Georgetown University

From the SelectedWorks of Robert C. Shelburne

March 25, 2009

A European Perspective on the Current Global Economic and Financial Crisis

Robert C. Shelburne, *United Nations Economic Commission for Europe*

Available at: https://works.bepress.com/robert_shelburne/42/

UNWTO

AZERBAIJAN

FORTY-NINTH MEETING of the UNWTO COMMISSION FOR EUROPE (CEU)

BAKU, REPUBLIC OF AZERBAIJAN, 25-26 March 2009

A European Perspective on the Current Global Economic and Financial Crisis

by

Robert C. Shelburne
Chief Economist and Senior Economic Affairs Officer
United Nations Economic Commission for Europe

The 49th Meeting of the United Nations World Tourism Organization Commission for Europe

Baku, Republic of Azerbaijan

March 25, 2009

A European Perspective on the Current Global Economic and Financial Crisis

by
Robert C. Shelburne
UNECE

Abstract

The world is now experiencing the worst economic downturn since the Great Depression of the 1930s. Its effects are truly global but the European region will be particularly negatively impacted not only economically but politically and socially. It has raised questions about the viability of the current design of western financial markets, the development model of the NMS, globalization and the international organizations that oversee it, and the design of European institutions, even that of the European Union. The cause of the crisis is explained, current economic conditions are described, some forecasts are suggested, and the needed policy responses are outlined. Some implications for the tourist sector are explored.

Let me begin by saying what an honor it is for me to speak to this group today. Travel, especially foreign travel has been one of my great pleasures in life. But travel is more than just one of life's enjoyments; I believe travel to foreign countries is important in creating more tolerant broad-minded individuals who understand and respect foreign cultures and traditions. Travel and the organizations that support it, such as this, make an important contribution towards creating a more peaceful world, and through increased cooperation, a more prosperous one as well.

Travel can also have profound effects on individuals. I began my serious travels when still a teenager. I came to Europe for a summer with nothing more than a backpack, a Eurail pass, and youth hostel card. That experience created an interest in a number of questions about why living standards varied, that I would later find out were addressed by the subject of international economies. It is doubtful if I would have the profession I have today, or the job I have today, if I had not spent that formative summer in Europe. Tourism is more than just a business with employment and foreign exchange implications; it also has important political, sociological and environmental impacts, and I am pleased in looking over the publications and activities of the UNWTO that it appreciates these broader implications.

Today I would like to discuss the current global economic crisis. I'll say a few things about how we got where we are, and where we appear to be going, discuss what needs to be done policy-wise, and draw a few broader implications for regional and global economic integration. I will finish with some thoughts on how this crisis is likely to affect the tourism sector.

Slide 1

The current global economic and financial crisis, which started in the summer of 2007 in the US financial market, has now turned into the worst worldwide economic slowdown since the Great Depression of the 1930s. A large number of economies are currently experiencing steep recessions, and in many, the worst effects, especially in terms of unemployment, are still to come. If not managed properly this crisis could turn into a deep prolonged recession similar to Japan's of the 1990s, which would have serious political, social and security implications. As a result, governments around the world need to implement a correct set of policies that can contribute to a resolution of the crisis. Although there are currently a number of significant policy disputes about what needs to be done, I believe a global consensus is now developing on what should be done and I believe this will be implemented, and therefore I am hopeful that a really serious situation can be avoided. However, this crisis will have long-term implications on a tremendous range of issues, from the design of the world's financial system to the growth of world tourism.

The current crisis resulted from a combination of macro-economic imbalances and micro-economic market failures which were both due to

inadequate governance and a failure to properly understand risk. This was a crisis that was clearly "Made in the USA", both in the sense that the subprime mortgages originated there and also because the so-called Anglo Saxon financial model that created the toxic assets and distributed them throughout the world was also designed and exported from the U.S.

The most fundamental cause of the crisis was that the U.S. had a housing bubble, which burst, which led to large scale defaults, which meant that the value of the financial assets derived from those mortgages collapsed.

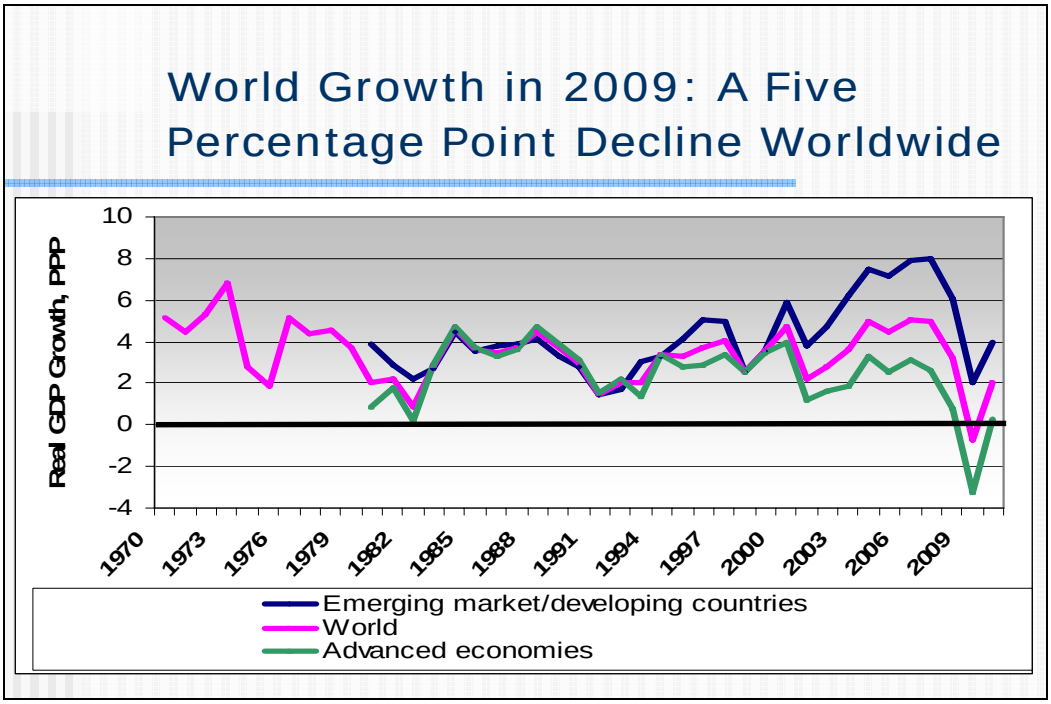
In theory, the creation of the sophisticated financial instruments based upon the underlying subprime mortgages was basically a model designed to take risks from those that did not want it, and distribute it to those willing and better able to manage it. However, what the model actually did instead, was to distribute the risks to those who did not understand the risks they were assuming and were often least prepared to deal with it. In this sense this financial model was a complete failure in that it did not achieve what was stated to be its primary objective.

Slide 2

What has been quite interesting is the large number of different channels which allowed the crisis to move to Europe. In some countries the banks owned large quantities of the toxic U.S. assets (i.e., Belgium, Germany, Switzerland), in other cases the countries had their own

housing bubbles (i.e., Ireland, Spain, UK), in other cases, banks and companies were dependent on global capital markets which have now seized up (most of east-central Europe), in other cases, domestic banks had foreign subsidiaries exposed to non-performing loans from countries negatively impacted by these (already mentioned) channels (i.e., Austria, Greece, Sweden), and in almost every case countries were negatively impacted by declining exports and commodity prices.

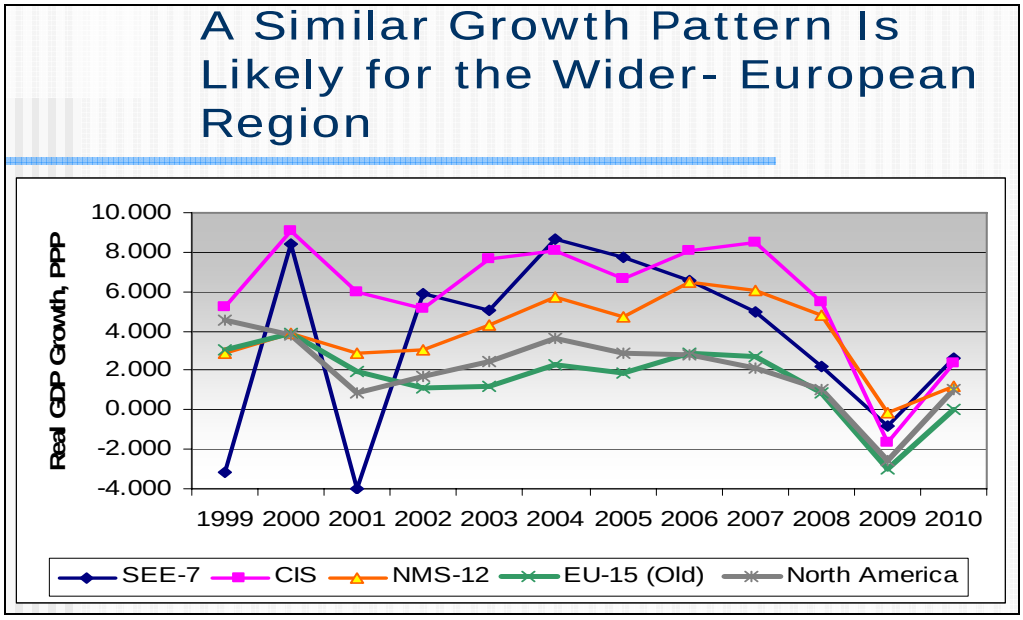
Slide 3



The UN and IMF are now predicting that world economic growth will be negative in 2009 (-0.7 per cent); this will the first time this has occurred since the Second World War. Growth is being forecast to decline to minus 3.25 per cent in the advanced economies and to fall to only about 2 per cent in the emerging economies.

As can be seen in Slide 3, the actual level of growth for 2009 is forecast to be significantly different in the emerging and advanced economies (2 per cent vs -3 per cent), but the growth rate in the emerging economies was about 5 per cent higher in the 2006-2007 period, so that the actual decline in growth in each of two groups is expected to be about the same (that being about 5 percentage points).

Slide 4

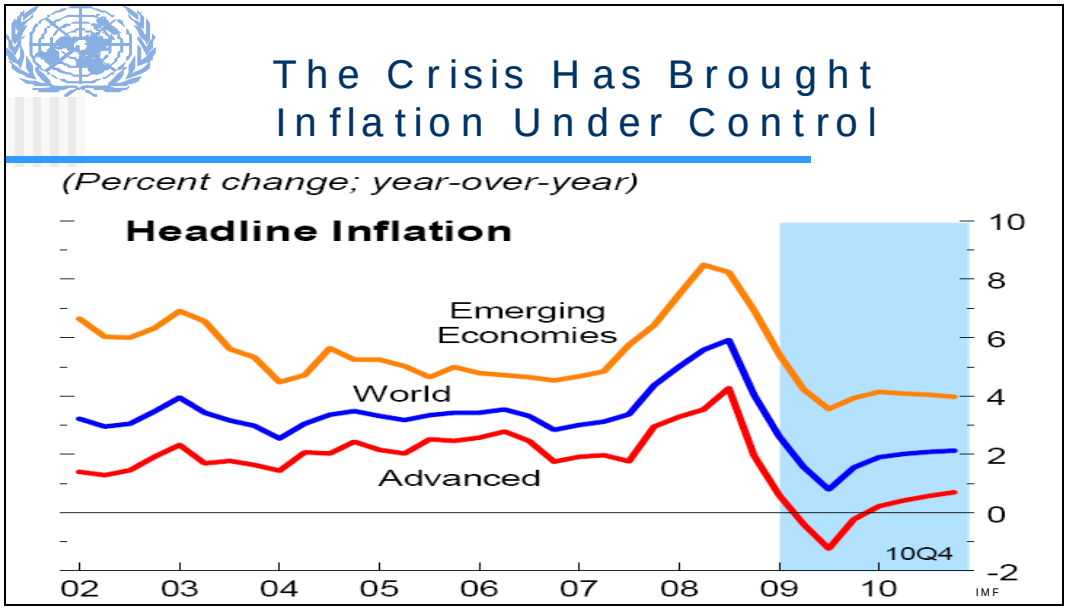


And as shown in Slide 4, a roughly similar pattern of growth is expected in the various sub-regions of the wider European area (which also includes North America since these economies are members of the UNECE). Growth is expected to be negative 3.2 percent in the eurozone, negative 2.6 per cent in the U.S., and negative but close to zero in the EU new member States. Earlier this year it was hoped that growth in south-east Europe and the CIS would at least stay positive despite declining, however those hopes are rapidly dissipating.

The collapse in economic activity is reflected in declining international trade (at the fastest rate in 80 years), falling commodity prices and sharp increases in unemployment throughout the world. The ILO is predicting that 50 million people will lose their jobs due to the current crisis as world unemployment increases from 180 million in 2007 to 230 million. Unemployment rates in Europe and the U.S may reach double digits by 2010; in some European economies the situation is much worse, for example unemployment in Spain may reach 20 per cent by 2010. [1]

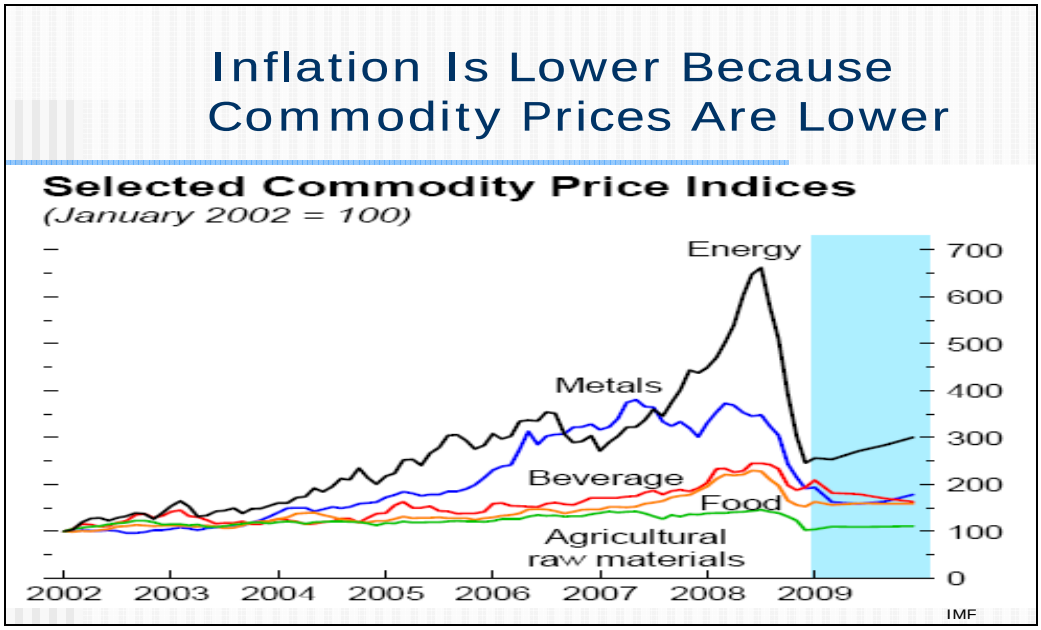
[1] The EU Commission is predicting that the EU rate will increase from 7% in 2008 to 8.7% in 2009 to 9.5% in 2010.

Slide 5



Perhaps one of the few good things to come out of this crisis is that it has suppressed inflation which was beginning to get a little too high. Current and forecast rates for the next two years are back to quite respectable levels. There may actually be a short period of deflation in the advanced economies but this is unlikely to be significant.

Slide 6



Inflation is under control primarily because the economic slowdown has brought world commodity prices down.

Given that in the developing countries, the cushion between normal incomes and human basic needs is much smaller and social safety nets are less developed, the actual toll in human suffering is likely to be greater in these economies. Therefore, although this is a crisis that started in the advanced economies, and they will largely need to implement the necessary policy adjustments to address it, it is critical that the solutions need to consider the implications on the developing and transition economies because they are likely to suffer the most.

Let me make a few brief comments about this. Firstly, why is it that the developing world will suffer as much or more than the US and western Europe although the developing countries neither created nor owned significant amounts the toxic assets at the center of the crisis? This is one of the great paradoxes of the global economy and does provide some basis for those who have argued over the years that the current design of the world economy is "biased" against the developing countries. There is even a well-known expression to summarize this state of affairs, that being "When the U.S. sneezes, the world catches a cold."

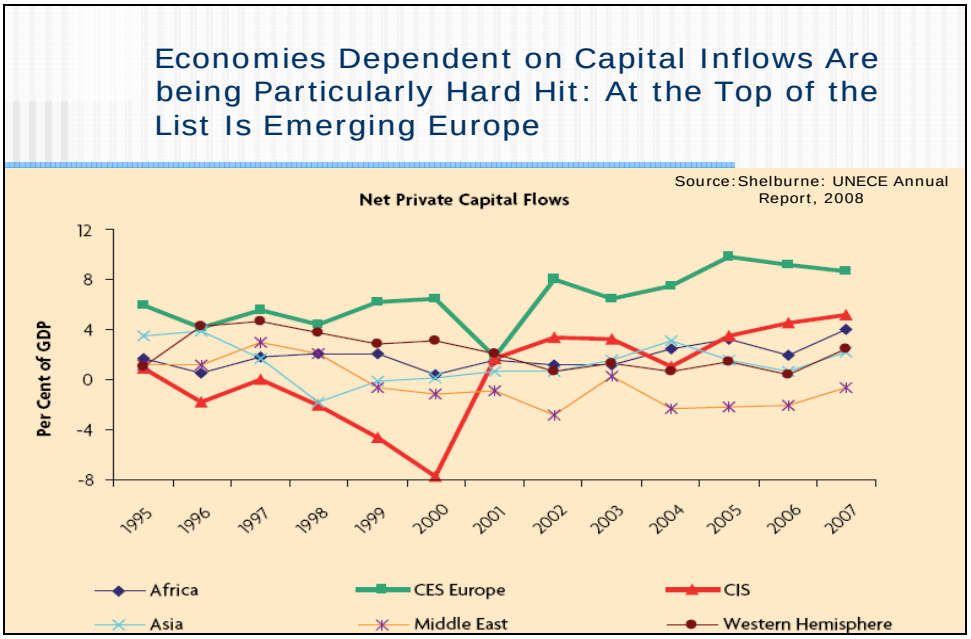
Slide 7

In answering this question, foremost is the fact that the advanced economies have the option of implementing counter-cyclical macroeconomic policies to help mitigate a crisis; developing or emerging economies (China is an exception) not only can not do that, but must actually do the opposite, that being implement pro-cyclical policies that

will actually cause their economies to contract further. Expansionary policies on their part would lead to a rapid loss of confidence on the part of global investors and large capital outflows, which would be very destructive. As a result, today, we see the U.S. and western Europe enacting massive stimulus programs while the governments in Hungary, Latvia and Ukraine are instead slashing budgets.

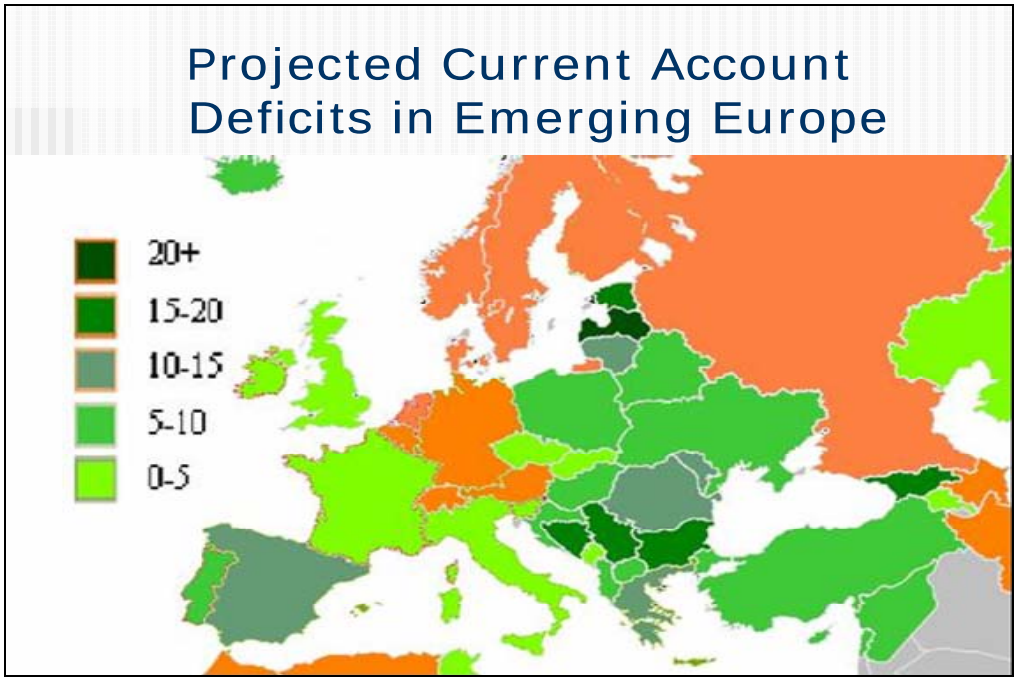
In addition, during periods of economic turmoil, the owners of capital want their funds to be in the advanced economies; they have more faith in the financial sectors and in the governments of these economies. This is the case, even in spite of the fact that it is this same group of advanced economies that created the crisis! As a result, capital flees the developing world, causing bank lending, asset prices and exchange rates to collapse. Thus the global economy is in many dimensions asymmetric; what is true for the advanced economies is not true for the developing economies.

Slide 8



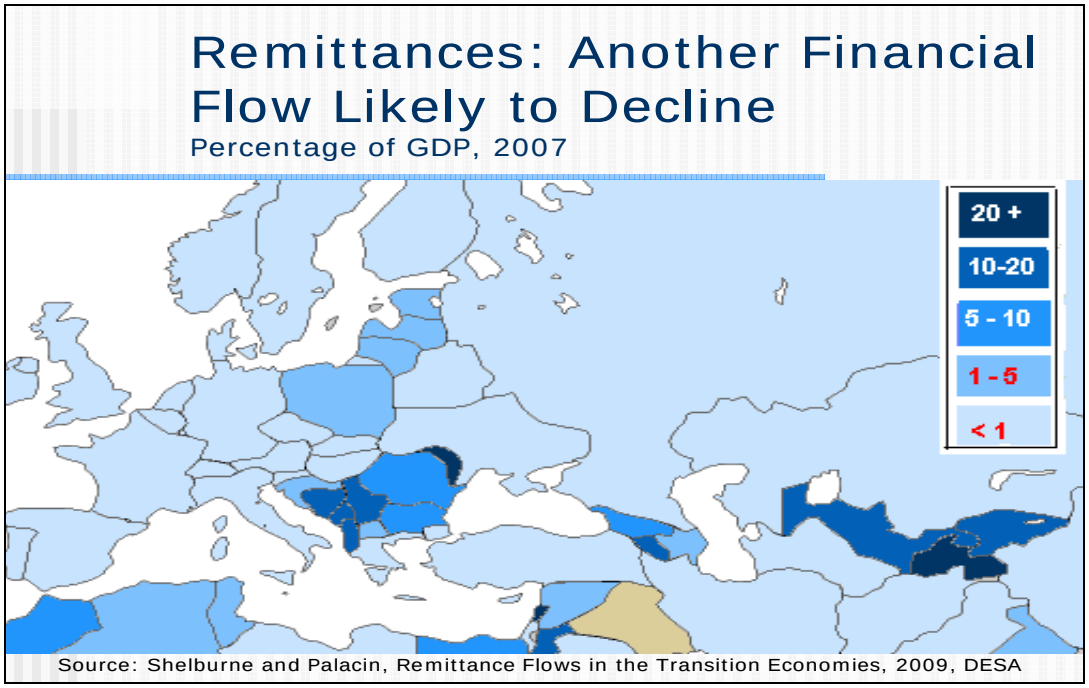
Since this crisis moved to the emerging markets mainly through the trade and capital flow channels, those economies with larger flows have generally been impacted the most. This is especially relevant for the emerging European economies (including the EU new member States, south-east Europe and the European CIS, except for Russia) which were much more reliant on capital inflows to finance their development than any other major region of the world. Now that global capital markets have seized up, these countries are being particularly hard hit.

Slide 9



Generally those with the largest dependence on foreign capital had the largest current account deficits and are now the most vulnerable.

Slide 10



There are two other external sources of finance that are being negatively impacted by the crisis. Remittances have been an extremely important source of income for many of the poorest economies in the region, often accounting for more than 10 per cent of gross national income. With unemployment rising in western Europe and Russia,

remittances are likely to fall significantly. These countries also rely significantly on development assistance, and ODA in particular. In previous economic downturns this has declined; thus this is also a major concern.

Addressing the Crisis

Slide 11

The solution to this crisis consists of three basic pillars. First, the real estate and financial sector defects in the advanced economies that created this crisis need to be corrected so that this will not happen again. Secondly, macroeconomic policy must jump start the economy and end this global recession, and thirdly and less appreciated, is the need for some fundamental reforms in the design of the international economic system to address systemic problems that lie at the root of the crisis.

Slide 12

Let me say a few words about each of these, beginning with reform of the financial and real estate industries. This crisis is not the result of a breakdown or failure in one or two specific areas, but is amazing in that so many things proved to be poorly designed and regulated. There is simply not time to go into much detail here but let me make a few brief points. The regulatory changes that will be necessary in the US and western Europe are primarily national issues. The governments in these economies recognize the need for reform and will implement it. There is broad agreement on what needs to be done but there remains debate about the precise changes needed as every policy action has costs and benefits and different groups and individuals view things differently.

But generally it is agreed that mortgage origination procedures need to be tightened,[2] 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.[3] 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, [4] and central banks will have to consider asset prices in making monetary policy.[5] Each of these is quite technical and the experts will have to decide how best to achieve these basic objectives.

---

[2] I think the non-recourse mortgages (if a house is worth less than the mortgage, the owner of the property can return the property to the bank and is not liable for the remaining difference, i.e., the bank has no recourse for obtaining the negative equity from the homeowner) that were virtually unique to the US have proven to be extremely undesirable, but there may not be enough political support for altering that.

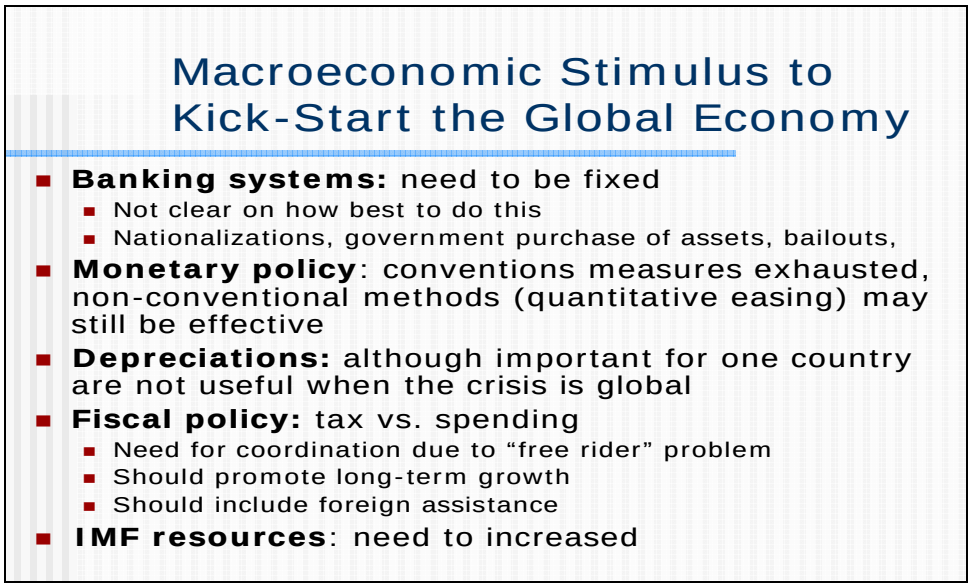
[3] The high leverage in the financial system was excessive, some banks had leverage ratios of 40 or more; there is a need to change the biases in tax systems that favor excessive amounts of debt (i.e., interest deductibility).

[4] It is a characteristic of market systems going back hundreds of years, that there are business cycles. Ideally the financial system should be designed in a manner that would tend to smooth out these cycles, instead, financial systems tend to exaggerate these cycles. Some recent changes, such as the widespread use of mark to market accounting have made the situation even worse. Thus a fundamental question is how should financial markets be altered either through regulatory changes or institutional practices to reduce this pro-cyclicality?

[5] Central banks will have to manage asset bubbles: the Greenspan philosophy that it is less costly to clean up a bubble after it bursts than to deflate it beforehand has proven to be wrong. Regulatory bodies will have to address this issue as well.

As mentioned, these are primarily national regulatory issues, but some global or regional coordination may be required given the highly integrated financial markets of the advanced economies. The need for regional coordination is especially strong in the EU.

Slide 13



The world economy is currently suffering from a collapse in aggregate demand. Firms are not investing and consumers are not spending. Two basic things need to be done, and they will have to be done by governments in the advanced economies. The banks in these countries are not lending because many of them are close to being insolvent; this will have to be corrected either through bank bailouts, nationalizations, or other schemes such as having the governments buy or guarantee the toxic assets. There is still not a clear consensus on what is likely to be the best option. The U.S. presented its new plan earlier this week. Also in many European emerging economies, the banking systems are in trouble from non-performing domestic loans and government support will be needed.

Secondly there is a need for monetary and fiscal stimulus. Although there is still a little room for further ECB easing, conventional monetary measures in the advanced economies are close to their limit; unconventional measures, such as quantitative easing, may work but they are untested.

It should be noted that in previous crises, whether it be the larger Asian crisis of the late 1990s or the more local ones like Sweden's and Japan's financial crises in the early 1990s, a key factor that helped pull these economies out of recession was the healthy growth of exports due

to a robust global economy combined with their depreciated currencies. These mechanisms are not available this time because the downturn is global, and the world as a whole can not depreciate. Therefore there is just one option left – increased government stimulus. This can be either tax cuts or spending increases, but while tax cuts can be quickly implemented, they are not particularly effective, as only 1/3 is actually spent, and new government infrastructure projects, although effective, take time to plan and implement. Thus in the U.S. most of the infrastructure spending in its recent ($787 billion) stimulus package will not actually begin until 2010.

Fiscal expansions, however, do have some long-term costs for those that undertake them and much of the benefit leaks out to other countries. The debt created will have to be repaid and that means higher taxes on future generations. In addition, these higher taxes may have negative implications for long-term growth by reducing the incentives to work and take risks. Also this debt can be inflationary if not carefully managed. Since a country can benefit from the fiscal expansions of others, it would be ideal for a small country to avoid any fiscal expenditures today so as to avoid these future costs, while still being able to benefit from the expenditures of the other countries. But if every country did this, nothing would be done. The solution to this "free rider" predicament is for all countries to commit to doing their part, i.e., there must be a coordinated international response. However, a **coordinated international response does not mean an equal response by every country.** Some countries have the flexibility to do more than others, and the uncertainty of determining who should do what has contributed to some disagreements among countries. For example, Europe and the US appear to have a disagreement about this now. And as mentioned, the emerging economies generally do not have the policy space to do this at all.

Because of the problems associated with large increases in deficits, fiscal policy must be tightened as soon as possible once a recovery begins. However this will prove to be very tricky, because it was tightened prematurely during the Great Depression in the 1930s which caused the world to have a relapse back into depression, and the same thing happened as well in Japan in the 1990s.

It is not just the size of the fiscal stimulus packages that is important, but also how it is spent. These expenditures should be used to build infrastructure projects that will promote long-term productivity growth while also being consistent with socially and environmentally

sustainable development. This includes addressing long-term concerns such as climate change, food and energy security, and poverty reduction.

Although budgets are being strained in the advanced economies to finance these stimulus programs, it would be most unfortunate if aid flows were to be cut back during this crisis.[6] If this happened, not only would long-run objectives of the world community, such as achieving the MDGs, be further negatively impacted (from what is already likely to happen), but even the interests of the advanced economies would be harmed in a number of other ways.

When global capital markets seize up, capital flows cease. As a result, emerging countries face extreme hardship in terms of falling output, increased bankruptcies, and depreciating currencies and asset prices. An alternative to making these painful adjustments to the collapse in private capital inflows, is to have the IMF and other international financial organizations step forward with public funds until confidence can be restored to private capital markets. In a very general way, the IMF plays the role in the global economy for countries, which a central bank plays domestically for banks, by being the lender of last resort. However, the huge size of capital flows to emerging markets, which are estimated to have been almost $1 trillion in 2007 and are forecast to decline to $165 billion in 2009, can not be fully replaced by the IMF, which had a total stock of resources of only about $250 billion. It now appears that G-20 countries will agree in London next week to double IMF resources to $500 billion; this is an important and necessary step. It is especially important for this region, as there are a number of countries that will likely need IMF assistance, as private financial flows to emerging Europe (including Turkey and Russia) are likely to fall to $30 billion in 2009, which is down from an already depressed $245 billion in 2008.

The contributions of the other financial institutions are important as well, and they are expanding financing where possible; this includes not only the World Bank and UN agencies but regional ones as well, such as EBRD, which has been providing much needed assistance and expertise to the east European financial sector.

In addition to increasing the resources of the international financial institutions, their legitimacy must also be increased by increasing the emerging countries' influence in the management of these institutions.

[6] The aid target of 0.7 per cent of GDP should not be relaxed, but instead countries should recommit to it and try to meet it as soon as possible.

That issue is also likely to be raised in London. In the months to come there will undoubtedly be additional discussions about how the global governance structure of the world economy should be reformed. There is an opportunity here to create a global trading and financial system that is more equitable and more development friendly.

One of the great advantages we have in dealing with this deep global recession is that we have experienced several similar events in the past and can learn from the lessons of them. One particular important point is the need to avoid retreating into "beggar thy neighbor" trade protectionism. Although these types of policies often appear logical from a strictly national perspective, the lesson of history is that it inevitably leads to a vicious downward cycle that ultimately harms everyone, especially developing countries and especially the poor. The best policy is therefore to stop it before it begins; every country has an obligation in this regard.

Much the same holds for restrictions on migration. Worker remittances have been an extremely important source of finance for many of the regions developing economies. The expected loss of these financial flows from the economic downturn will be difficult enough without an additional loss from new restrictions on migration. Thus although the viewpoint of host governments in wanting to preserve jobs for their domestic workers is understandable, hopefully these governments will consider the extra hardship they are imposing on the source countries.

Another lesson from Europe's past experiences with economic crises is the possible rise of nationalist or extremist political parties. Hopefully the consequences of following this path are now appreciated and this mistake will not be made again. European institutions will limit the policy space available to those promoting a nationalist agenda, but more importantly, ensuring that societies have adequate social safety nets will keep those most negatively impacted from resorting to desperate measures.

Thus, to quickly summarize the current situation: the crisis is quite serious, even in the emerging markets that had no part in creating it. The solution to the crisis requires coordinated action which will primarily have to be taken by the advanced economies, but for humanitarian as well as their own self-interest, their policies must fully consider their impact on the developing countries. For the emerging economies, their macroeconomic options are quite limited, but they must maintain and strengthen their social safety nets, recapitalize their banks, and work to

resist protectionist pressures which will certainly arise once unemployment increases.

Recovery will be some time in coming. Perhaps the U.S. may begin growing again by the end of the year due to its aggressive policy response; but in Europe, where the policy response has been much weaker, recovery will come later.[7] Since the transition economies have such extensive trade and financial links with the EU, 2010 is likely to be a difficult year for them as well.

The Impact of the Crisis on Regional and Global Institutions

Slide 14

Next, I would like to explore what I think will be some of the longer-run implications of this crisis for our region, both globally and for European institutions. The institutions that are responsible for global economic governance will have to be reassessed. One issue that will have to be examined is how to reduce global imbalances (i.e., large current account surpluses and deficits); many have argued that this is the real underlying cause of the current crisis. However, there is little agreement at this time on what needs to be done regarding this.

Intergovernmental cooperation is very high in Europe, higher than in any other region of the world. A cause of this and an effect of this is

[7] Currently, the ECB is predicting zero growth in 2010 for eurozone, and the EU is predicting 0.5% for EU27.

that economic integration is also higher in Europe. In order to be efficient and stable, a highly integrated market economy requires a proper regulatory framework. When this framework is inadequate or fragmentary, the performance of the economic system is inferior. The current economic crisis is a testament to this principle.

In a significant number of cases, current European intergovernmental institutions and cooperation arrangements grew out of a realization that the existing arrangements were not working properly. The creation of the European Union in its most basic form came from a belief that the competitive economic and political order that existed prior to the Second World War was inadequate and needed to be replaced with something that would provide a more institutionalized structure for promoting economic cooperation. Much more recently, the creation of the euro came from an understanding that a highly integrated area in terms of trade and financial flows was inconsistent with having more than a dozen different currencies. It took the financial crisis of the ERM in the early 1990s to force policymakers to recognize this. There are many other lessons in European history where a crisis that evolved from poorly functioning institutions or inadequate cooperation ultimately acted as the stimulus to reform. The current crisis will be no different.

The current crisis has exposed a number of shortcomings in the design of European institutions that has limited the effectiveness of Europe in addressing this crisis and has also created some political tensions amongst its States. For example, it has been argued that macroeconomic policy has been too limited and cross-border regulatory structures inadequate. The reason for these is generally given to be the inadequate design of the institutional arrangements overseeing the particular activity. In response to these shortcomings, European institutions will undoubtedly be reformed in the coming years. It is always possible that it could be decided that it is economic integration that should be scaled back instead of political integration being further tightened, but that is not the recent history of Europe and I would be the first to bet against it.

The Crisis and Tourism

Clearly 2009 and 2010 will be difficult years; both business and vacation travel will be below trend. Millions however will travel, so it will just be a more competitive environment. Previous economic downturns and preliminary estimates from this one suggest that trips are likely to be closer to home and for shorter periods of time, people will

trade down to cheaper hotels, weekend leisure travel may be particularly hard hit, and less will be spent on discretionary items.[8] Financing construction of new facilities, especially hotels, will be much more difficult. Oil prices, however, will probably stay reasonable for another year and this will keep transport costs down.

Slide 15

The depreciations of eastern European currencies will make travel there cheaper and should help these economies; this, however, will obviously reduce the number of east Europeans going to western Europe and the US.

In terms of public policy towards the tourism sector, there are a number of economic policies that wouldn't normally be appropriate that may make sense now, when there is significant unemployment and when financial markets are not functioning. This might include special subsidies, tax holidays, or other forms of support in order to promote employment or improve financing for small and medium sized businesses. These types of things, however, should be temporary.

In the medium to longer term (i.e., after 2010), there are two developments that are particularly important. First, the overall effect of the crisis has been to destroy $50 trillion of asset value – that is roughly the current GDP of the world; most stock markets are down 50 per cent.

[8] Brand name hotels will do better than independents and independents should try to increase their presence on global internet sites, such as expedia.com or hotels.com, as a way to overcome the disadvantages of being an independent. Estimates suggest that for 2009, revenues per hotel room are likely to fall 15 per cent.

Given that vacation travel is a very discretionary expenditure, vacation travel, especially to far away and expensive locations, is likely to be severely impacted even in the longer run. In addition, because of this significant decline in wealth which has reduced people's retirement savings, many workers will have to work a few years longer. Thus instead of vacationing during those years they will be working. As a result, the number of Americans traveling to western Europe and the number of Europeans going to America are likely to be below what they would have been, but that does not necessarily mean actual decreases.

A counter balance to this, however, is the growth of the middle income countries. Many of these economies, such as China and Brazil, will do OK in 2009-2010 and then should begin to grow briskly again. These economies have very large populations with rapidly growing middle classes who will want to travel to Europe, so the increases from these countries will be more than able to compensate for the declines from the US and Japan. Thus after 2010 the European tourism sector has a great future, but because of the crisis it will be less great than what was being predicted in 2006.