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Regional cooperation

The economic situation in the Economic Commission for Europe region: Europe, North America and the Commonwealth of Independent States in 2008-2009

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Summary

The Economic Commission for Europe (ECE) region entered in 2008 what is forecast to be the worst economic downturn since the Second World War. Each of the sub-regions of the ECE is either experiencing or expecting to experience negative growth in 2009. The decline in growth has been accompanied by rising unemployment, and especially large declines in international trade and capital flows. Government fiscal positions have deteriorated significantly. The global slowdown and ECE-wide recession resulted from a financial crisis which began in the US but quickly spread to western Europe, and then to the periphery regions of the ECE as well as the rest of the world. In fact, the declines in economic growth in the emerging economies of the ECE are likely to be greater than in the advanced economies where the crisis originated. The crisis is noteworthy not only due to its severity but to its global synchronization.

Due to tight integration and interconnected financial markets, the potential for adverse contagion in emerging Europe is viewed to be quite high. Although relatively small, there remains a non-negligible possibility that there could still be a systemic financial meltdown throughout the European emerging markets that would have significant and long-lasting global implications. In addition, if the consequences of the crisis are not properly addressed, social and political instability could arise in some of the ECE emerging economies

I. Overview of economic situation in the Economic Commission for Europe region

1. Annual real growth in the ECE region in the three years prior to the beginning of the crisis (2005-2007) averaged 3.2 per cent but this fell to half of that (1.5 per cent) in 2008 and is forecast to fall to negative 3.5 per cent in 2009 before recovering slightly to about one-half per cent in 2010. Prior to the crisis, the growth pattern in the ECE had followed global trends with the European emerging economies growing two to three times faster than the advanced economies in North America and western Europe. To a significant degree this growth was due to large capital inflows which allowed them to maintain investment at higher rates than would have been possible from relying solely on domestic savings. This dependence on external finance, however, has proven to be a major disadvantage during the current downturn as it provided a channel for importing the crisis.

2. The ECE region which is composed of 56 economies is a very diverse area with advanced, emerging, and a few rather poor developing countries. The nature of the crisis in terms of how it entered and impacted these different economies varies considerably, and the policy options available to these countries also vary considerably due to differing economic circumstances and institutional constraints. In 2009 growth in each of the ECE's subregions is forecast to be in the range of minus three to minus five per cent. Not only is growth forecast to be lower in the European emerging economies but their declines relative to their recent historical experience will be much larger as well. In addition the emerging economies have weaker social safety nets than the advanced economies and have a larger percentage of their populations nearer subsistence levels; thus for these reasons, the economic downturn is much more severe in the European emerging economies than in the advanced economies.

3. In 2009, growth is expected to be negative 5.1 per cent in the Commonwealth of Independent States (CIS), negative 4.6 per cent in south-east Europe (SEE), negative 4.2 per cent in the eurozone, negative 2.7 per cent in North America, and negative 2.4 per cent in the EU new member States (NMS). The economic downturn has been quite severe in the Baltic economies, Iceland and Ireland where growth is forecast to be close to negative 10 per cent and somewhat severe in Germany, Russia, and Ukraine. A few of the smaller ECE economies such as Albania, Azerbaijan, Cyprus, Tajikistan, Turkmenistan, and Uzbekistan may have positive growth in 2009; it may be relatively solid in the latter two economies. Although a slow recovery is expected for 2010 with positive but low growth throughout most of the region, there is considerable uncertainty surrounding this forecast, and there is a reasonable possibility that growth could still be negative in the EU.

4. The negative growth being forecast for 2009 in the European emerging economies is an unfortunate setback because a number of them, especially in southeast Europe and the CIS, had yet to fully recover from the transition process which began in 1989. For example, most of the states created out of Yugoslavia (except Croatia and Slovenia) and the energy-poor CIS had real GDPs in 2008 which were below what they had in 1989 and Moldova had a real income of only about half of what it had before the transition. By 2008, Russia had approximately returned to its 1989 income level although some of the energy-rich CIS including Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan were significantly above their 1989 levels, as were Armenia and Belarus. Thus for many of the transition economies, real income in 2009 will be below what it had been 20 years earlier.

5. At a general level, although the financial and economic shock was smaller in Europe than in the US, the European policy response was more delayed and considerably weaker and as a result their decline in GDP has been as large or even larger than in the US. For the advanced economies of the ECE (North America and western Europe) this will be their deepest recessions since the second World War, although unemployment may not reach the levels of the 1981-82 downturn. In emerging Europe, which experienced a “sudden stop” in terms of capital inflows, the magnitude of the shock was large, although of a different nature than in the advanced economies. These emerging economies, however, have been unable to implement counter-cyclical macroeconomic policies and as a result their economic declines have been quite large, generally larger than in the advanced economies. Their downturns, however, will not be as severe as their transitional recessions of the early 1990s. The 2007-2010 global crisis will likely be remembered as the “Great Recession.”

6. Unemployment rates in the U.S, Europe, Turkey, and the CIS are likely to reach double digits by 2010; in some European economies the situation is much worse, for example by 2010 unemployment may reach 20 per cent in Spain and 17 per cent in Ireland. Labor layoffs seemed to occur much earlier in this economic downturn than they had in earlier ones.

7. For the advanced economies, the crisis has moderated inflation that had begun to increase above target levels in early 2008; the economic slowdown by leading to a rapid and steep decline in international commodity prices brought headline inflation rates in Europe down sharply. Although the advanced economies may experience a short period of deflation during 2009, this is unlikely to be persistent since it was due to one-time declines in world commodity prices. For emerging Europe,

however, the crisis by leading to significant currency depreciations has in some cases increased inflation. Thus for example, average consumer prices were 14 per cent higher in the CIS in January 2009 than a year earlier, and inflation may be over 5 per cent in most of south-east Europe in 2009. The fall in world commodity prices resulted in large declines in the export earnings of Russia and the energy abundant CIS in central Asia.

8. Trade for the ECE economies has declined significantly over the last year, generally declining by a quarter to a half. This has been due to both the decline in national incomes and consumption and the collapse of trade financing as credit markets seized up. Particularly hard hit has been investment spending and the purchase of durable consumer goods, and as a result trade in manufactures has been especially negatively impacted. In February 2009 US merchandise exports were 22.6 per cent lower than a year before and US imports were 30.4 per cent lower. For the same period, Russian merchandise exports declined by 47.5 per cent and imports declined by 36.5 per cent. In January 2009 EU exports were down 24.8 per cent and imports were down 22.1 per cent from a year earlier. Germany exported almost \$1.5 trillion in 2008 and remained the world's largest exporter; the US is third having been overtaken by China.

9. The equity markets in the ECE's advanced economies have lost more than one-half of their value since their peaks in 2007 while those in many of the emerging economies have lost three-quarters of their value. A large percentage of the equity capital of the banking sector in the US, western Europe and the European emerging markets has been wiped out by the crisis. A significant number of the largest marque banks are insolvent or close to becoming insolvent, although the vast majority of small

and medium-sized banks are in a much healthier situation. In the spring of 2009, the US Treasury performed “stress tests” on its large banks to assess their viability. Governmental attempts to recapitalize the banks have so far been only marginally successful; as a result the issue of how to recapitalize the banking sectors of these countries remains largely unresolved. Currently interbank markets in the US and Europe remain dysfunctional and most newly created bank debt requires a government guarantee to be marketable. The Canadian banking sector largely avoided the problems that plagued US and European banks; there were no bank failures or bailouts.

10. The advanced economies of the ECE have responded to the crisis with unprecedented fiscal stimuli and monetary easing. However, it is generally believed that the response has been below what was required, especially in western Europe. The weak European response is due significantly to inadequately designed institutions for conducting macroeconomic policy. There are, however, long-run costs in terms of potential inflation and debt repayment that result from the aggressive use of macroeconomic stimulus. Only after the crisis is completely over and many of the longer-term complications of debt and inflation have been resolved will it be possible to fully evaluate whether the more aggressive response of the US was preferable to the more cautious European approach.

11. The fiscal stimulus packages in North American and Europe consisted of both spending increases and tax cuts. Approximately two-thirds of the US 2009 stimulus consisted of additional spending and one-third was tax reductions; approximately a third of the spending was for infrastructure projects. In Europe, the German program was tilted towards tax cuts while the French plan emphasized public projects. Most of the packages allocated some funds towards environmental projects consistent with

the “Green New Deal” theme, however the ECE region compared unfavorably on this score to what some of the Asian economies (especially the Republic of Korea) proposed.

12. Once the current crisis/recession is over, it will be necessary to unwind any stimulus quickly in order to avoid inflation and limit the excessive growth of government debt. However, this will be a major policy challenge and will probably prove to be very tricky to time properly, because macroeconomic policy was tightened prematurely during the Great Depression in the 1930s, which caused the world to have a relapse into several more years of depression, and the same thing happened as well in Japan in the 1990s.

13. Regulatory reform of the financial sectors is expected in the US and western Europe; these are primarily national issues but there is a strong need for international cooperation and harmonization in implementing these reforms. Generally it is agreed that mortgage origination procedures need to be tightened, banking supervision needs to be strengthened and extended to a wider range of institutions, hedge funds and derivative markets need more oversight, credit rating agencies need to be regulated, and bank leverage should be reduced. There is a need to reduce pro-cyclicality in accounting rules (i.e., accounting practices may have to move away from mark to market valuation) and in bank lending practices, and central banks will have to consider asset prices in making monetary policy. Each of these is quite technical and the national financial authorities will have to decide how best to achieve these basic objectives.

14. Although the ECE region is composed of a mix of economies from some of the richest to some of the poorest in the world, the region is primarily composed of advanced economies which have in general been growing significantly slower than the world economy overall. As a result the share of the world economy accounted for by the regions economies has been on a long-run downward trend. The region accounted for 57.5 per cent of real world output in 1999 but that has declined to 51.2 per cent in 2009. The reduced world share has been roughly similar for North America and the EU-27 with their respective shares falling from 25.9 and 25.5 in 1999 to 22.0 and 21.8 in 2009. The share accounted for by the CIS economies has increased from 3.5 percent in 1999 to 4.6 per cent in 2009.

15. Five countries in the ECE region- Denmark, Luxembourg, the Netherlands, Norway, and Sweden - have exceeded the UN target of 0.7% of GDP in official development assistance (ODA) in 2007. Most of the other western European economies and Canada provided only about one-half of the target, and the U.S., which provides the largest amount in absolute terms (\$21.8 billion), provided only about a fourth of the target.

16. Energy security remains an import concern for both the suppliers and users of energy in Europe. A number of the EU economies, especially the NMS are currently dependent on Russia for a large percentage of the energy needs. There have been several pricing disputes between Russia and Ukraine on the transshipment of gas to the EU over the last several years that have resulted in the temporary closure of pipelines that have created serious shortages in the EU.

17. Due to the effects of globalization, technological change, labor market reforms, and less progressive tax structures, income inequality has been increasing in North American and Europe, especially those economies following a more market-oriented model. The growth in the income of the richest 1 percent or the richest 0.1 percent has been particularly high (relative to average wage levels) over the last decade. For example, in the U.S. the income of the top one percent increased (238 per cent) over ten times more than that of the middle 60 per cent of the population (21 per cent) between 1979 and 2005. Inequality increased considerably in the transition economies during the 1990s and has recently stabilized in some but continues to deteriorate in others. Given that globalization and technological change affect all countries, but that the increase in inequality has varied extensively, suggest that institutional factors and the policy environment for dealing with these changes are quite important in limiting the rise of inequality.

II. North America

18. The US entered into recession in the fall of 2007 and has remained in recession through the spring of 2009. By March 2009 the level of employment in the US had declined by 5.1 million jobs since its recession began in December 2007; unemployment increased to 13.1 million, which translates into an unemployment rate of 8.5 per cent which is the highest in 25 years. Since approximately half of the job losses have been in the male-dominated construction and manufactures sectors, the unemployment rate for men was approximately two percentage points higher than for women, and it was 5.4 percentage points higher for blacks than for whites. The employment-population ratio in March was 59.9 per cent, the lowest level since 1985. The number of people receiving unemployment insurance benefits in the US reached 5.84 million in the spring of 2009, the largest number since record-keeping

began in 1967. The number of people on food stamps increased to 32.2 million in January 2009, also the largest in history; this is about 20 per cent more than the previous record in 1994. Despite the negative net jobs situation, the US economy exhibits considerable dynamic churning; during February 2009 although 4.8 million workers lost or quit their jobs, 4.3 million workers were hired.

19. In February 2009 industrial production in the US was down 11.8 per cent from a year earlier and manufacturing output was down 14.0 per cent while manufactures employment had declined by 1.5 million (or 11 per cent) since the recession began. In March 2009 car sales were down 23.5 per cent y-o-y.

20. The US macroeconomic policy response in terms of the standard tools of monetary and fiscal policy was unprecedentedly large by historic standards but was nevertheless insufficient to fully contain the crisis. Interest rates were reduced rapidly to near zero by late 2008 and monetary policy was further magnified by the implementation of quantitative easing. However, with dysfunctional capital markets, the effectiveness of monetary policy was reduced. There was a fiscal stimulus in mid-2008 followed by another historically large stimulus of \$787 billion in early 2009 composed of approximately two-thirds spending increases and one-third tax cuts. Policy efforts to restore the functionality of financial markets have been less successful. Initial efforts to remove the toxic assets from the banking sector did not achieve their objective. Stress tests performed by the government which found 10 of the largest 19 banks needing more capital (\$74.6 billion in all) did help clarify the financial condition of the banking system which was a necessary step for reestablishing normality to bank lending. In the first four months of 2009, 32 banks failed in the US while 25 had failed during

2008. The US government also implemented a number of programs to help stabilize its housing market and assist mortgage holders experiencing difficulty in making their payments.

21. For the 2009 fiscal year the federal government of the U.S. is projected to have revenues of 15.4 per cent of GDP and spending of 27.7 per cent; these are the lowest and highest percentages of the respective variables in over 50 years. As a result, the deficit of 12.3 per cent (\$1.75 trillion) was its largest since the Second World War; the deficit for fiscal 2010 is forecast to be approximately 10 per cent; as a result of these deficits the US national debt as a percentage of GDP is likely to more than double and approximately reach 100% of GDP in 2012. By 2008 in the US, household debt as a percentage of national income was the highest that it had been since the 1930s. As the crisis developed, households began retrenching their spending in anticipation of uncertainty and tough times and the ongoing attempt of households to increase their savings has further depressed economic growth.

22. In the US housing starts fell 33% to 904,300 from 1.335 million in 2007 and were the lowest since records began. By December 2008 they were 76% below their peak in January 2006. There were more than 3 million foreclosures in the US in 2008 and they were running at about 300,000 a month in early 2009. In several states (i.e., California and Florida) most negatively impacted, foreclosure sales represent almost one-half of all home sales. The median price of an existing house fell (-15.3%) the most in 2008 of any year since records began in 1968. By Feb. 2009 average US home prices were back to their levels in the third quarter of 2003; from the peak in July 2006, the S&P-Shiller Home

Price Index for 20 cities was down 30.7%, and the 10-city composite was down 31.6%. US mortgage rates, however, by the spring of 2009 were near all-time lows.

23. The widely followed U.S Dow Jones Industrial Average index fell by 33.8 per cent in 2008 which was the largest yearly calendar decline since 1931. US stock prices also fell significantly in the first quarter of 2009 but quickly recovered from those lows during an April rally. The stock market recovery was widely interpreted as suggesting that market participants had come to believe that the possibility of a depression had been averted.

24. In order to avoid inflation once a recovery begins, the US Fed will have to act aggressively to reduce the money supply and the nearly \$700 billion of excess reserves being held by the commercial banks as deposits at the Fed.

III. Advanced economies of Europe

25. The economic performance of the eurozone is likely to be one of the world's worst during this global crisis with growth of -4.2% in 2009 and -0.5 in 2010. The economic slowdowns being forecast for Iceland and Ireland would represent the largest for an advanced economy since the 1930s.

26. In the EU the unemployment rate was 7.9 per cent in February 2009; 7.8 per cent for men and 8.0 per cent for women. It varied considerably from 15.5 per cent in Spain, 14.4 per cent in Latvia, and 13.7 per cent in Lithuania to a low of only 2.7 per cent in the Netherlands. Currently there are 19.2 million unemployed in the EU and estimated job losses for 2009 and 2010 may be about 8.5 million.

The unemployment rate in Iceland increased from 1 per cent prior to the crisis to 9 per cent in March 2009.

27. The regulatory failure that produced the current crisis was not restricted solely to the US as it was often the European affiliates of US firms that engaged in some of the riskiest behavior and these were generally outside the jurisdiction of US regulators. For example, this was the case for Lehman Brothers, where its UK office was responsible for many of its questionable trades, and AIG, which sold many of its credit default swaps through a London-based French banking subsidiary (Banque AIG). Thus the European financial sector was not simply a passive purchaser of these assets but played an active role in securitizing, distributing, and insuring the assets that would later prove to be toxic. Overall, the crisis has revealed that the regulatory failure was not confined to one or two specific operations in one or two countries but to a broad spectrum of financial market activities throughout the US and western Europe.

28. The severity of the crisis in the advanced economies of Europe has been due to the fact that: 1) many European banks owned a surprisingly large share of the toxic assets, 2) the national regulatory and institutional structure of the financial sector in most European economies was poorly designed for dealing with financial market turmoil, 3) regional or pan-European institutions and regulatory systems were inadequately designed for the financial situation that developed, 4) European banks were more highly leveraged than US banks, 5) in some cases European banks were overly reliant on international wholesale financing, 6) European banks had lent far more to emerging markets (than US banks) and were thus much more exposed to the downturn in these economies, especially those in European

emerging markets which were particularly vulnerable to a crisis due to large current account deficits and extensive foreign-currency denominated debts, 7) even in those economies that escaped the initial financial shocks, the regional trade linkages were quite large, 8) the design of the European Monetary System essentially eliminated lender of last resort backing for national commercial banks and sovereign debt, 9) European policy makers were more reluctant to implement counter-cyclical macroeconomic policy, 10) several European economies had their own housing bubbles combined with weaker mortgage lending standards, and 11) government assistance to the sectors most negatively impacted was constrained by nationalistic competitive concerns.

29. The European macroeconomic response to the crisis was weaker and implemented more slowly than in the US. Although the European Central Bank increased liquidity in inter-bank markets at the first sign of trouble, one year into the crisis, interest rates in the eurozone were higher than when the crisis first began late in the summer of 2007. The ECB was instead preoccupied with headline inflation that was slightly over its target due to escalating world commodity prices. Interest rates were finally lowered to one per cent in May 2009, but they remain higher than in most other advanced economies. A number of other economies in the EU but outside the eurozone, had to roughly follow the pattern established by the ECB. The Bank of England was much more aggressive in lowering rates early in the crisis and ultimately lowered them to 0.5 per cent, the lowest in its 315 year history. Norway had also cut rates to 1.5 per cent which was an all-time low by May 2009.

30. The advanced western Europe countries, led by Germany, were reluctant in implementing large discretionary fiscal stimulus packages due to their large automatic stabilizers (which are estimated to

be about twice the size of those in the US), their conservative economic philosophies regarding macroeconomic policy, more pressing long-run demographic concerns, and built-in institutional constraints on fiscal deficits. The consolidated eurozone fiscal deficit is forecast to be 6% in 2009; this is twice the limit enshrined in the Stability and Growth Pact. The UK's deficit is forecast to be as high as 14% of GDP in 2009 and 11% in 2010, although public debt is only likely to reach 61% of GDP in 2009.

31. In February 2009 industrial production was 18.4 per cent lower y-o-y in the eurozone and 17.5 per cent lower in the EU, a record decline. Manufacturing activity was particularly hard hit in the eurozone; new orders in January 2009 were 34% lower than a year earlier. This represented the largest monthly y-o-y decline since Eurostat began compiling this data in 1996. The decline in European industrial production was due significantly to the world-wide decline in trade and was therefore especially large for those economies that exported a high percentage of capital and consumer durables.

32. Housing prices in western Europe and the NMS increased substantially over the last decade, often more than in the US. Currently EU house prices are falling mostly in the range of 10 to 20 per cent y-o-y, and sales of existing homes are down between 25% and 50%. The situation is considerably worst in some economies such as Spain, Ireland and the UK than in others such as Germany which really did not experience a price boom. The number of unsold new homes in Spain is equal to about three years of construction at the current level (260,000) which is about one-third of the level (749,000) in 2005-2007. Although the housing busts in these economies do have significant financial implications,

Europe is unlikely to experience the level of foreclosures or the collapse of European mortgage-backed securities because lending standards were much more rigorous than the subprime loans in the US.

33. The future institutional shape of the European Union remains in some doubt as it is not clear whether the Lisbon reforms will be implemented or not. These reforms generally attempt to ease the decision making process by increasing the range of issues to be decided by qualified majority voting instead of by unanimous agreement, create an EU president and diplomatic service, and expand the powers of the European parliament. The Irish voted against it in June 2008 and it is not clear how the very severe recession currently in the country will impact a second referendum being anticipated for the fall of 2009.

34. Iceland suffered a major financial crisis in 2008 when its banking system, which was highly leveraged, failed. Iceland required an IMF rescue package. The government of Iceland fell in early 2009 largely as a result of the economic crisis. The new government is likely to apply to begin the EU accession process in the summer of 2009 and hold a referendum on the issue over the next year and a half; a major advantage for Iceland would be the ability to join the eurozone.

35. In the coming year there is likely to be significant reform in a wide array of activities in the European financial sector as in the US. One issue of particular importance to Europe will be how to address a number of regulatory issues concerning cross-border banking entities. Western European banks owned a large share of the banking sector in the EU new Member States and south-east Europe,

and questions arose as to what were the responsibilities of host and parent governments in addressing the banking crisis.

36. The gap between Europe and the United States of per capita income and productivity which had been declining for most of the post-World War II period, reversed in the 1990s due to a productivity surge in the United States. This led the European Union to launch the Lisbon agenda which had the goal of closing this gap. Up to this point this initiative has only been partially successful. The gap in per capita income is no longer widening but is not closing either. With Europe experiencing a larger downturn due the crisis and perhaps a slower recovery, and with the US proposing increased federal funding for scientific research there is little likelihood that any progress will be made in closing this gap over the next five years.

IV. European emerging economies

37. The European emerging markets were initially sheltered from the first wave of financial instability, as their banking activity was based on traditional lending models, with no exposure to the toxic assets. However, the situation deteriorated dramatically in late 2008, as global capital markets came to a standstill as a result of increased risk aversion and the accompanying “flight to quality”. Private capital flows to the world’s emerging markets declined from \$929 billion in 2007 to \$466 billion in 2008 and are forecast be only \$165 billion in 2009. The European emerging economies had been major recipients of these flows and their access to them was particularly curtailed as market

participants increasingly became fixated on the vulnerability associated with their large current account deficits.

38. It is likely that a significant number of the European emerging markets will need some type of multilateral support before the crisis is over. By April 2009, seven economies (Bosnia and Herzegovina, Hungary, Latvia, Ukraine, Belarus, Georgia, and Armenia) already had IMF programs and others were close to concluding an agreement (Romania and Serbia). The sizes of the packages were in the range of 5 to 10 per cent of their GDPs. Several of the countries have experienced difficulties in meeting IMF agreed targets and their disbursements have been temporarily put on hold (Latvia, Hungary, and Ukraine). These are in addition to the IMF rescue of Iceland, a European advanced economy. Several other countries established new credit lines from the IMF as a precautionary move; Poland obtained \$20.5 billion to boost the reserves of its national bank so as to provide more support for its currency.

39. Industrial production and especially manufacturing have been impacted the most severely in these economies; trade in these sectors has also fallen the most. Car production has been especially impacted and accounts for a sizeable percentage of their industrial production; per capita automobile production is quite large in several of the NMS, including Slovakia, Slovenia, and the Czech Republic. The largest declines in industrial production in the NMS occurred in Estonia (-30.2%), Hungary (-29.0%), Latvia (-24.2%), Slovenia (-21.2%), and the Czech Republic (-20.3%). In the largest European emerging economies outside the EU, industrial production (January 2009, y-o-y)

was significantly lower as well, falling by 34 per cent in Ukraine, 21 per cent in Turkey and 16 per cent in Russia. By January 2009 automobile production had declined by 60 per cent (y-o-y) in Turkey.

40. The development model of many of the European emerging economies, especially the NMS, was one that has relied extensively on external capital to finance their development. The region was somewhat unique in this respect as many of the other emerging economies became exporters of capital. As a result of importing capital, businesses have been able to invest more and households consume more than would have been possible otherwise. However, the crisis caused global capital markets to seize up which limited the access of these economies to external finance and plunged many of them into a serious economic downturn. The crisis has thus exposed the weakness of relying on external capital for developmental finance; without significant reform of the international monetary system, countries are likely to avoid this development model in the future and this will have a detrimental effect on global development.

41. Economic inequality remains relatively low in the transition economies compared to other emerging markets at a similar level of development; inequality however is higher than it was historically under planning and somewhat higher than in the western European economies. Direct taxes and transfers have had a significant redistributive impact in these economies. Cross sectional comparisons reveal that democratization and low inflation appear to contribute to reduced inequality while large scale infrastructure privatization appear to increase it.

42. After the financial crisis which began in August 2007, both the inflows and outflows of portfolio equities and bonds were significantly reduced in the European emerging economies. During 2008 these dropped to about one-half of their levels prior to the beginning of the crisis. An important financial flow for a number of the European emerging economies has been remittances; for some, these are the largest external financial inflow and are larger than either capital inflows or official developmental assistance (ODA). Remittances are expected to decline significantly in the next two years, and this will have not only macroeconomic consequences but will directly affect poverty, human capital accumulation and health outcomes, as these flows generally go to some of the poorest households. In Moldova, remittances fell from 35 per cent of GDP in 2006 to 25 per cent in 2008 and are likely to fall further in 2009 and 2010.

43. The rapid economic growth experienced in the European emerging markets between 2002 and 2007 allowed some progress in terms of achieving the Millennium Development Goals (MDGs). Within the poorer economies, the problems of poverty and social exclusion have a strong regional and ethnic dimension. Trends for several of the MDG goals especially relevant for the region, such as those connected with the AIDS and tuberculosis epidemics, seem unrelated to income trends; for example HIV infection has more than doubled in the CIS since 2001 despite the rapid growth of the region. Therefore with growth slowing down and some MDG indicators invariant to growth, significant further progress will require more explicit policy changes in a number of areas if the goals are to be achieved by 2015.

44. The current crisis has already and will further retard or even reverse the recent progress in achieving the Millennium Development Goals (MDGs) in the ECE region. For the ECE region, extreme poverty had almost been eliminated by the end of 2007 but with higher food prices, falling employment opportunities, reduced remittances, and strained safety nets, it is estimated (by UNDP) that already another 10 million people in the region have been pushed back into extreme poverty. There is likely to also be a reversal of recent progress in addressing gender equality. The deteriorating economic situation is likely to further worsen the basic underlying conditions (poverty, prostitution, drug use) that have contributed to the spread of HIV/AIDS and tuberculosis and the worsening fiscal positions of the relevant governments will mean that public health resources that are critical for controlling these diseases will be reduced.

45. Economic progress in a number of European emerging markets has been hampered by unresolved political issues and “frozen” conflicts which has produced economic uncertainty and limited the gains from inter-governmental cooperation. This has been especially the case in the Caucasus and in the states created out of Yugoslavia.

IV.A. EU NMS

46. The EU new member States (NMS) have characteristics of both advanced and emerging economies and thus represent the border of the two groups. As a group the NMS have a PPP per capita income of about 56 per cent of the European Union and have been converging by slightly over one percentage point per year; a rate that is slightly above that achieved by the southern EU members

over the last two decades. Several of the NMS now have per capita incomes above that of some of the poorer western European economies which are generally classified as advanced economies. During this economic crisis, however, market participants have generally treated the NMS as if they were emerging economies due to the fact that they had a number of vulnerabilities such as large current account deficits and sizable foreign currency denominated loans which are often associated with emerging markets. The four NMS which have already adopted the euro were protected slightly. The possibility of a typical emerging market financial and currency crisis remains non-negligible in a number of the NMS.

47. The NMS were affected by the crisis through a number of channels, but the most important were the financial linkages between the parent banks in the advanced European economies and their subsidiaries in these economies and their large declines in exports from the economic slowdown in western Europe. In most of the NMS a large percentage of total bank assets, often over half, were of subsidiaries of western European banks.

48. The policy response of the NMS to the economic crisis has been hampered significantly by the institutional constraints in the Stability and Growth Pact and the Maastricht criteria. For example, counter-cyclical fiscal policy has been limited by the need to limit the deficit to less than three per cent of GDP and a number of countries were reluctant to alter their exchange rate pegs.

49. In response to the crisis, exchange rates, prices and wages in the NMS will have to adjust significantly; some of the economies have fixed exchange rates which will make these adjustments

particularly difficult, but generally the region has flexible product and labor markets (due to weak labor unions). Multilateral support from the IMF, World Bank, and European Bank for Reconstruction and Development will be important in providing some needed external financial resources until private markets recover.

50. The NMS face a number of challenges in being able to continue to converge towards the EU-15 including increasing the labor force participation rate for younger and older workers, creating more dynamic innovative economies, and completing the structural and institution process associated with their transition to market economies. The EU structural funds continue to provide an important source of finance for bringing about these changes.

51. The EU-15 export share to the NMS has increased from one per cent in 1988 to seven per cent today. The NMS rely heavily on other EU members as a destination for their exports. However, over the last several years there has been a steady reorientation of the share of the central European NMS exports away from the older advanced economies of the EU towards other NMS and towards Russia and the European CIS.

52. The employment to population ratio remains low in the NMS relative to the EU average especially for younger and older workers. There are increasing shortages of highly skilled workers (tertiary and above) which has been compounded by their relatively high migration rates to western Europe.

IV.B. Non EU south-east Europe

53. The situation and vulnerabilities (current account deficits, foreign-currency denominated debt, etc.) in south-east Europe (SEE) was similar in many ways to that of the NMS but worse since they did not have the financial support of the EU or ECB. They do, however, continue to benefit from a number of longer-term EU assistance programs. Growth in the sub-region is forecast to be minus 4.6 per cent in 2009, led by the decline in Turkey of minus 5.1 per cent.

54. The level of unemployment varies considerably in SEE from being moderate in Bulgaria and Croatia to extremely high in Serbia and Bosnia and Herzegovina. Throughout the region labor force participation remains low and the informal sector is large. The economies in SEE also experienced significant decreases in growth as exports, capital inflows and remittances declined dramatically.

55. Croatia and Turkey are in the mist of the multi-year EU membership process; Croatia's membership is being held up by a maritime border dispute with Slovenia and a number of more fundamental problems face Turkey. The economic size of Turkey and its Muslim culture are important factors in slowing progress for Turkey. In the spring of 2009, the EU accepted Montenegro's application to begin the formal EU accession process and Albania formally submitted its application. The remaining countries or territories of SEE have a number of domestic reforms to implement before they can consider EU membership. The EU has agreed that membership for any country other than Croatia can not be finalized until the Lisbon treaty is approved.

56. The economic crisis has potentially long-run implications for the economies of south-east Europe. Before the crisis it was generally thought that these economies should attempt to roughly duplicate the

successful economic model of the NMS. However, their ability to develop by relying on external finance (as the NMS had) will likely be constrained considerably in the future. Thus their ability to grow and converge to western European levels is likely to be reduced considerably.

IV.C. CIS

57. The decline in economic growth in the CIS including Russia during the current crisis has been extraordinary, and represents probably the greatest “reversal of fortune” of any of the world’s major regions. Real GDP in the CIS is expected to fall from 8.6 per cent in 2007 to -5.2 per cent in 2009; a turnaround of almost 14 percentage points which is over twice the turnaround in the US or the eurozone over the same period. The largest reversal of approximately 16 percentage points is likely in Ukraine where growth is forecast to decline from 8.0 per cent in 2007 to -8.0 in 2009.

58. In Russia real GDP is likely to decline from 8.1 per cent in 2007 to -6.0 per cent in 2009. This is quite remarkable since Russia owned few of the toxic assets at the center of the crisis, was running a large current account surplus and had very sizeable international reserves, little government debt and a large fiscal surplus. The Russian unemployment rate rose to 8.5 per cent in Feb. 2009, the highest rate since March 2004; unemployment is expected to increase to 12 per cent by the end of 2009. Also in February, Russian retail trade declined 2.4% y-o-y, the first monthly decline since 1999. The large economic decline was primarily caused by a very large decline in export revenue and loss of access by its private sector to world capital markets. Private capital inflows came to a sudden stop in mid-2008, followed by a sharp reversal in the second half of the year, with net outflows reaching a record level

of \$130 billion over the whole year. Net outflows have continued in 2009, amounting to \$33 billion in the first quarter. Due to excessive volatility, the stock exchanges were closed on several occasions.

59. The decline in energy prices and the slowing economy have caused the Russian government budget to fall from a surplus of 4.1 per cent of GDP in 2008 to an estimated deficit of 8.5 per cent 2009. This projected large swing in the fiscal position suggests that Russia has implemented one of the largest fiscal stimulus packages of the world's major economies. Spending is forecast to increase by 30 per cent (y-o-y) while revenues will decline by 30 per cent (y-o-y). The deficit will be mostly financed by the oil reserve fund; additional domestic borrowing should amount to only around 1 per cent of GDP. The weight of supply-side initiatives is a distinctive feature of the Russian anti-crisis package in comparison with other G-20 countries.

60. Although the Russia government was not a significant borrower on international capital markets, its private sector was. Thus while the public sector has a strong external position, corporates and banks are facing significant external debt payments with very limited access to new borrowing. The banking system in a number of the CIS is now under considerable stress and bailouts or other forms of government assistance or subsidies are likely to be required.

61. Governments throughout the world have attempted during this crisis to support their domestic industries through various tax, subsidy or tariff policies; often times, however, these were limited by WTO agreements. Russia and a number of the CIS which are not members of the WTO were less constrained in this respect but they generally did not have the financial resources to provide much aid

to industrial sectors. Russia provided about \$50 billion to support various companies that were having difficulties. The Russian government increased tariffs on imported used cars in January 2009 by as much as 200 per cent, depending on the age and engine size, and promised to subsidize car loans on some domestically produced models as a way to help protect its automobile manufactures. However, by not being members of the WTO the CIS were not protected from the protectionist policies of other countries.

62. There has been only limited regional cooperation or coordination in addressing the crisis amongst the CIS. Russia, despite its own serious economic situation, nevertheless has increased its financial support for neighboring economies. In early 2009 it proposed an anti-crisis fund within the framework of the Eurasian Economic Community (EurAsEC) of about \$10 billion (of which Russia provided \$7.5 billion) to aid primarily the other CIS economies. This fund is supposed to work with the Eurasian Development Bank in isolating joint projects that can help these economies response to the crisis. Russia also provided some bilateral assistance including a \$2 billion loan to Belarus and a \$500 million stabilization loan to Armenia. The crisis may also have implications for the creation of a currency union between Russia and Belarus or for the adoption of the rouble in a larger grouping such as EurAsEC. Unfortunately the Russian rouble as well as all the other currencies of the region experienced significant declines, and the crisis provides no clear evidence that a larger currency union would necessarily have provided any additional stability.