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The Economic Situation in Europe, North America and the CIS in 2008-2009

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

Summary

In 2008, the Economic Commission for Europe region entered into what has been forecasted to be the worst economic downturn since the second world war. Each of the subregions covered by the Commission is either experiencing or expecting to experience negative growth in 2009. The decline in growth has been accompanied by rising unemployment and by especially large declines in international trade and capital flows. Government fiscal positions have deteriorated significantly. The global slowdown and the wide recession being experienced throughout the Commission region resulted from a financial crisis which began in the United States of America but which quickly spread to Western Europe and then to the periphery regions of the Commission area, as well as the rest of the world. In fact, the declines in economic growth in the emerging economies in the Commission area are likely to be greater than in the advanced economies where the crisis originated. The crisis is noteworthy not only because of its severity, but also because of its global synchronization.

As a result of tight economic integration and interconnected financial markets, the potential for adverse contagion in the emerging economies of Europe is considered to be quite high. Although relatively small, there remains a not insignificant possibility that there could still be a systemic financial meltdown throughout the European emerging markets, which 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 emerging economies of the Economic Commission for Europe region.

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

1. Annual real growth in the Economic Commission for Europe region in the three years prior to the beginning of the world economic and financial 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 minus 3.5 per cent in 2009, before recovering slightly to about 0.5 per cent in 2010. Prior to the crisis, the growth pattern in the region 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 the emerging economies to maintain investment at higher rates than would have been possible from relying solely on domestic savings. This dependence on external finance, however, has proved to be a major disadvantage during the current downturn, as it provided an entrance for the crisis.

2. The Economic Commission for Europe region, which is composed of 56 States, is a very diverse area with advanced and emerging economies and a few rather poor developing countries. The nature of the crisis in terms of how it entered these different economies and what impact it had on them varies considerably, and the policy options available to these countries also vary considerably owing to their different economic circumstances and institutional constraints. In 2009, growth in each of the Commission's subregions is forecast to be in the range of minus 3 to minus 5 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; 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 minus 5.1 per cent in the Commonwealth of Independent States (CIS), minus 4.6 per cent in South-East Europe, minus 4.2 per cent in the Eurozone, minus 2.7 per cent in North America, and minus 2.4 per cent in the States that are members of the European Union. The economic downturn has been quite severe in the Baltic economies, Iceland and Ireland, where growth is forecast to be close to minus 10 per cent, and somewhat severe in Germany, the Russian Federation and Ukraine. A few of the smaller economies in the region covered by the Commission, such as Albania, Azerbaijan, Cyprus, Tajikistan, Turkmenistan and Uzbekistan, may have positive growth in 2009, which may be relatively solid in the latter two economies. Although a slow recovery is expected to take place in 2010, with positive but slow 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 European Union.

4. The negative growth being forecast for 2009 in the emerging economies of Europe is an unfortunate setback, because a number of them, especially in South-East Europe and the CIS, had yet to fully recover from the transition process that began in 1989. For example, real gross domestic product (GDP) in 2008 in most of the States created out of former Yugoslavia (except Croatia and Slovenia) and in the energy-poor CIS States was below what it was in 1989, and the Republic of Moldova had a real income of only about half of what it had before the transition. By 2008, the Russian Federation had returned to approximately its 1989 income

level, although some of the energy-rich CIS States, including Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan were significantly above their 1989 levels, as were Armenia and Belarus. Thus, for many of the countries with economies in transition, 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 United States, 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 United States. For the advanced economies of the Economic Commission for Europe region (North America and Western Europe), this will be their deepest recession since the second world war, although unemployment may not reach the levels of the 1981-1982 downturn. In the emerging economies of 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 United States, 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. Labour layoffs seemed to occur much earlier in this economic downturn than in earlier ones.

7. In the advanced economies, the crisis has moderated inflation, which had begun to increase above target levels in early 2008; because it led to a rapid and steep decline in international commodity prices, the economic slowdown 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 persist because of its origin in unrepeated declines in world commodity prices. For emerging Europe, however, the crisis, because it has led to significant currency depreciation, has in some cases increased inflation. Thus, for example, average consumer prices were 14 per cent higher in the CIS countries 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 the Russian Federation and the energy abundant CIS countries in Central Asia.

8. Trade for the economies in the Economic Commission for Europe region has declined significantly over the past year, generally declining by between one quarter and one half. This has been the result of 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 affected. In February 2009, exports of merchandise from the United States were 22.6 per cent lower than a year before and imports into the United States were 30.4 per cent lower. For the same period, exports of merchandise from the Russian Federation declined by 47.5 per cent and its imports declined by 36.5 per cent. In January 2009, exports from the European Union were down 24.8 per cent

and its imports were down 22.1 per cent from a year earlier. Germany exported almost $1.5 trillion worth of goods in 2008 and remained the world's largest exporter; the United States is in third place, having been overtaken by China.

9. The equity markets in the advanced economies of the Economic Commission for Europe region 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 United States, Western Europe and the European emerging markets has been wiped out by the crisis. A significant number of the largest well-known banks are insolvent or close to becoming insolvent, although the vast majority of small and medium-sized banks are in a much healthier state. In the spring of 2009, the United States Treasury performed "stress tests" on its large banks to assess their viability. Attempts by Governments 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, inter-bank markets in the United States 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 United States and European banks, experiencing no bank failures or bailouts.

10. The advanced economies of the Economic Commission for Europe region 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 in large part to inadequately designed institutions for conducting macroeconomic policy. In the long run, however, there are costs in terms of potential inflation and debt repayment that result from the aggressive use of macroeconomic stimulus measures. 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 evaluate fully whether the more aggressive response of the United States was preferable to the more cautious European approach.

11. The fiscal stimulus packages in North America and Europe have consisted of both spending increases and tax cuts. Approximately two thirds of the stimulus measures in the United States for 2009 consisted of additional spending and one third consisted of tax reductions, with approximately one third of the spending for infrastructure projects. In Europe, the stimulus programme in Germany was tilted towards tax cuts, while the plan in France emphasized public projects. Most of the packages allocated some funds for environmental projects consistent with the "green new deal" theme; however, the Economic Commission for Europe region compared unfavourably on this score with what some of the Asian economies (especially the Republic of Korea) proposed.

12. Once the current crisis and recession are over, it will be necessary to unwind any stimulus measures 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 difficult to time properly. 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 also happened in Japan in the 1990s.

13. Regulatory reform of the financial sectors is expected to take place in the United States and Western Europe; this is primarily a national issue, but there is a strong need for international cooperation and harmonization in implementing such reform. Generally, it is agreed that mortgage approval 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 take asset prices into account in making monetary policy. Each of these issues is quite technical and the national financial authorities will have to decide how best to achieve these basic objectives.

14. Although the Economic Commission for Europe 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 that have in general been growing at a significantly slower pace than the world economy overall. As a result, the share of the world economy accounted for by the region's 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 figure has declined to 51.2 per cent in 2009. The reduced share of world output has been roughly similar for North America and the 27 States of the European Union with their respective shares falling from 25.9 per cent and 25.5 per cent in 1999 to 22 per cent and 21.8 per cent in 2009. The share accounted for by the CIS economies has increased from 3.5 per cent in 1999 to 4.6 per cent in 2009.

15. Five countries in the Economic Commission for Europe region (Denmark, Luxembourg, Netherlands, Norway and Sweden) exceeded the United Nations target of 0.7 per cent 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 United States, 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 suppliers and users of energy in Europe. A number of the European Union economies, especially the new member States, are currently dependent on the Russian Federation for a large percentage of their energy needs. There have been several pricing disputes between the Russian Federation and Ukraine on the trans-shipment of gas to the European Union over the past several years that have resulted in the temporary closure of pipelines, creating serious shortages in the European Union.

17. As a result of the effects of globalization, technological change, labour market reforms and less progressive tax structures, income inequality has been increasing in North America and Europe, especially in the economies that follow a more market-oriented model. The growth in the income of the richest 1 per cent or the richest 0.1 per cent has been particularly high (relative to average wage levels) over the past decade. For example, in the United States between 1979 and 2005 the income of the top 1 per cent of the population increased by 238 per cent, over 10 times more than that of the middle 60 per cent of the population, whose income increased by 21 per cent. Inequality increased considerably in the countries with economies in transition during the 1990s, and has recently stabilized in some of those countries but continues to deteriorate in others. Given that globalization and technological

change affect all countries but the increase in inequality has varied extensively between countries, it can be suggested 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 United States entered into recession in the autumn of 2007 and has remained in recession through the spring of 2009. By March 2009, the level of employment in the United States had declined by 5.1 million jobs since its recession began in December 2007; unemployment increased to 13.1 million people out of work, which translates into an unemployment rate of 8.5 per cent, the highest in 25 years. Since approximately half of the job losses have been in the male-dominated construction and manufacturing sectors, the unemployment rate for men was approximately 2 percentage points higher than for women, and it was 5.4 percentage points higher for blacks than for whites. The employment to population ratio in March 2009 was 59.9 per cent, the lowest level since 1985. The number of people receiving unemployment insurance benefits in the United States 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; and about 20 per cent higher than the previous record, reached in 1994. Despite the negative situation in terms of net loss of jobs, the United States economy exhibits considerable dynamic churning; during February 2009, although 4.8 million workers lost or resigned from their jobs, 4.3 million workers were hired.

19. In February 2009, industrial production in the United States was down 11.8 per cent from a year earlier and manufacturing output was down 14 per cent, while employment in manufacturing 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 year on year.

20. The United States 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 rapidly reduced to near zero by late 2008 and the monetary policy in the United States was further intensified by the implementation of quantitative easing. However, with dysfunctional capital markets, the effectiveness of the monetary policy was reduced. A fiscal stimulus was implemented in mid-2008 followed by another historically large stimulus package 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 to clarify the financial condition of the banking system, which was a necessary step for re-establishing normality to bank lending. In the first four months of 2009, 32 banks failed in the United States, while 25 had failed during 2008. The United States Government also implemented a number of programmes 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 United States 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 United States national debt as a percentage of GDP is likely to more than double and reach approximately 100 per cent of GDP in 2012. By 2008 in the United States, 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 ahead and the ongoing attempts of households to increase their savings has further depressed economic growth.

22. In the United States, housing starts fell 33 per cent to 904,300 from 1.335 million in 2007 and were the lowest since records began. By December 2008, they were 76 per cent below their peak reached in January 2006. There were more than 3 million foreclosures in the United States in 2008 and foreclosures were running at about 300,000 a month in early 2009. In several states (California and Florida) that were most negatively affected, foreclosure sales currently represent almost one half of all home sales. The median price of an existing house fell by minus 15.3 per cent in 2008, the most in any year since records began in 1968. By February 2009, average United States home prices were back to the levels reached in the third quarter of 2003. From the peak in July 2006, the S&P/Case-Shiller Home Price Indices for house prices in 20 cities was down 30.7 per cent, and the 10-city composite index was down 31.6 per cent. United States mortgage rates, however, were near all-time lows by the spring of 2009.

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

24. In order to avoid inflation once a recovery begins, the United States Federal Reserve 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 Federal Reserve.

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 minus 4.2 per cent in 2009 and minus 0.5 per cent 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 European Union, the unemployment rate was 7.9 per cent in February 2009, 7.8 per cent for men and 8 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 people unemployed in the European Union and estimated job losses for 2009 and 2010

stand at 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 United States, as it was often the European affiliates of United States firms that had engaged in some of the riskiest behaviour and these were generally outside the jurisdiction of United States regulators. For example, this was the case for Lehman Brothers, where its office in the United Kingdom of Great Britain and Northern Ireland was responsible for many of its questionable trades, and for AIG (American International Group), 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 spanned a broad spectrum of financial market activities throughout the United States and Western Europe.

28. The severity of the crisis in the advanced economies of Europe was due to the following factors: (a) many European banks owned a surprisingly large share of the toxic assets; (b) the national regulatory and institutional structure of the financial sector in most European economies was poorly designed for dealing with financial market turmoil; (c) regional or pan-European institutions and regulatory systems were inadequately designed for the financial situation that developed; (d) European banks were more highly leveraged than United States banks; (e) in some cases European banks were overly reliant on international wholesale financing; (f) European banks had lent far more to emerging markets than United States banks and were thus much more exposed to the downturn in those economies, especially in European emerging markets, which were particularly vulnerable to a crisis owing to large current account deficits and extensive foreign-currency-denominated debts; (g) even in those economies that escaped the initial financial shocks, the regional trade linkages were quite large; (h) the design of the European monetary system essentially eliminated lender of last resort backing for national commercial banks and sovereign debt; (i) European policymakers were more reluctant to implement counter-cyclical macroeconomic policy; (j) several European economies had their own housing bubbles combined with weaker mortgage lending standards; and (k) Government assistance to the sectors most negatively affected was constrained by nationalistic competitive concerns.

29. The European macroeconomic response to the crisis was weaker and implemented more slowly than in the United States. 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 European Central Bank was instead preoccupied with headline inflation that was slightly over its target owing to escalating world commodity prices. Interest rates were finally lowered to 1 per cent in May 2009, but they remain higher than in most other advanced economies. A number of other economies in the European Union but outside the Eurozone had to roughly follow the pattern established by the European Central Bank. 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 to implement significant discretionary fiscal stimulus packages because of their large automatic stabilizers (which are estimated to be about twice the size of those in the United States), 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 per cent in 2009; this is twice the limit enshrined in the Stability and Growth Pact. The deficit in the United Kingdom is forecast to be as high as 14 per cent of GDP in 2009 and 11 per cent in 2010, although public debt is likely to reach only 61 per cent of GDP in 2009.

31. In February 2009, industrial production was 18.4 per cent lower year on year in the Eurozone and 17.5 per cent lower in the European Union, a record decline. Manufacturing activity was particularly hard hit in the Eurozone; new orders in January 2009 were 34 per cent lower than a year earlier. This represented the largest monthly year on year decline since Eurostat began compiling this data in 1996. The decline in European industrial production was in large part due to the worldwide 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 new member States of the European Union increased substantially over the past decade, often more than in the United States. Currently, European Union house prices are falling mostly in the range of 10 to 20 per cent year on year, and sales of existing homes are down between 25 per cent and 50 per cent. The situation is considerably worse in some economies, such as Spain, Ireland and the United Kingdom, than in others, such as Germany, which did not really 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 seen in the United States or the collapse of European mortgage-backed securities because lending standards were much more rigorous than the subprime loans made in the United States.

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 are generally aimed at easing the decision-making process by increasing the range of issues to be decided by qualified majority voting instead of by unanimous agreement, creating a European Union president and diplomatic service and expanding the powers of the European parliament. The Irish voted against the Lisbon reforms in June 2008 and it is not clear what impact the very severe recession currently in the country will have on a second referendum being anticipated for the autumn of 2009.

34. Iceland suffered a major financial crisis in 2008 when its banking system, which was highly leveraged, failed. Iceland required a rescue package from the International Monetary Fund (IMF). The Government of Iceland fell from power in early 2009, largely as a result of the economic crisis. The new Government is likely to apply to begin the European Union accession progress 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 United States. 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 new member States of the European Union and in South-East Europe, and questions have arisen 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 in terms of per capita income and productivity, which had been declining for most of the period following the Second World War, reversed in the 1990s owing 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. To date, the Lisbon initiative has been only partially successful. The gap in per capita income is no longer widening, but it is not closing either. With Europe experiencing a larger downturn because of the economic crisis and perhaps a slower recovery, and with the United States 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 to reach 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 (Armenia, Belarus, Bosnia and Herzegovina, Georgia, Hungary, Latvia and Ukraine) already had IMF programmes in place and others were close to concluding an agreement (Romania and Serbia). The size of the packages ranged between 5 and 10 per cent of GDP. Several of the countries have experienced difficulties in meeting IMF agreed targets and their disbursements have been temporarily put on hold (Hungary, Latvia and Ukraine). This is in addition to the IMF assistance to Iceland, an advanced European economy. Several other countries established new credit lines from 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 the most severely affected in the emerging economies in Europe; trade in these sectors has also fallen the most. Car production has been especially hard hit and accounts for a sizeable percentage of the industrial production of the emerging economies. Per capita automobile production is quite large in several of the new member States of the European Union, including Slovakia, Slovenia and the Czech Republic. The

largest declines in industrial production in the new member States occurred in Estonia (minus 30.2 per cent), Hungary (minus 29 per cent), Latvia (minus 24.2 per cent), Slovenia (minus 21.2 per cent), and the Czech Republic (minus 20.3 per cent). In the largest European emerging economies outside the European Union, industrial production (January 2009, year on year) was significantly lower as well, falling by 34 per cent in Ukraine, 21 per cent in Turkey and 16 per cent in the Russian Federation. By January 2009, automobile production had declined by 60 per cent year on year in Turkey.

40. The development model of many of the emerging economies of Europe, especially the new member States of the European Union, was one that has relied extensively on external capital to finance their development. The region was somewhat unique in this respect, as many other emerging economies have become 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 has 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 countries with economies in transition compared with other emerging markets at a similar level of development; inequality, however, is higher than it was historically under central 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 appears to contribute to reduced inequality while large scale infrastructure privatization appears to increase it.

42. After the financial crisis that 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 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 as these flows generally go to some of the poorest households. In the Republic of 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. Within the poorer economies, the problems of poverty and social exclusion have a strong regional and ethnic dimension. Trends for several of the Millennium Development 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 Millennium Development Goal 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 slowed and will further retard or even reverse the recent progress in achieving the Millennium Development Goals in the Economic Commission for Europe region. Extreme poverty had almost been eliminated in the region by the end of 2007, but with higher food prices, falling employment opportunities, reduced remittances and strained safety nets, it is estimated (by the United Nations Development Programme) that already another 10 million people in the region have been pushed back into extreme poverty. There is likely also to 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 intergovernmental cooperation. This has been especially the case in the Caucasus and in the States created out of the former Yugoslavia.

A. European Union new member States

46. The European Union new member States have characteristics of both advanced and emerging economies and thus represent the intersection of the two groups. As a group, the new member States have a purchasing power parity per capita income of about 56 per cent of the European Union standard and have been converging by slightly over one percentage point per year, a rate that is slightly above that achieved by the Southern European Union members over the past two decades. Several of the new member States now have per capita incomes above those 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 new member States as if they were emerging economies owing 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 new member States that have already adopted the euro were protected slightly. The possibility of a typical emerging market financial and currency crisis remains not insignificant in a number of the new member States.

47. The new member States 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 new member States, a large percentage of total bank assets, often over half, were of subsidiaries of Western European banks.

48. The policy response of the new member States to the economic crisis has been hampered significantly by the institutional constraints in the Stability and Growth Pact and the Treaty on European Union (Maastricht Treaty) criteria. For example,

counter-cyclical fiscal policy has been limited by the need to limit the deficit to less than 3 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 new member States 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 labour markets (as a result of weak labour unions). Multilateral support from IMF, the World Bank, and the European Bank for Reconstruction and Development will be important in providing some needed external financial resources until private markets recover.

50. The new member States face a number of challenges in being able to continue to converge towards the conditions in the States that were members of the European Union at the time they joined, including increasing the labour 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 European Union structural funds continue to provide an important source of finance for bringing about these changes.

51. The export share of the 15 European Union States to the new member States has increased from 1 per cent in 1988 to 7 per cent today. The new member States rely heavily on other European Union members as a destination for their exports. However, over the past several years there has been a steady reorientation of the share of the exports of the central European new member States away from the older advanced economies of the European Union towards other new member States, the Russian Federation and the European CIS countries.

52. The employment to population ratio remains low in the new member States relative to the European Union 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.

B. Non-European Union South-East Europe

53. The situation and vulnerabilities (current account deficits, foreign-currency denominated debt, etc.) in South-East Europe was similar in many ways to that of the new member States, but worse since they did not have the financial support of the European Union or the European Central Bank. They do, however, continue to benefit from a number of longer-term European Union assistance programmes. Growth in the subregion 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 South-East Europe, from being moderate in Bulgaria and Croatia to extremely high in Serbia and Bosnia and Herzegovina. Throughout the region, labour force participation remains low and the informal sector is large. The economies in South-East Europe have also experienced significant decreases in growth as exports, capital inflows and remittances declined dramatically.

55. Croatia and Turkey are in the midst of the multi-year European Union 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 the slowing progress for Turkey. In the spring of 2009, the European Union accepted Montenegro's application to begin the formal European Union accession process and Albania formally submitted its application. The remaining countries or territories of South-East Europe have a number of domestic reforms to implement before they can consider European Union membership. The European Union has agreed that membership for any country other than Croatia cannot 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 new member States. However, their ability to develop by relying on external finance (as the new member States 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.

C. Commonwealth of Independent States

57. The decline in economic growth in the CIS, including the Russian Federation, 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 minus 5.2 per cent in 2009; a turnaround of almost 14 percentage points, which is over twice the turnaround in the United States 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 per cent in 2007 to minus 8 per cent in 2009.

58. In the Russian Federation, real GDP is likely to decline from 8.1 per cent in 2007 to minus 6 per cent in 2009. This is quite remarkable, since the Russian Federation owned few of the toxic assets at the centre 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 February 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 per cent year on year, 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. Because of excessive volatility, stock exchanges were closed on several occasions.

59. The decline in energy prices and the slowing economy have caused the Government budget of the Russian Federation to fall from a surplus of 4.1 per cent of GDP in 2008 to an estimated deficit of 8.5 per cent in 2009. This projected large swing in the fiscal position suggests that the Russian Federation has implemented one of the largest fiscal stimulus packages of the world's major economies. Spending is forecast to increase by 30 per cent year on year, while revenues will decline by 30 per cent year on year. 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 package to counter the crisis in comparison with other Group of 20 countries.

60. Although the Government of the Russian Federation was not a significant borrower on international capital markets, its private sector was. Thus, while the public sector has a strong external position, corporations and banks are facing significant external debt payments with very limited access to new borrowing. The banking system in a number of the CIS countries 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 agreements under the World Trade Organization. The Russian Federation and a number of the CIS countries that are not members of the World Trade Organization were less constrained in this respect, but they generally did not have the financial resources to provide much aid to industrial sectors. The Government of the Russian Federation provided about $50 billion to support various companies that were having difficulties and 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 manufacturers. However, by not being members of the World Trade Organization, the CIS countries were not protected from the protectionist policies of other countries.

62. There has been only limited regional cooperation and coordination in addressing the crisis among the CIS countries. The Russian Federation, despite its own serious economic situation, nevertheless has increased its financial support for neighbouring economies. In early 2009, it proposed a fund to combat the crisis within the framework of the Eurasian Economic Community of about $10 billion (of which the Russian Federation provided $7.5 billion) to aid primarily the other CIS economies. This fund is supposed to work with the Eurasian Development Bank in identifying joint projects that can help these economies respond to the crisis. The Russian Federation 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 the Russian Federation and Belarus and for the adoption of the rouble in a larger grouping such as the Eurasian Economic Community. Unfortunately, the Russian rouble and all the other currencies of the region have experienced significant declines, and the crisis provides no clear evidence that a larger currency union would necessarily provide any additional stability.