordinated policy actions in the direction of the SDGs could still propel the world economy onto a sustainable and inclusive development path.

We expect inflation to fall in the second half of 2022 and the beginning of 2023. A recession in Europe and a growth slowdown in the US and China may pull commodity prices down and reduce inflationary pressures. At the same time, the appreciation of the US dollar, driven by the interest rate hikes, may generate recessionary shocks in developing economies, further slowing down world output and prices in 2023. According to the IMF, global annual consumer inflation will peak at 9%, in the third quarter of 2022, and then fall rapidly to 4%, by the end of 2023.

Commodity prices are critical for developing countries: on average, commodities make up slightly less than one-third of their imports (in US$ terms). The share of commodities in China's and Egypt's imports is 38% and more than 50% of India's imports are (primary) commodities including food and fuel. As a result, higher commodity prices have a strong impact on domestic prices via imports. Recent estimates covering the past five decades suggest that a 50 percent increase in oil prices (which is approximately the increase occurred in 2021) is associated with an increase in inflation of between 3.5 and 4.4 percentage points, with a lag of about two years suggesting that in emerging economies too a considerable part of the inflation experienced in 2021-22 has been caused by higher commodity (oil) prices.

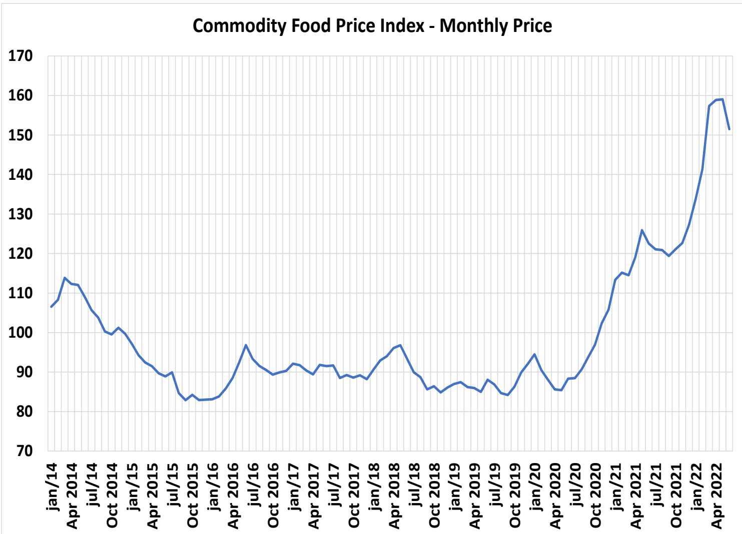
There is a silver lining to the past year of high inflation: it has pushed real interest rates, at least for advanced economies, deep into negative territory. As a result, if nominal interest rates do not climb too much, the net cost of public debt may continue to be negative or null after the disinflation process, assuaging concerns about sovereign debt and providing more room for expenditure plans, including for the energy transition.

3. Multiple adverse supply shocks

The Covid shock caused prices to swing down and up. The fall of consumption during the lockdowns drove prices down but subsequent bottlenecks during the demand surge drove them up. A V-shaped fluctuation in commodity prices has had an arguably larger role. After a 30% fall between December 2019 and April 2020, the IMF world commodity index climbed almost uninterruptedly until the beginning of 2022, with a cumulative increase of 187%.

As of mid-2022, the monetary tightening in the United States and the deceleration in world output seem to have stopped the global inflationary trend in commodities, despite continued uncertainty surrounding the war in Ukraine. High interest rates and slower demand growth in markets, such as food and fuel, that are increasingly financialized make a further fall in commodity prices the most probable scenario for 2023. However, since the starting point of the disinflationary trend is very high, the relative prices of commodities in terms of world per-capita income will continue to be high in the short-term. In fact, despite its recent fall, in June 2022, the commodity food price index was still 64% above its pre-Covid value (**Figure 2**).

Figure 2 Commodity Food price index. 2014 to 2022



Source: IMF.

Food price inflation poses significant challenges for households in developing economies, who spend a larger share of their income on food. Higher food prices imply sharp decreases in real incomes for low-income workers, whose wages do not increase with inflation, and may push millions into poverty. Higher food prices alone are estimated to be pushing an additional 75 million to 95 million people into extreme poverty in 2022, compared to pre-pandemic trends. Energy inflation may be even more detrimental with warnings that higher food and energy prices and persistent crisis conditions may raise the number of people living in extreme poverty by 263 million in 2022.

Higher food prices also force households in the emerging economies to lower their spending on non-food items—and, hence, demand for manufactured goods and services will go down. The result is a slowdown of growth in non-primary sectors, if not a recession—and the 'stagflation' may well trigger social unrest and food riots, especially in foreign-exchange-constrained countries that are net food importers.

In the short-term, efforts must be pursued to end the cost-of-living emergency, which is in essence an affordability crisis that must be dealt with by bringing prices down, and increasing liquidity in developing countries. The UN Global Crisis Response Group on the War in Ukraine I set up in April this year, has provided some policy results on this front, most notably through the Black Sea Grain Initiative, and the Agreement for the Unimpeded Access to Russian Grains and Fertilizers into World Markets, which has almost halved some relevant grain prices from their earlier peaks this year.

Because of financialization in food and seed markets, the long-term effects of global warming and the short-term implication of high fertilizer's prices for the next harvest cycle (Figure 19), the normalization of the world food market is far from granted. On top of the uncertain post-Covid adaptation of world food supply to demand, the war in Ukraine created another adverse supply shock for wheat and fertilizers, which pushed some countries to restrict their exports of the two products. In the absence of global coordination, the localized conflict in Eastern Europe can lead to trade wars in the global food market.

4. Markups and margins calls

As markets have, in recent decades, become more concentrated, price setting has become the preserve of large firms, often with a significant international footprint.

Corporate profits in the United States fell as a share of total income in early 2020, but quickly recovered in 2021. In the first 18 months of the pandemic the ratio had gained 0.75 points, or more than $170 billion that were transferred from workers to corporate owners in the time of direst economic hardship. And between 2020 and 2022 more than half of the average price increase in the US non-financial sector is estimated to have been owed to higher profit margins, compared to only 11 percent in the previous 40 years. High wage costs and non-wage costs (for energy and fuel) cannot fully explain the recent price acceleration in the US. Procyclical markups have been a major factor. In this context, strengthened competition policy and price controls have a critical role to play.

There is, in addition, a good deal of evidence to suggest that speculation is a contributing factor to rising food and energy prices. The financialization of commodity markets, linked to the creation of tradable commodity indexes by the big banks, was already visible with the commodity price boom and bust in the first decade of the new millennium. Today, there is strong evidence indicating that the disconnect between financial speculation and commercial hedging is one of the key factors driving up energy, food and commodity prices.

While a balance between speculators and commercial hedgers is necessary for price discovery and sustained liquidity in regulated financial markets, the participation of large financial institutions – investment banks, pension funds, sovereign wealth funds, etc. – in commodity price bets has come to outstrip the role performed by commercial hedgers. All the major oil companies, leading US banks, and private energy trading houses are involved in speculative energy trading. The effect of the excessive speculation is overwhelming volatility in oil prices. Likewise, speculative activity by hedge funds, investment banks and pension funds has driven up wheat prices. The resulting super profits enjoyed by these firms stand in sharp contrast to the economic hardship experienced by households, in developed and developing countries alike, as the price of these basic necessities has spiked.

Without undermining the positive role financial instruments can play in boosting liquidity and reducing hedging costs in these markets, UNCTAD proposed a series of market-level reforms following the global financial crisis that could help reduce the distortions and volatility such instruments can also introduce. These aimed for greater transparency in physical markets through the provision of more timely and accurate information and tighter regulation of financial market participants. But subsequent, progress on these fronts has been slow or has not advanced at all, leaving gaps and loopholes in the regulatory system and limiting the space for policy makers to reduce the incidence of commodity price volatility. In the meantime, financial innovation and arbitrage strategies deployed, in particular, in over-the-counter (OTC) deals with financial swap contracts, have blurred the lines between commercial hedging and financial speculation.

In light of recent developments, revisiting earlier proposals and considering more radical regulatory steps, would be timely including increased margin requirements, forcing a trader to hold larger capital reserves for a given number of positions, making it much more expensive to corner the market and gain from speculation, an outright ban on commodity index funds and compulsory premarket government licensing of complex financial instruments can also form the menu of a strong regulatory toolset.

As previous experience shows, to be effective these proposals need to be implemented systemically, in line with other institutional measures aimed to protect the most vulnerable parts of the world population from the crises driven by financial speculation, corporate arbitrage and market manipulation.

5. Obscured by monetary clouds: Towards a more sustainable agenda

While interest rate hikes can fight temporary inflationary pressures and help contain expectations they also cause damage to the productive economy and increase exposure to future supply-side shocks, perpetuating the line of policy action that privileges financial markets over non-financial businesses. This is especially concerning since the current policy mix does not consistently include a strategy to eliminate production bottlenecks, raise investment rates, increase productivity, and rebalance budgets in a progressive direction.

Moving on from a narrow focus on inflation is urgent given the multitude of other challenges that also need to be tackled. While the cost-of-living crisis needs immediate solution, it requires a comprehensive approach that understands supply-side constrains as well as negative spill-over effects in developing countries resulting from rapid monetary tightening. Under current supply-chain challenges and rising uncertainty, where monetary policy alone cannot *safely* lower inflation, pragmatism is direly needed.

Time is running out to avoid a major global economic crisis in 2023. Four key points of action are urgently needed:

1. Avoid a policy-induced global recession. Policy makers should avoid an undue reliance on monetary tightening and foreswear a premature return to austerity budgets. There are supply-side factors behind current inflation metrics. A narrow-focus on interest rate hikes will only reduce inflation by producing a recession. The alternative requires a pragmatic mix. First, while subsidies to ease the cost-of-living are important in the short term, price and markup controls are paramount as they allow for overdue increases in real wages. This requires reinforcing anti-trust regulation and a reconsideration of specific markets.

2. Step off the precipice of a systemic debt crisis in developing countries. Net capital flows to developing countries have turned negative with the deterioration of financial conditions since the last quarter of 2021. On net, developing countries are now financing developed ones. Some 90 developing countries have seen their currencies weaken against the dollar this year – over a third of them by more than 10%. This is increasing debt distress at a global scale. To avoid a systemic crisis, liquidity must be ramped-up, including through a new allocation and more rechanneling of Special Drawing Rights, raising access limits to emergency lending windows, and eliminating interest rate surcharges. Furthermore, the international community must prioritize progress on a multilateral legal framework for handling debt restructuring, including all official and private creditors.

3. End commodity price speculation. Commodity prices climbed for much of the last two years. Costlier food and energy posed significant challenges for households everywhere. Added upward pressure on fertilizer prices means the damage could be lasting. The war in Ukraine has contributed to this situation but commodity markets have been in a turbulent state for a decade. Insufficient attention has been paid to the role of speculators in this. Our report outlines better regulation and calls for windfall taxes to be part of the policy mix governments deploy to curb price spikes.

4. Foster a new policy agenda, a new Bretton Woods. The world desperately needs a new policy mix that delivers economic stability and boosts productive investment, both public and private. Warning signs are flashing across a range of economic and environmental indicators. We must reclaim our future with innovative, ambitious policies, political will and private and public support. Our report lays out a

strategy of increased cooperation among developing countries. With reforms to the multilateral architecture, we can shift the global economy in the right direction. We still have time to step back from the edge of recession. We have the tools to calm inflation and support all vulnerable groups. This is a matter of policy choices and political will. The current course of action is hurting the most vulnerable, especially in developing countries.