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7

WORLD ECONOMY ON RECOVERY PATH:

IS THE CRISIS OVER?

STATISTICAL ECONOMIC AND SOCIAL RESEARCH AND TRAINING CENTRE FOR ISLAMIC COUNTRIES (SESRIC)

2010-2 Issue

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SESRIC Reports on Global Financial Crisis : The financial crisis which started in July 2007, when investors lost their confidence in the mortgage- and asset-based securities in the United States, has deepened during 2008-2009 with a global reach and affecting a wide range of financial and economic activities and institutions in both developed and developing countries around the world. As the crisis deepened, the governments of major developed and developing countries as well as international financial regulators attempted to take some mitigation actions and coordinate efforts to contain the crisis.

Given this state of affairs, the SESRIC has been preparing short reports since May 2009 with the aim of monitoring the developments related to the current global financial crisis at the global, regional and national levels. In particular, these reports focus on the impact of the crisis on the economies of the developing countries, including the OIC Members, and highlight the actions taken by these countries to contain the negative impact of the crisis on their economies.

Introduction

More than two years has passed since the bankruptcy of Lehman Brothers, the seminal collapse in financial sector in triggering the global financial crisis, but many developed and developing countries are still suffering from the negative impacts of the global crisis in terms of continuous slowdown of economic growth and high unemployment rates. International, regional and national development organizations are still struggling to curb the adverse impacts of the global recession and, in particular, to reduce the burden of unemployment on societies. Although the global output is now projected to recover in 2010 with an estimated growth rate of 4.8 percent and to continue to grow in 2011 by 4.3 percent, concerns over sound recovery still persist particularly in developed economies, which were hardly hit by the crisis.

Today, many developing countries around the world, including the OIC member countries, are now more integrated into the world economy and international financial system through the increasing trends of their foreign trade, FDI, and remittances. Consequently, they have become more vulnerable to the frequent shocks in international financial markets and global economy. Therefore, though rooted and deepened in developed countries, the global financial crisis have imposed serious adverse effects on the

economies of many developing countries as well, particularly those with high level of integration into the world economy and international financial markets.

Like many other developing countries, the OIC member countries have been also suffering various negative impacts of the current global financial crisis. Yet, the extent of these impacts has apparently varied from one country to another due to the variation in their economic structures and levels of economic integration into the world economy. The most common impacts are slowdown in their economic growth; fall in the demand for their exports; sharp drops in their private capital inflows; interruption in their inflows of ODA and remittances; high exchange rate volatility; deterioration in current account balances; and increase in unemployment.

Previous reports of SESRIC on Global Financial Crisis have focused on global as well as regional actions to tame the impacts of the global crisis, evaluated alternative approaches to the world financial system and assessed the overall achievements in response to the crisis. In this issue, after briefly reviewing the major macroeconomic developments, the report focuses on the role of financial liberalization in fostering growth and transmitting the crisis to otherwise robust economies and discusses the impact of the crisis on the poorest segment of the world population.

Trends and Prospects

After experiencing one of the deepest declines in the modern times, world economy has started to recover and there has been significant improvement in economic activity, industrial production and trade since the beginning of 2009. Nevertheless, mainly due to their relative exposure to the negative impacts of the crisis and their pre-crisis fiscal conditions, the pace of recovery remained highly uneven across the regions and countries. In general, majority of the developed economies are experiencing a very slow recovery compared to many emerging and developing economies.

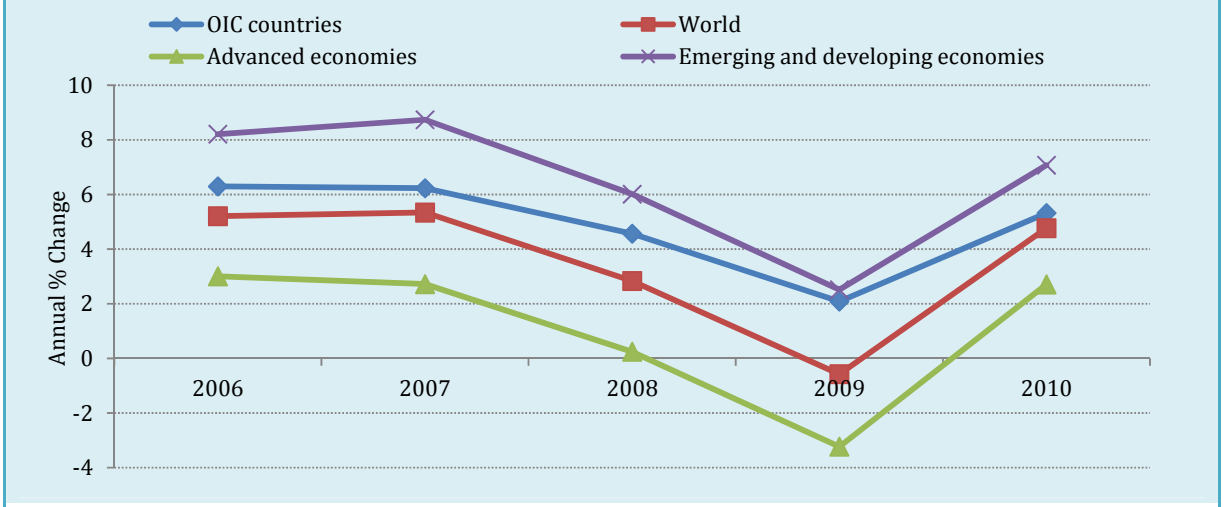
Despite these positive developments, the prospects for the global economy are not very promising. There is a so called universal consensus that global recovery is highly fragile as many developed economies are still suffering from huge fiscal imbalances, weak domestic demand, low business activity and high unemployment rates. According to the IMF (2010), to support the stimulus led recovery there is an urgent need for policies to strengthen the private demand by introducing accommodative monetary measures. Furthermore, to improve the confidence of investors and to re-energize the financial sector the governments should continue financial repair and financial reform. Although, government intervention played an important role in the global recovery, the sovereign default risk associated with unprecedented accumulation of public debts in many developed economies could undermine the recovery. In this regard, there is a strong need for fiscal consolidation by designing credible short and medium term plans for debt stabilization and debt reduction.

This section reviews the major macroeconomic developments in the post-crisis period, including the developments in output, trade and unemployment. In addition to these major indicators, developments in fiscal balances and inflation rates will also be investigated with a view to monitoring the most widespread concerns of excessive indebtedness in developed countries and fear of overheating in developing countries.

GDP Growth

According to the latest estimates of IMF (WEO, Oct. 2010), global output growth is expected to reach 4.8 % at the end of 2010, an upward revision of 0.6% from the April 2010 forecast (Figure 1). Economic recovery and improvement in global GDP growth is mainly contributed by the emerging and developing economies. As a group, emerging and developing economies managed to wither the negative impacts of the crisis and majority of them were only affected by the spillover effects of the crisis on their export earnings, remittances, aid and FDI. In 2010, emerging and developing economies are expected to grow by the rate of 7.1%, an upward revision of 1.4% from the April 2010 forecast. Meanwhile, advanced economies are also expected to grow with a higher rate of 2.7% compared to the growth rate of 2.3% as forecasted in April 2010. Within developing world, recovery in economic activity is led by the Developing Asia with an expected growth rate of 9.4% in 2010. The tremendous growth in this region is mainly attributed to the performance of export oriented Asian economies especially China and India which are benefiting from the normalization of global trade, increasing capital inflows and stable domestic demand. Among other developing and emerging regions, Latin America and Caribbean is expected to grow by 5.7% followed by Sub-Saharan Africa (5.0%), Commonwealth of Independent States (4.3%), Middle East and North Africa (4.1%) and Central and Eastern Europe (3.7%).

Figure 1: Real GDP Growth (annual % change)



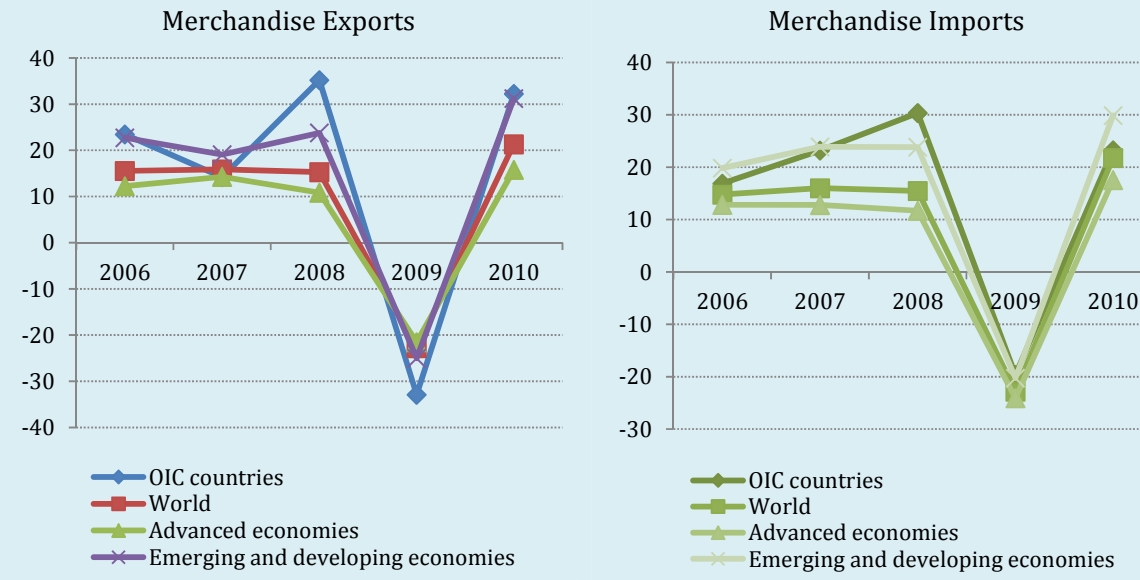
Source: IMF WEO, October 2010.

OIC member countries are also recovering from the negative impacts of the crisis and their GDP is expected to grow by the rate of 5.3% in 2010, an upward revision of 0.5% from the April 2010 estimates based on IMF data. Similarly, OIC regions are also expected to experience resurgence in economic activity in near future and with the exception of Latin America & Caribbean, South Asia and Sub-Saharan Africa, all OIC regions are expected to grow with a rate higher than one percent in 2010.

Foreign Trade

After experiencing heavy losses during the peak of the crisis the world trade started to recover. According to the IMF Direction of Trade Statistics (DOTS), the global merchandise trade is expected to grow with an annual rate of 21.5% in 2010 compared to a negative growth rate of 22.8% in 2009. Despite some regional differences with respect to the scale, the ongoing global economic recovery will bring trade benefits to all regions. As shown in Figure 2, both imports and exports are showing upward trend across the world. Merchandise exports of emerging & developing countries are expected to grow with 31.2% in 2010 while for the advanced economies growth rate is estimated at 15.8%. On the import side, emerging and developing economies are expected to experience growth rate of 29.9% in their merchandise imports whereas it is estimated at 17.6% for the advanced economies. In line with the global trends, OIC member countries are also experiencing resurgence of foreign trade activity and their merchandise trade is expected to grow with an annual rate of 27.8% in 2010 compared to a negative growth rate of 27.0 % in 2009. As shown in Figure 2, OIC merchandise exports are expected to grow at a rate of 32.2% in 2010 which is higher than the growth rate of world and other groups. Similarly, OIC merchandise imports are also expected to grow at a rate of 23.2% in 2010.

Figure 2: Merchandise Trade (annual % change)



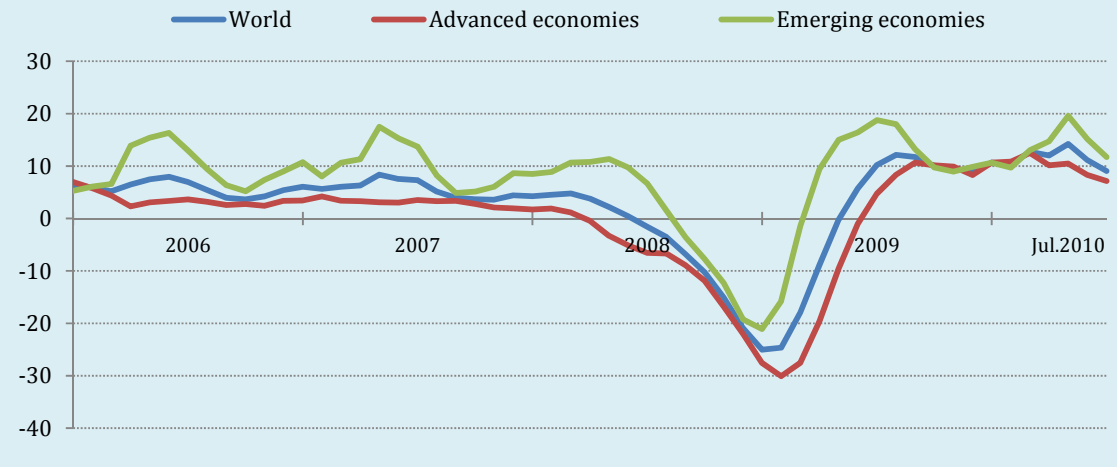
Source: IMF DOT Database.

Industrial Production

There is an impressive resurgence of manufacturing activity across the globe and industrial production is on rise. Despite the reversal of industrial production, there is an ongoing concern about the sustainability of this upward trend amid the growing threat of Euro zone debt crisis and double dip recession. Emerging economies lead by the China, India, Russia and Brazil are driving the global industrial production recovery and they are expected to achieve their pre-crisis levels of industrial production by the end of 2010. As shown in Figure 3, global industrial production will continue growing with a positive

rate during the second quarter of 2010. As of July 2010, global industrial production registered an average growth rate of 9.05%. At the regional level, emerging economies recorded significantly higher industrial production growth rate of 11.73% whereas in advanced economies industrial production is growing with a rate of 7.16% (IMF WEO, 2010).

Figure 3: Industrial Production (% change)*



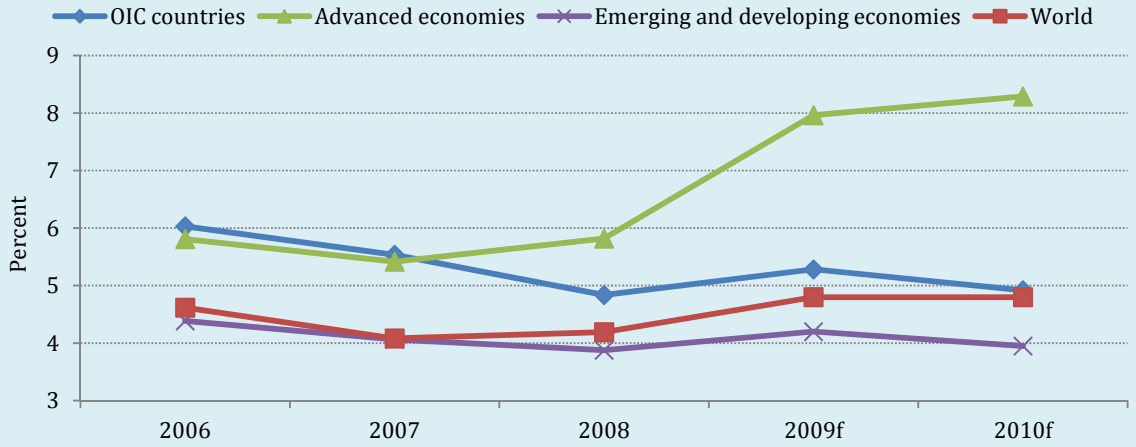
Source: IMF WEO, October 2010.
* Annualized percent change of three-month moving average over previous three-month moving average.

Unemployment

Since the beginning of the crisis, the global job losses mount to over 30 million, which has increased the world total number of unemployed people to over 210 million people (IMF WEO, Oct. 2010). This means that about 6.6 % of the world total workforce is without job today. The burden of job losses is highly skewed towards the advanced countries which accounted for the three-fourth of global increase in unemployment during 2007-2010. Despite recovery in the global economic activity, industrial production and foreign trade the outlook for the job market is not very promising especially in the developed countries. And some three million more people are expected to lose their jobs in Europe and other developed economies up to the end of 2010; whereas unemployment will stabilize or decline slightly in other regions (ILO, 2010).

According to the findings of the IMF, global unemployment rate will remain stable at 4.8% in 2010. The situation is very critical especially in developed countries which experienced an exponential hike in unemployment during the period 2008-09. Due to sluggish recovery, deteriorating fiscal balances and higher prevalence of financial stress, advanced economies are expected to witness further increase in unemployment rate which may climb up to 8.29% in 2010. On the other hand, for the developing and emerging economies unemployment rate is expected to recover to the pre-crisis level in 2010. The job situation is also improving in the OIC member countries and their unemployment rate is expected to decline from 5.28% in 2009 to 4.92% in 2010.

Figure 4: Unemployment Rate (% change)

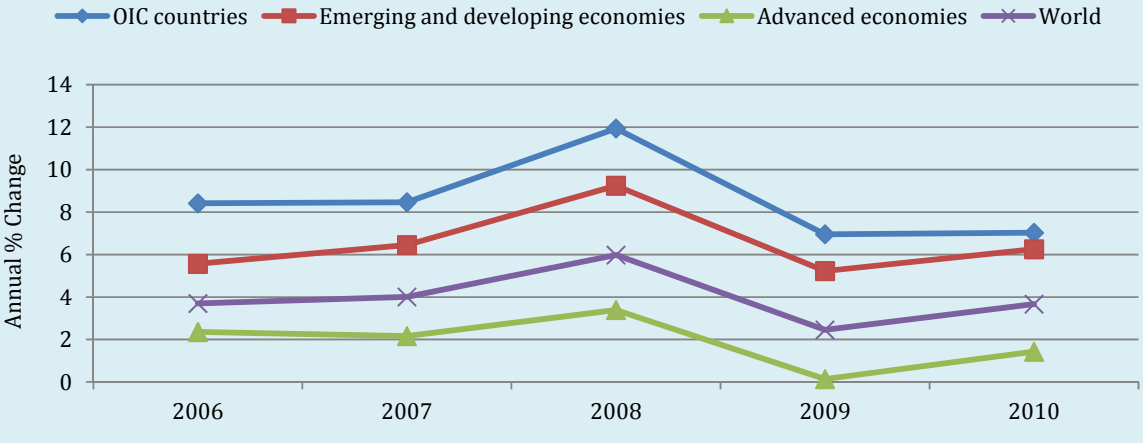


Source: IMF WEO, October 2010.

Inflation

After witnessing significant decline during 2009, global inflation started to increase in first half of 2010. This reversal in the inflation is expected to continue during the second half of the 2010. This acceleration in inflation is mainly attributed to the increase in international commodity prices amid global economic recovery and resurgence of demand. According to the estimates of IMF (WEO Oct. 2010), as the world economy is recovering from the negative impacts of the crisis the global inflation is also expected to soar up from 2.5% in 2009 to 3.7% by the end of 2010 (Figure 5) . Inflation is expected to remain comparatively very high in emerging and developing economies i.e. 6.3% reflecting the higher share of food and fuel in consumption as well as impressive recovery in local demand. On the other hand, inflation will remain about 1.4% for the advance economies. Bing a substantial part of the developing world, OIC member countries are no exception. According to the estimates, for the OIC countries inflation will be around 7.0% by the end of 2010 which is even higher than the emerging and developing economies rate.

Figure 5: Inflation (annual % change)



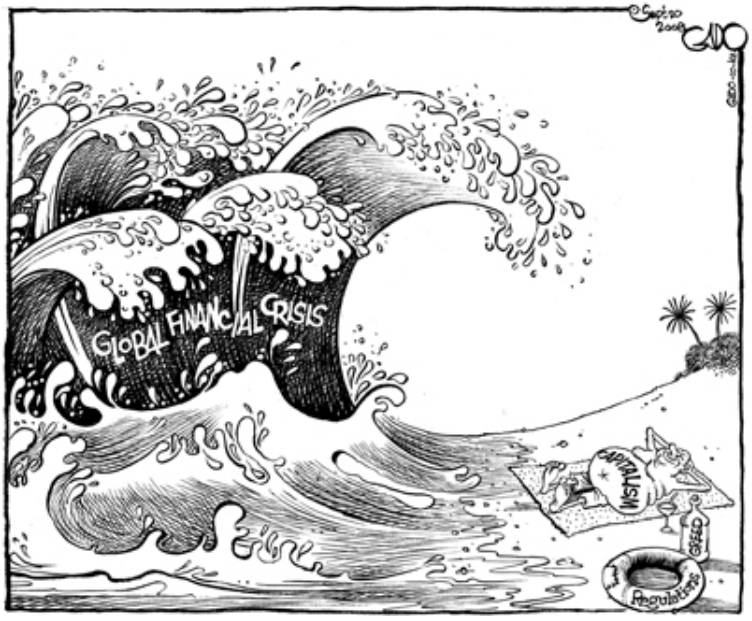
Source: IMF WEO, October 2010.

Rethinking the Financial Liberalization

During the last few decades, many developing countries have lifted restrictions on cross-border financial transactions. According to the conventional view, this would allow receiving capital inflows from developed countries that would finance higher investment and growth. It is also believed that financial liberalization would insure against aggregate shocks, reduce consumption volatility, accelerate the development of domestic financial markets and achieve a better sharing of individual risks. However, this conventional view is proved to be wrong. Even worse, financial liberalization is claimed to play a major role in transmitting the negative impacts of crisis to otherwise resilient economies. This section provides a cost-benefit analysis and summarizes the role of financial openness in promoting growth and investment as well as in increasing the vulnerability to international shocks.

Financial liberalization refers to the deregulation of domestic financial markets and the liberalization of the capital account. It is extremely difficult to measure the extent of capital account openness. Although many measures exist to describe the extent and intensity of financial openness, it is generally agreed that such measures fail to capture fully the complexity of real-world capital controls. Notwithstanding the measurement issues, many developing countries, with very low domestic saving ratios and extremely volatile terms of trade (resulting from export concentration in commodities), liberalized their capital accounts to support their development efforts with foreign capital inflows, especially with foreign direct investment. The private sector was seen as the engine of growth and the role of the central government was limited only to facilitation of competition and the proper functioning of the market economy.

Historically, however, financial liberalization is followed by boom-bust cycles. During the boom, rapid expansion of bank credits as well as undertaking of excessive credit risk is commonly observed. As a result, the overall financial fragility of the economy increases and economies become prone to crisis. Many booms do eventually end in a crisis. The recent global financial and economic crisis has returned the costs and benefits of greater financial integration to the forefront of global economic agenda. The heavy exposure of European financial institutions to assets associated with sub-prime US mortgages and raising concerns in emerging markets about adverse and destabilizing impact of large and volatile capital flows on financial stability and economic growth heightened these concerns.



Broadly, the operation of the financial system puts forth a powerful influence on economic growth. Well-functioning financial systems allocate resources to those with the best ideas and entrepreneurial skills, enhancing efficiency and improving economic

prospects. Poorly functioning financial systems channel credit to those with strong political and social networks, with detrimental consequences on economic prosperity. Prior to financial liberalization, a good functioning financial sector with prudential supervision and monitoring of the financial system is required. Otherwise, the desired outcomes from greater financial integration will not be realized.

When assessing the impacts of Asian financial crisis, Stiglitz (2000, p.1075) notes that:

> *"I suggested that one might compare capital account liberalization to putting a race car engine into an old car and setting off without checking the tires or training the driver. Perhaps with appropriate tires and training, the car might perform better; but without such equipment and training, it is almost inevitable that an accident will occur. One might actually have done far better with the older, more reliable engine: performance would have been slower, but there would have been less potential for an accident. Similarly, the international economic architecture must be designed to "work" not just in the presence of perfect economic management, but with the kind of fallible governments and public officials that in fact occur in democratic societies."*

A growing and diverse body of empirical research produces remarkable evidence. Overall, there is no evidence that financial liberalization systematically increases investment or growth in emerging markets. Capital flows have also been highly volatile and procyclical, and there is evidence that financial liberalization has increased both output and consumption volatility. There is also evidence that financial liberalization has made domestic financial markets more unstable and prone to crises. Perhaps the most robust finding is that the effects of financial liberalization vary substantially across countries. Specifically, the effects of financial liberalizations depend on whether the liberalizing country is rich or poor, on whether it has developed or underdeveloped financial markets, and on whether it has high- or low-quality institutions (Broner and Venture, 2010).

In a comprehensive study, Reinhart and Reinhart (2008) analyze capital inflow bonanzas in 181 countries during 1960-2007. They find that for emerging markets, such bonanzas are associated with higher likelihood of financial and economic crisis. Similarly, Kaminsky and Reinhart (1999) and Reinhart and Rogoff (2009) show that domestic financial crises are more frequent during periods of international financial integration, and that defaults on foreign debts are associated with domestic financial crises. The global economic crisis correspondingly raised the possibility that financial integration went too far, reinvigorating the debate about the desirability of a laissez-faire approach towards financial integration (Stigliz 2010).

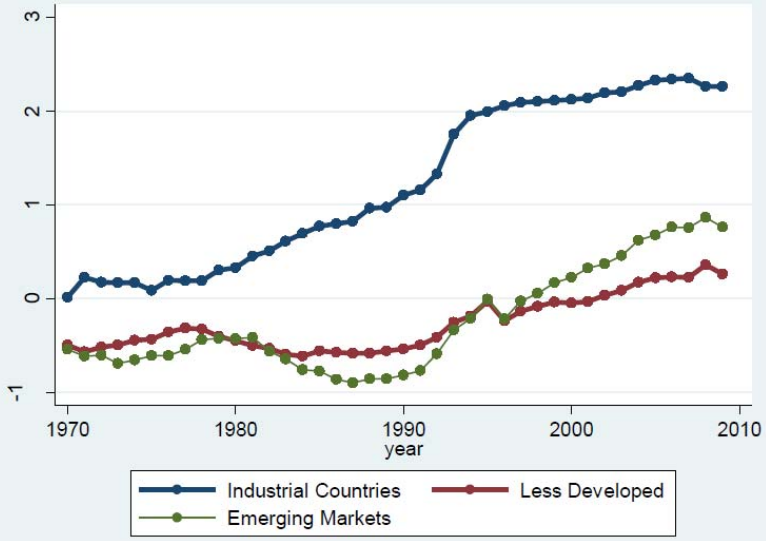
As mentioned previously, it is extremely difficult to measure the extent of financial openness. Several attempts have been made to construct proxies for the degree of financial openness. Among others, Chinn and Ito (2008) provide an index, which they call KAOPEN, based on the IMF's AREAER tabulation with the goal of incorporating the extent and intensity of capital controls.[1] This index takes on higher values the more open the country is to cross-border capital transactions. According to the latest update of the index, only 10 countries increased the level of KAOPEN in 2009 compared to 2008 while as many as 26

[1] KAOPEN is based on the four binary dummy variables reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). There are the variables indicating the presence of multiple exchange rates, restrictions on current and capital account transactions, and the requirement of the surrender of export proceeds. Index is the first standardized principal component of these variables. The updated dataset is available at http://web.pdx.edu/~ito/Chinn-Ito_website.htm.

countries decreased the level of KAOPEN the same year, possibly reflecting the impact of the financial crisis of 2008-09.

Figure 6 shows development of capital account openness measured by the KAOPEN index for different income groups. It is clear that the world is moving steadily toward greater and greater financial openness. The industrialized countries have maintained high levels of financial openness throughout the period and steadily increased the levels since the 1970s. Both the less developed and emerging market countries groups slowed down the efforts of opening financial markets during the 1980s, but have accelerated financial opening since the 1990s. However, the speed of liberalization was faster in emerging economies in 2000s.

Figure 6: Development of *KAOPEN* for Different Income Groups



Source: Chinn and Ito dataset.

Table 1: Financial Openness in the OIC Member Countries in 2009

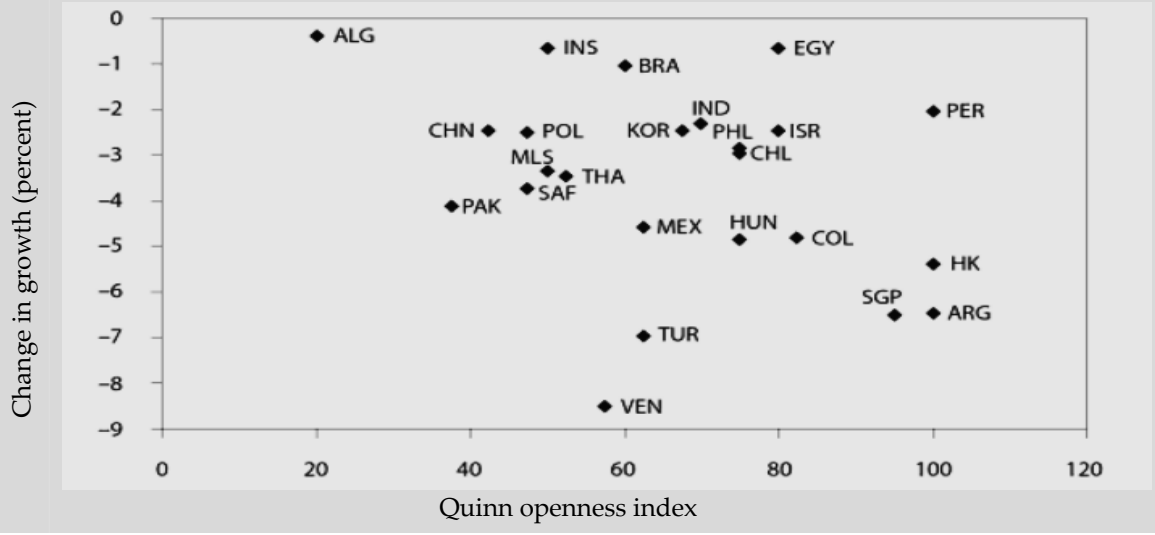
	Country	Index		Country	Index		Country	Index
1	Bahrain	2.48	**20**	Iraq	0.63	**38**	Libya	-1.15
2	Gambia	2.48	**21**	Iran	0.10	**39**	Mali	-1.15
3	Guyana	2.48	**22**	Turkey	0.10	**40**	Mauritania	-1.15
4	Jordan	2.48	**23**	Malaysia	-0.10	**41**	Morocco	-1.15
5	Oman	2.48	**24**	Nigeria	-0.51	**42**	Mozambique	-1.15
6	Qatar	2.48	**25**	Azerbaijan	-0.62	**43**	Niger	-1.15
7	Uganda	2.48	**26**	Albania	-1.15	**44**	Pakistan	-1.15
8	United Arab Emirates	2.48	**27**	Algeria	-1.15	**45**	Senegal	-1.15
9	Yemen	2.48	**28**	Bangladesh	-1.15	**46**	Tajikistan	-1.15
10	Djibouti	2.21	**29**	Benin	-1.15	**47**	Togo	-1.15
11	Egypt	2.21	**30**	Burkina Faso	-1.15	**48**	Tunisia	-1.15
12	Maldives	1.78	**31**	Cameroon	-1.15	**49**	Turkmenistan	-1.15
13	Afghanistan	1.68	**32**	Chad	-1.15	**50**	Uzbekistan	-1.15
14	Kyrgyz Republic	1.68	**33**	Comoros	-1.15	**51**	Guinea	-1.84
15	Indonesia	1.15	**34**	Côte d'Ivoire	-1.15	**52**	Sierra Leone	-1.84
16	Kuwait	1.15	**35**	Gabon	-1.15	**53**	Sudan	-1.84
17	Lebanon	1.15	**36**	Guinea-Bissau	-1.15	**54**	Suriname	-1.84
18	Saudi Arabia	1.15	**37**	Kazakhstan	-1.15	**55**	Syria	-1.84
19	Somalia	0.98						

Source: Chinn and Ito (2008). Updated dataset is available at http://web.pdx.edu/~ito/Chinn-Ito_website.htm.

Table 1 shows the level of openness in the OIC member countries. 22 countries have relatively open capital account, while 33 countries have rather closed capital account. Average of the 55 member countries is almost zero, -0.02. Before the US sub-prime mortgage crisis turned into a global crisis, 9 OIC member countries increased their financial openness in 2008. However, in 2009, 7 member countries reduced their degree of openness in response to the crisis, while only 4 member countries eased the controls on capital movements. Afghanistan, Bahrain, Iraq and Somalia were the 4 countries that opened up further their capital accounts. Among the countries that raised the openness level in 2008, Malaysia and Tajikistan restored their pre-crisis level of openness by limiting capital flows again, but Azerbaijan put only partial restrictions while Sierra Leone applied further restrictions compared to their pre-crisis level of openness.

A critical question that arises from recent experience is whether countries with less-open financial markets have enjoyed insulation from the global economic crisis. Cline (2010) compares the changes in growth from the three-year average in 2005-2007 to the expected average for 2008-2010 for 24 emerging economies (Figure 7). The horizontal axis reports the Quinn index of financial openness (for (2000-2004) and vertical axis the change in growth rate. There is little evidence between the decline in growth and financial openness.

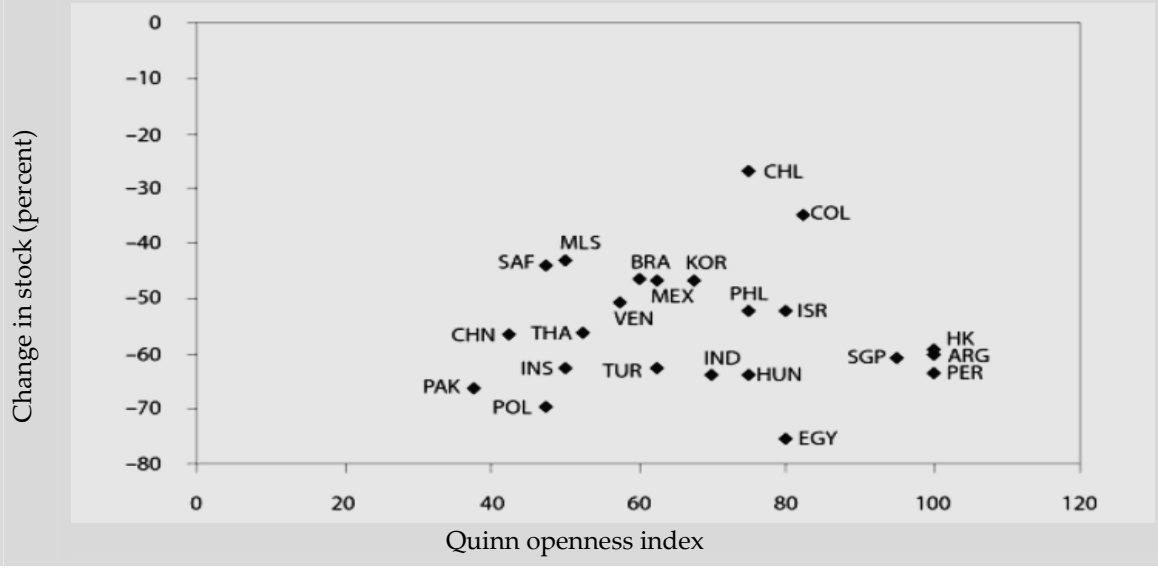
Figure 7: Change in average real growth from 2005-2007 to 2008- 2010 and financial openness



Source: Cline (2010), p. 257.

Figure 8 correspondingly compares the percent change in real stock prices from end-2007 to March 9, 2009, the low point for international equity prices, and Quinn financial openness index. It appears to be no significant relationship between the two variables, implying that the financial crisis did not impose greater stock market collapses on more financially open emerging economies than on more closed ones. Among the OIC member countries considered in the study, Egypt appears to be affected most severely in terms of stock market losses. Egypt had also relatively more liberalized financial accounts compared to other OIC member countries.

Figure 8: Real change in stock prices and financial openness (End-2007 to March 2009)



Source: Cline (2010), p. 258.

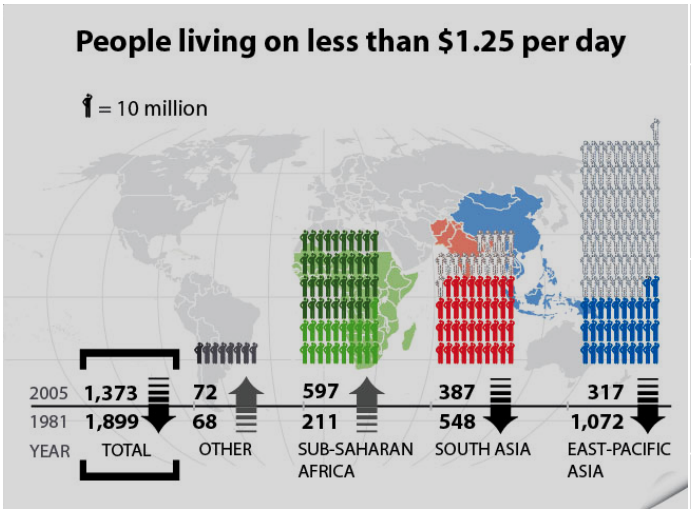
What is the role of financial innovation in economic growth? Given the roles of credit default swaps, collateralized debt obligations, and other new financial instruments in the recent financial crisis, financial innovation has developed a bad reputation. Correspondingly, financial innovations are regarded as mechanisms for fooling investors, dodging regulatory frameworks, and boosting the bonuses of bankers without improving the quality of the services provided by the financial sector. Financial innovation can bring about economic instability, stagnation, and despair. However, without innovations in finance that match the increases in complexity in economic activities, the quality of financial services moderates and reduces the prospects for future growth.

The overall tendency towards more open capital accounts in the world is apparently associated with the increased frequency of crisis during the last decades. Evidence suggests that benefits from financial liberalization can be realized only if there exists a well-developed financial sector with prudential supervision. The financial system can be a catalyzer of economic prosperity or a destructive cause of poverty and misery. The impact of the financial system on the rest of the economy depends on its efficiency and efficacy in mobilizing and allocating resources, monitoring the use of funds, diversifying risk, and easing the exchange of goods and services.

Food Insecurity and the Impact of the Crisis on the World's Poorest

Poor were hit twice, first by the global food crisis of 2007/08 then by global economic crisis of 2008/09. In approximate terms, the global food crisis of 2007/08 involved a doubling of international wheat and maize prices within two years and a tripling of international rice prices within just a few months. Moreover, low-income countries (LIC) faced a sharp contraction in export growth, FDI inflows, and remittances, and lower-than-committed aid. As a result, prospects for economic growth are deteriorated. Such rapid increases in the international prices of basic foods and income reductions understandably raised concern about impacts on the world's poor.

Many simulation exercises of the impact of higher food prices on poverty have been conducted by international organizations. Using the concept of calorie insufficiency rather than poverty, the U.N. Food and Agriculture Organization estimated that around 75–80 million people were thrown into hunger during the 2008 food crisis and another 97 million during the 2009 financial crisis. A study by World Bank also estimated that 63 million people were thrown into hunger by the two crises (Tiwari and Zaman, 2010). Prior to the crises, however, the incidence of poverty in the developing world had been declining. Estimates show that the poverty rate for the developing world as a whole over 1981-2005 using the poverty line $2.00 a day, at 2005 purchasing power parity (PPP) for consumption, had a declining trend. Fall in the poverty rate over 1981-2005 was about 0.8% point per year (Chen and Ravaillon, 2008).



GLOBAL POVERTY INDICATORS

Poverty headcount ratio at $1.25 a day (PPP) (% of population)

41.7% 1990 to 25.2% 2005

People living on less than $1.25 a day (PPP) (millions)

1,818 1990 to 1,373 2005

Source: PovcalNet

In connection with the discussion in the previous section, the direct impact of the global financial crisis on LICs is expected to be stronger for countries with a higher degree of financial integration. With small derivatives and interbank markets, low level of reliance on international capital, and regulatory barriers constraining new financial products, the depth, diversification, and competitiveness of LICs' financial systems remain mostly shallow and distortionary (IMF 2009). As a result, the direct financial transmission of the global crisis appears to have been relatively limited.

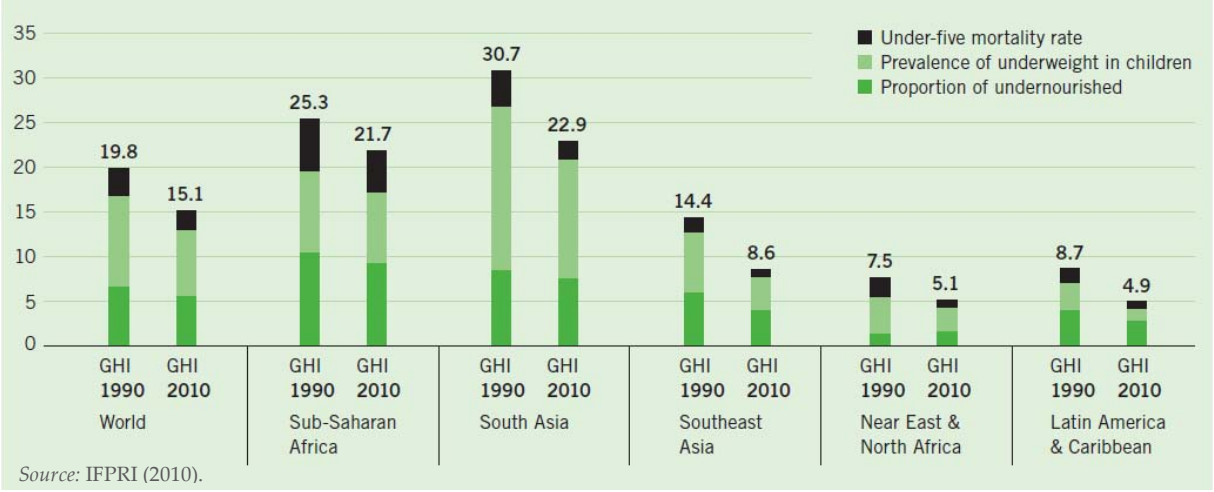
Hunger and Undernourishment

According to the FAO statistics, a total of 925 million people are still estimated to be undernourished in 2010, representing almost 16 percent of the population of developing countries. The fact that nearly a billion people remain hungry even after the recent food and financial crises have largely passed indicates a deeper structural problem that gravely threatens the ability to achieve internationally agreed goals on hunger reduction. After increasing sharply from 2006 to 2009, owing to high food prices and the global economic crisis, the number of undernourished people in the world is estimated to have declined in 2010 as the global economy recovers. But the number of undernourished people remains unacceptably high – higher than it was before the recent crises, higher than it was 40 years ago, and higher than the level that existed when the hunger-reduction target was agreed at the World Food Summit in 1996 (FAO, 2010a).

Based on the latest available data, the total number of undernourished people in the world is estimated to have reached 1,023 million in 2009 and is expected to decline by 9.6 percent to 925 million in 2010. Developing countries account for 98 percent of the world's undernourished people and have a prevalence of undernourishment of 16 percent – down from 18 percent in 2009 (FAO, 2010a).

According to the Global Hunger Index (GHI)[2] of International Food Policy Research Institute (IFPRI), the 2010 world GHI shows some improvement over the 1990 world GHI, falling from 19.8 to 15.1 (Figure 9). Over the last three years, improvement was, however, only 0.1 points. In the world GHI for 2010, the proportion of underweight children still contributes close to half of the total score (7.4 points in 2010 compared with 10.1 points in 1990). The proportion of undernourished people contributes 5.4 points and under-five mortality, 2.2 points (IFPRI, 2010).

Figure 9: Contribution of components to 1990 GHI (based on data from 1988–92) and 2010 GHI (based on data from 2003–08)



Source: IFPRI (2010).

[2] The GHI captures three dimensions of hunger: insufficient availability of calories, shortfalls in the nutritional status of children, and child mortality. The Index ranks countries on a 100-point scale, with 0 being the best score (no hunger) and 100 being the worst. Values less than 5.0 reflect low hunger, values between 5.0 and 9.9 reflect moderate hunger, values between 10.0 and 19.9 indicate a serious problem, values between 20.0 and 29.9 are alarming, and values of 30.0 or higher are extremely alarming.

Financial Speculation in Commodity, Speculative Bubbles and Food Crisis

In one of the briefing notes of De Schutter, United Nations Special Rapporteur on the Right to Food, he argues that the magnitude of the increase in the price of rice by 165% between 2007 and 2008 is difficult to explain by using market fundamentals. The note also disagrees with the IMF's argument that food price increases in 2007-08 were resultant of the increase in per capita growth in China and India. The note suggests that there are number of signs in the data suggesting the price spikes were due to the emergence of speculative bubbles. Stanley (2010) stated that the outstanding contracts in maize futures increased from 500,000 in 2003 to 2.5 million in 2008. The value of index fund holdings jumped from $13 billion in 2003 to US$ 317 billion by 2008. It has been stated that "the trend towards greater financialisation of commodity trading is likely to have increased the number and relative size of price changes that are unrelated to market fundamentals" (UNCTAD 2009). Went *et al.* (2009) investigated the existence of speculative bubbles in commodity markets using the non-parametric duration dependence test. They found evidence of speculative bubbles in 11 out of the 28 commodities in their study. The commodities with speculative bubbles include oilseeds, soybean, wheat and others.

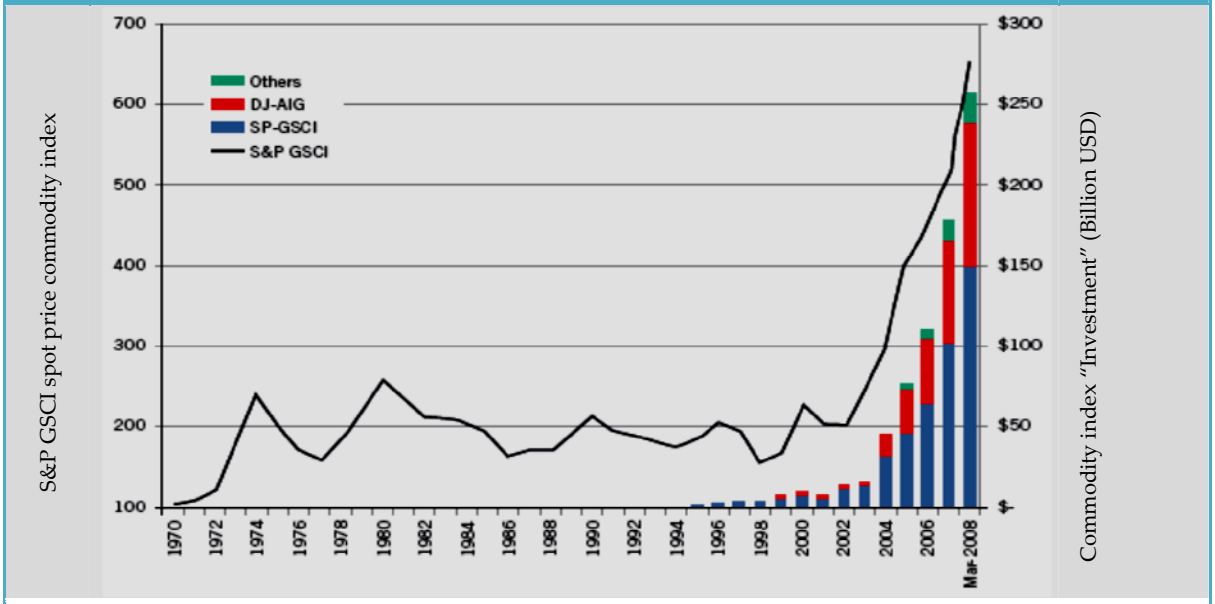

Photograph: Jose Cendon/AFP/Getty Images

In contrast, some other studies argue against the existence of such bubbles. However, most of the studies agree that there is strong correlation between food price volatility and future investments in commodities. The disagreement is about the causal relationship between the two. More work is needed to fully understand the impact of commodity speculation on prices increases in recent years. However, there is already compelling evidence that speculation is causing adverse impacts on global food prices and therefore it is highly important that trading in international commodity markets should be regulated more effectively. Speculative food prices are likely to have a direct negative impact on the people who are already food insecured and therefore will suffer more from hunger and malnutrition.

In his briefing note, De Schutter presented data on commodity index investment and spot price commodity index (Figure 10). The initial increase in the spot prices led to increased futures prices, which attracted the speculation and thus resulting in repeating the motion again. So the bubble continues to grow until the non-traditional speculators lose the ability to continue, when they feel the upward spiral comes to an end.

In principle, future investments in commodities help the consumers and producers to hedge against the risk of future price increases. However, it is interesting to note that only 2% of all the future contracts are actually involved in actual delivery of the physical commodity (FAO, 2010b).

Figure 10: Spot Price Commodity Index and Commodity Index Investment



Source: Schutter (UN, 2010). DJ-AIG and SP-GSCI are commodity futures investment indices.

The UN and G20 had called for regulatory measures to improve the functioning and transparency of international financial markets, including the commodity markets across the globe (UN 2009). It had been emphasized that the financial crisis has to be seen as a global crisis and accordingly the responses have to be framed from a global perspective. The UN report concludes that the financial sector has systematically failed to perform its key roles in allocating capital and managing risks. Governments have been deluded by market fundamentalism and failed to enforce adequate regulations. One of the concluding notes of the report is as follows:

> *"In periods before the outbreak of the crisis, inflation spread from financial asset prices to petroleum, food and other commodities, partly as a result of their becoming financial asset classes subject to financial investment and speculation…"*

The UN Commission Report concluded that the present financial crisis demonstrates failure at many levels. The essential insight of the report is that the crisis is not the result of the failures of the system but rather the system itself: its organizations and principles, and its distorted and flawed institutional mechanism are the cause of many of these failures.

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