April, 2009

The Global Economic and Financial Crisis: Regional Impacts, Responses, and Solutions: Europe, North America, and the CIS

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

The Global Economic and Financial Crisis: Regional Impacts, Responses and Solutions: Europe, North America and the CIS

Robert C. Shelburne
United Nations Economic Commission for Europe
Geneva, Switzerland
April 2009

This chapter relies extensively on a study by Robert C. Shelburne and Jose Palacin, *The 2007-2010 Financial Crisis in Europe*. A slightly edited version of this paper was published as chapter II in *The Global Economic and Financial Crisis*, New York: United Nations, 2009 and available as UN Sales No. E.09.II.F.18 (ISBN 978-92-1-120585-5).

The Global Economic and Financial Crisis: Regional Impacts, Responses and Solutions: Europe, North America and the CIS
by
Robert C. Shelburne[1]

I. Introduction and overview

The 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. 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.

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. As such it is difficult to generalize about the economic situation and policy responses of the ECE economies overall; at a minimum North America, the advanced western Europe countries and the European emerging economies must be treated separately. However, there is also significant heterogeneity within the latter two groups.

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 by market participants to properly understand risk. The core of the crisis was a US property bubble, which after bursting led to widespread defaults on mortgages, which then led to the collapse in the value of the financial assets that had been created from them. The regulatory failure, however, 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

---

[1] United Nations Economic Commission for Europe. This chapter relies extensively on a study by Robert C. Shelburne and Jose Palacin, *The 2007-2010 Financial Crisis in Europe*. A slightly edited version of this paper was published as chapter II in *The Global Economic and Financial Crisis*, New York: United Nations, 2009 and available as UN Sales No. E.09.II.F.18 (ISBN 978-92-1-120585-5).

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.

The severity of the crisis in 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, 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 generally did not appreciate the importance or necessity of counter-cyclical macroeconomic policy, 10) the European emerging economies were particularly vulnerable to a crisis due to large current account deficits and extensive foreign-currency denominated debts, 11) market participants treated the eastern European economies as emerging markets which limited their policy space, 12) several European economies had their own housing bubbles combined with weaker mortgage lending standards, and 13) government assistance to the sectors (i.e., automobiles) most negatively impacted was constrained by nationalistic competitive concerns.

II. The impact of the crisis

At a general level, although the 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 this will be their deepest recessions since the Great Depression of the 1930s, 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.

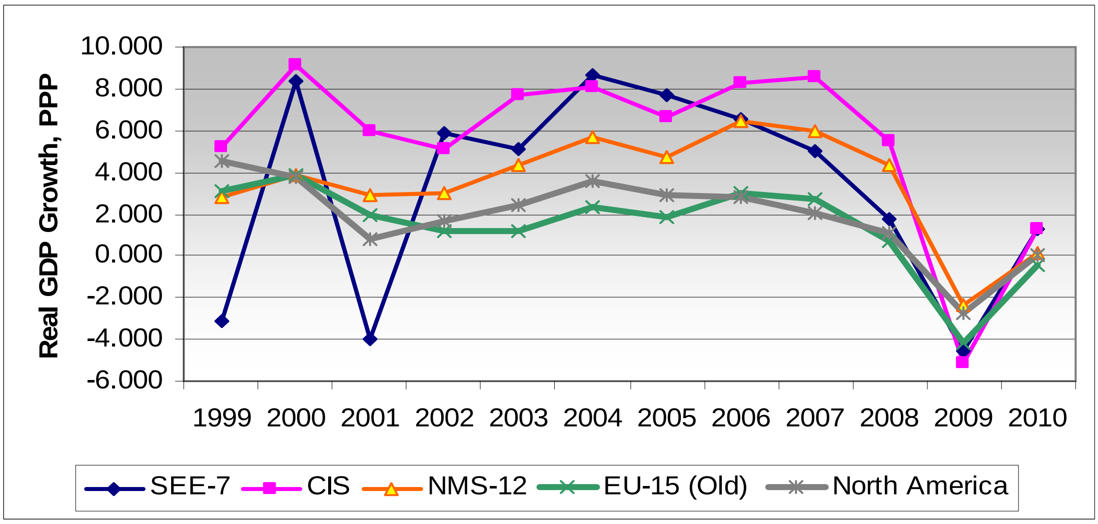
Once the value of the US mortgaged-backed securities began to fall, the crisis moved to the wider-European region quite rapidly through a surprisingly large number of different channels. In some countries the banks owned large quantities of the toxic U.S. assets (i.e., Belgium, Germany, Switzerland), in other cases the countries had their own bursting housing bubbles (i.e., Ireland, Spain, UK), in other cases, banks and companies were dependent on global capital markets which seized up (Russia and 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), in other cases there were large declines in remittances which had been a significant component of their gross national incomes (Armenia, Georgia, FYR of Macedonia, Moldova, Serbia, and Tajikistan), and in almost every case countries were negatively impacted by declining exports and commodity prices and declining tourism.

<u>Key macroeconomic indicators</u>

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.

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.

Figure 1 –Real Growth in the Major ECE Sub-regions, 1999-2010



Growth turned negative in the US beginning in December 2007, in the eurozone in the second quarter of 2008, and in Russia and most of the emerging economies in the last quarter of 2008. In 2009, growth is expected to be negative 5.1 per cent in the CIS, negative 5.1 per cent in Turkey, negative 4.2 per cent in the eurozone, negative 2.8 per cent in the U.S., and negative 2.4 per cent in the EU new member States. The economic downturn has been quite severe in the Baltic economies and Iceland where growth is forecast to be close to negative 10 per cent and somewhat severe in Germany, Ireland, 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 especially strong 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.

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 unemployment in Spain may reach 20 per cent by 2010.

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.

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. 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.

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.

The decline in economic growth in Russia during the current crisis has been extraordinary, and represents probably the greatest “reversal of fortune” of any of the world’s major economies. GDP is likely to decline 6.0 per cent in 2009; in 2007 growth was 8.1 per cent. Thus Russia has experienced a growth turnaround of approximately 14 percentage points; this is over twice the decline in the US or the eurozone over the same period. This is all the more 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 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. The stock exchanges have been closed on several occasions.

For the advanced economies, the crisis has moderated inflation that had begun to increase above target levels in early 2008; although they may experience a short period of deflation during 2009, this is unlikely to be persistent. 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.

Sectoral impacts

Since the core of the crisis was in the US housing market, as expected, the US construction sector has been especially negatively impacted; employment in that sector has declined by 1.1 million (or 15 per cent) since the beginning of the US recession in Dec. 2007. By December 2008 US housing starts were 76 per cent below their peak in January 2006. In Europe, however, construction is down only slightly except in a few markets with housing busts such as Spain.

As the crisis has deepened, it was investment spending on capital goods and consumer spending on durables that declined the most; this meant that industrial production and manufacturing in particular were especially hard hit. In February 2009 industrial production in the US was down 11.8 per cent from a year earlier; it was 18.4 per cent lower y-o-y in the eurozone and 17.5 per cent lower in the EU, a record decline. The largest declines occurred in Estonia (-30.2%), Hungary (-29.0%), Latvia (-24.2%), Spain (-22.0%), Slovenia (-21.2%), Italy (-20.7%), Germany (-20.6%), the Czech Republic (-20.3%), Sweden (-20.3%), and Finland (-19.9%). In the largest European economies outside the EU, industrial production (January 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.

The decline in manufacturing activity has been particularly large in the advanced economies. In the eurozone new orders in January 2009 were 34 per cent lower than a year earlier; this represented the largest monthly y-o-y decline since Eurostat began compiling this data in 1996. Especially hard hit were European exporters of manufactured capital goods such as Germany which is the world's largest exporter of manufactured goods. By February 2009 US manufacturing output was down 14.0 per cent and manufactures employment had declined by 1.5 million (or 11 per cent) since the recession began. In Ukraine, the declines in steel and metal production have been especially large, declining 43.3 per cent in the first quarter of 2009 y-o-y.

Worldwide, the automobile sector has been one of the most negatively impacted sectors due the fact that cars have a relatively long potential life and as such represent a discretionary expenditure that can be postponed in uncertain times. In addition, cars are a product that is mostly purchased on credit and with the collapse of credit markets, financing was not available. In March 2009 car sales were down 23.5 per cent the US and 47 per cent in Russia than a year earlier. In the final quarter of 2008 European new car sales were down 19.3 per cent (y-o-y). In the EU, automobile production, which accounts for 6.5 per cent of the manufacturing sector, has declined significantly and some of the governments have provided various types of support. In the EU, Germany is by far the largest producer of automobiles; in February production was down 65 per cent from a year earlier. Car production per capita is even larger in several of the NMS, including Slovakia, Slovenia, and the Czech Republic, and accounts for a sizeable percentage of their industrial production. By January 2009 automobile production had declined by 60 per cent (y-o-y) in Turkey.

The expansion of the financial services sector over the last two decades, especially in some economies such as the UK and the US, probably came at the expense of the manufacturing sector. The UK and the US went through a process of deindustrialization in the 1980s and 1990s as the financial sector grew, and by 2007 manufacturing accounted for only 13 percent of total value added in these economies; this was almost 10 percentage points less than in Germany. The industry attracted many of the brightest students which might otherwise have gone into the sciences and engineering. The crisis is likely to result in a decline in the size of the financial industry, and as a result it is expected that manufacturing, and especially its human capital research and design aspects might increase in importance. There will be several implications for this. Manufacturing is generally dispersed more widely geographically than are financial services, which tend to concentrate in a major city (like London or New York); thus the increase in manufacturing may alter slightly the geographical distribution of jobs and reduce the geographical inequality that has developed in these economies. In addition, manufacturing provides relatively high wage jobs for non-college workers, so the increase in inequality by education that has also grown over the last two decades in these economies might be moderated as well.

As is usual in an economic downturn, world commodity prices have declined considerably, and that has meant that those commodity exporters, which are primarily in the CIS, have suffered a large decline in export earnings. The decline in energy prices has been especially large, and that has had large repercussions for Russia and the energy abundant CIS in central Asia.

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. 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.

The condition of the financial sectors

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 poorly designed and implemented. 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 any newly created debt requires a government guarantee to be marketable. Domestic credit expansion in Europe and the US has essentially collapsed.

It is currently estimated that the total global loss from toxic assets during this crisis will ultimately reach $4 trillion; of that amount, US residents and firms will suffer a loss of $1.8 trillion (about 12.6 per cent of US GDP) while those in western Europe will experience an even greater loss of close to $2 trillion (the eurozone losses will be 11 to 15 per cent of GDP) and those in European emerging markets will lose $150 billion. Thus the ECE economies will have to absorb over 95 per cent of the global losses resulting from the current crisis. Approximately ¾ (or $3 trillion) of the total losses result from assets originated in the US, while the other quarter were originated in Europe and Asia. US bank loan losses will total $1.1 trillion of which half have already been written down, while eurozone and UK bank loan losses will be over $900 billion, of which only 17 per cent have so far been written off. (The remaining $2 trillion are losses from the ownership of mortgage-backed securities.) The US losses are due primarily to subprime mortgages although commercial real estate and credit card debt has increasingly become problematic. The European banks also owned sizeable amounts of subprime securities but, unlike their American counterparts, also have large exposures to non-performing loans in emerging markets throughout the world. Of the $4.6 trillion of foreign bank loans to emerging economies, eurozone banks account for $3.4 trillion or 73.4 per cent while US banks account for only $475 billion or 10.3 per cent; UK banks also have exposure. Thus European banks are being impacted to a much greater extent than US banks by the fact that the slowdown is now global. In many cases this exposure is in the European emerging markets where they established subsidiaries, but a number of European countries have large exposures to Latin America (Spain) and Asia (Switzerland, the Netherlands, the UK). By March 2009, EU governments had provided $380 billion for bank recapitalizations and guaranteed $3.17 trillion of bank loans.

The Canadian banking sector largely avoided the problems that plagued US and European banks; they have had no bank failures or bailouts. Russian and Kazak banks owned few US subprime assets, but were dependent on external sources of finance which have now dried up while at the same time domestic non-performing loans are increasing. In the coming months, a sizeable number of banks in these economies are likely to fail and/or require government support.

The major European banks were much more leveraged than US banks and as a result were more vulnerable to declining asset values. The difference in leverage ratios (debt/equity) between Europe and the US may be exaggerated considerably by different accounting standards as Europe uses the International Financial Reporting Standards (IFRS) while the US uses the Generally Accepted Accounting Principles (GAAP). However, despite this incompatibility it is generally believed that the European banks had approximately twice the leverage of their American counterparts (or Tier 1 capital levels of European banks were half those of US banks) and three times the leverage of Canadian banks. European banks had a fairly prudent leverage ratio of about 10 for their regulated operations, but their in-house investment bank activities were not subject to a capital requirement; as a result, the ratio for their entire operations was often as high as 50. Although European banks had much higher leverage ratios, they had compensated for this to some degree by holding less risky assets or insuring this risk by purchasing credit default swaps. However, this insurance, purchased to a large degree from AIG which would go bankrupt, was only redeemable because the US government agreed to use taxpayer funds to pay these claims.

Without this US taxpayer bailout, western European banks would currently be in a much direr situation.

In Europe, there has been an issue regarding the absolute size of their banks because they are exceedingly large relative to their home countries' GDP. This is important because in most advanced economies there is some expectation, whether legal or not, that the government will provide a lender of last resort guarantee to depositors should the banks fail. The fact that advanced economies are able to provide a more convincing guarantee to depositors is one fundamental factor why during uncertain times wealth holders prefer to transfer their funds from emerging to advanced economies. This problem was most apparent with Iceland where the banks had assets ten times the GDP of the country. The assets of Fortis were several times the GDP of Belgium, those of Barclays were over 100 per cent of the UK's GDP, and those of Deutsche Bank were over 80 per cent of Germany's GDP. European governments therefore could not reasonably be expected to guarantee the liabilities of their banks, especially retail deposits, but were nevertheless forced to do so as the potential for global bank runs developed in the autumn of 2008. Also and quite importantly, while the US Federal Reserve can act as lender of last resort if the US government is unable to obtain the needed funds (through taxes or borrowing), eurozone governments have no lender of last resort to monetize their debts since the European Central Bank (ECB) is not authorized to do this. The European situation has been described quite accurately as one where the banks are too big to fail but too large to save.

Considerable uncertainty remains about the financial condition of US and European banks because the true value of the toxic assets which they hold is unknown and can not be determined until the price of US real estate stabilizes. Through the spring of 2009 US housing prices have continued to fall. By Jan 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 29.1 per cent, and the 10-city composite was down 30.2 per cent. Extremely large inventory levels and foreclosures (running at about 300,000 a month in early 2009) suggest that home prices have yet to reach their bottom.

Ultimately the governments in the US and Europe will have to either nationalize their problem banks, bail them out or purchase their toxic assets at a premium; whatever approach is taken, government finances are likely to be negatively impacted. Several approaches have been attempted to date, but none has so far appeared to be reasonably effective. The US Troubled Asset Relief Program has been particularly chaotic, having had a number of false starts, and even the basic objectives have changed directions several times. As a result financial markets remain largely frozen. Government bailouts of banks have occurred in several European economies (i.e., Belgium, Germany, Iceland, Ireland, the Netherlands, and the UK). It is estimated that west European banks will need to raise from $160 billion to $300 billion in new capital. Ireland has so far been the first country to set up a "bad bank" patterned after the successful Swedish program in the early 1990s in order to clean up its banking sector, but is unlikely to be the last. The Irish government paid €50 billion to take over €80-90 billion (at face value) of real estate loans by Irish developers; this program, however, does not address the problems surrounding non-performing mortgages and credit card debt. The German approach has been to try to distinguish between illiquid and insolvent assets by providing a government guarantee for the former.

The national regulatory and institutional structure of the financial sector in most European economies was poorly designed for dealing with financial market turmoil. For example, deposit insurance for bank depositors which had been implemented in the US after the Great Depression was largely absent in Europe although it had been implemented in Sweden in 1992 during that country's real estate induced financial crisis. As banking solvency issues arose in the fall of 2008, beginning with Ireland (which was the first eurozone economy to enter into a recession in the second quarter of 2008) one government after the other in an uncoordinated and somewhat competitive fashion had to extend a government guarantee to bank deposits. In the UK, banking supervision was so separated from the central bank's lender of last resort facility that the latter had no idea in its dealings with Northern Rock whether it was insolvent or just illiquid.

Another fundamental regulatory weakness in Europe involves the fact that banking is regional or global but most regulation is, and any bailout will have to be, national. More specifically, there is no politically agreed to understanding as to how financial losses experienced by cross-border banking entities should be addressed. When non-performing loans wipe out the equity of a foreign subsidiary bank, the responsibility of the parent bank to support its subsidiary is unclear. If a bailout is required, there is no agreement which government is responsible. The obligation of a parent bank not to drain liquidity from a subsidiary in order to store up its own finances is unresolved. The current legal obligation of the parent bank as stated in the Maastricht Treaty Article 73(d) is limited to the equity in the subsidiary, and the parent is under no obligation to support the subsidiary. However, in addressing these issues as they arose during this crisis, this legal standard was questioned and political considerations often dominated strictly legal obligations. For example, after the collapse of the Icelandic banks, some countries used extraordinary means in order to get compensation for their nationals who had been depositors. For example, the UK used anti-terrorist legislation and implied that there would be other foreign policy repercussions. In another case, when government action was necessary to address the problems of Fortis Bank, it was decided to divide it along national lines (Belgium and the Netherlands). So far international or regional discussions of how to better address these issues have been limited; there was no meaningful discussion of internationally coordinated responses to cross-border bank rescues at the G-20 meeting. Within the EU, however, this issue will be re-examined as the political authorities do not agree with the current legal structure.

The banking sectors of the European emerging markets were heavily dependent on external capital markets for obtaining funds to loan. Generally banks borrowed externally at short maturities but made domestic loans for much longer maturities. When world capital markets froze in 2008, these banks were not only unable to get new funds but were unable roll over existing ones. As their domestic economies began to decline, they also had increasing numbers of non-performing assets; these accounted for about 8 per cent of assets in early 2009 but are forecast to increase to as much as 25 per cent. The NMS and south-east Europe benefited to some degree from the fact that their external borrowing was by local subsidiaries from parent banks in western Europe which were somewhat accommodating. However, parent country governments did not want the assistance they were providing to their domestic institutions to be transferred abroad to their subsidiaries. For example, the Greek government warned its multinational banks in January 2009 not to transfer funds provided by them in a $37 billion support package to their foreign subsidiaries in the Balkans. Countries such as Russia, Kazakhstan, and Ukraine borrowed at arms length in global capital markets and thus did not have any support from parent banks, and their governments therefore had to take a more active role in supporting their banking systems. The policies varied, but generally the governments often played an intermediary role in providing domestic participants government-guaranteed assets, and the funds so raised were deposited in the banks, or they nationalized and recapitalized banks directly. The banking system in Ukraine was essentially frozen by the beginning of March 2009, as early withdrawals from time deposits were restricted and depositors of other accounts were limited to small daily withdrawals after long waits in line.

External financing requirements

One measure of a country's need for required external financing is a calculation of the amount of maturing external debt that will need to be rolled over plus the size of the current account.[2] Overall the European emerging markets (except Russia) are found to have an external financial requirement of $497 billion in 2009 and a somewhat smaller one for 2010 which brings the total for the two years to approximately $900 billion. Over the two years, Poland has the largest financing requirement ($190 billion), followed by Turkey ($180 billion), Romania ($100 billion), Hungary ($75 billion), and Ukraine ($70 billion). Out of the total financing requirements, the IMF estimates that not all of this will be available from the private sector and that a significant percentage of it must come from external public sources. This financing gap is estimated to be $123 billion in 2009 and $63 billion in 2010 or $186 billion for the two years; it is the largest for Poland ($59 billion), followed by Turkey ($40 billion) and Romania ($34 billion). The IMF calculated that of the $186 billion gap, it would be able to provide only $81 billion based upon the countries' quotas. Thus slightly more than $100 billion will need to be covered by other institutions: presumably the EU (or member governments), the European Investment Bank, the European Bank for Reconstruction and Development, or the World Bank.

Effects on achieving the Millennium Development Goals

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. History has shown that it is usually the poorest and those socially marginalized that often suffer the most during a crisis and this pattern is likely to be repeated in this 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.

One of the MDGs for which progress has been disappointing has been in controlling HIV/AIDS and tuberculosis in the European emerging markets. The deteriorating economic situation is likely to further worsen the basic underlying conditions (poverty, prostitution, drug use) that have contributed to this problem 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. This situation has global implications as a higher incidence of disease in one region spreads to other regions; in addition, the spread of antibiotic-resistant tuberculosis in eastern Europe will ultimately affect the ability of the world community to control this disease.

[2] The calculations presented assume that 50 per cent of private debt and 90 per cent of public maturing debt will need to be rolled over. These do not include Russia despite the fact that their private sector has very large financing needs; the Russian central bank's international reserves may ultimately be used to cover the private sector's needs.

Another MDG objective that is likely to be reversed is the progress recently made on improving gender equality in the region. Since women are more likely to be in the informal sector, they receive few benefits when laid off, and thus the rate of poverty for them or single parent households will increase.

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. The central Asian economies, especially the poorest of them like Tajikistan have experienced some recent setbacks prior to the onset of the crisis due to a number of adverse developments such as higher food prices and the harshest winter (2007/2008) in three decades, which was followed by spring flooding which destroyed infrastructure and farmland. These economies are particularly dependent on remittances and will especially feel the impact of their decline.

III. Policy responses to the crisis

Country specific responses

Economic policy in North America and western Europe has concentrated on addressing the meltdown in their financial sectors and accompanying recessions by providing governmental support for the financial sector, attempting to provide additional macroeconomic stimulus to minimize the recession, and reforming the governance structure and regulatory apparatus of their financial markets to avoid a repeat of the current crisis. There have, however, been significant differences in the initiatives proposed in the two regions in terms of their focus, their magnitude, and their speed of implementation. The US has been far more focused on macroeconomic stimulation in order to get out of the current crisis while the focus in Europe (especially continental Europe) has been on regulatory reform to avoid a future crisis. Their macroeconomic policies for addressing the economic slowdown have varied significantly. Neither region has been particularly successful in recapitalizing their banking systems.

The US reacted quickly at the earliest signs that there might be a problem with aggressive monetary and fiscal stimulus; the U.S. Federal Reserve in particular started loosening almost immediately. The response of western Europe (except perhaps the UK) was more delayed and much weaker. Generally, the effectiveness of European policy was limited by: a failure to appreciate the seriousness of the situation, a general hesitancy combined with built-in institutional limitations in using counter-cyclical macroeconomic policy, and inadequate regional coordination. Both European policy makers and academics have traditionally been far more skeptical of the use of discretionary counter-cyclical macroeconomic policies than their American counterparts. This is evident not just from empirical studies of the use of macroeconomic policy in Europe but even in the design of European institutions. For example, macroeconomic policy in the eurozone has essentially been neutered by the limitations on fiscal policy imposed by the Growth and Stability Pact while monetary policy is restricted to a narrow focus on medium term inflation under the charter of the European Central Bank. Thus European politicians and policy analysts simply did not believe at a general level that large fiscal stimulus combined with monetary loosening were appropriate policy responses for dealing with deteriorating economic conditions. As a result they were slow to act as the crisis developed and timid when they finally did act. The delay in implementing macroeconomic stimulus was also the result of the general failure by policymakers to appreciate the degree to which Europe would be impacted by the crisis until relatively late. Even by January 2009, IMF Managing Director Strauss-Kahn could say, “In Europe especially, they are still behind the curve.”

The European emerging markets, like all emerging markets, have had far less policy space in terms of macroeconomic stimulus and little influence in discussions about financial market reforms. Instead of being able to expand fiscal and monetary policy to stimulate demand as the advanced economies have been able to do, they have been essentially forced to tighten these to demonstrate to world capital markets that there will be no defaults or inflation that would destroy asset values. Automatics stabilizers are also weak for these economies. The NMS have additional institutional constraints in that a number of the economies have committed to fixed exchange rates or currencies boards. With their exchange rates fixed to the euro, their monetary policy has had to follow the lead of the ECB. Their fiscal policy has been restricted to budget deficits of less than 3 per cent of GDP if they want to stay on track for future euro accession. Finally, a number of the emerging economies are under IMF programs, which have strict macroeconomic requirements to fulfill. The difference in the economic policy options available to advanced and emerging economies in the region has been stark.

Fiscal policy

Although the US and to a lesser degree western Europe have implemented historically large fiscal expansions in order to make up for the collapse in consumer and investment spending, these packages are currently believed to be only about one-half of what would have be optimal. Depending on the evolution of the crisis, another round of fiscal packages may be required.

There are a number of different methodologies for assessing the size of the stimulus packages and different organizations or researchers have provided strikingly different calculations. For example, some packages were for a year and others for several years, and in some cases spending was incorporated into the usual budget process and in others it was separate legislation. Of fundamental importance in comparing the US with Europe was how automatic stabilizers (which don’t require new legislation) should be counted since they were much larger in Europe. At one extreme there was an approach that considered only special “crisis” legislation, and at the other extreme was a comparison of the change in fiscal deficits between some base year (perhaps 2007) and either 2009 or 2010. The former method suggested the US was doing far more than Europe, while the latter suggested the difference was much smaller. The degree to which bank bailouts or guarantees should be included in this number is also important given the size of these packages to support the financial sector. The logic of including support for banks depends on what is to be measured; although they represent a cost to governments they do not translate necessarily into increased aggregate demand. Given all these complications, countries have been able to calculate the number in a manner favorable to their political objectives and thereby deflect any criticism from other governments.

Despite these general qualifications, the US has taken the lead in stressing the importance of fiscal stimulus and has implemented the largest program in the ECE economies. A $787 billion package (about 6 per cent of GDP) was agreed to in early 2009, and by comparison this was slightly larger than Japan's package of 4.5 per cent of GDP but less than the Chinese plan. The US package included $507 billion of additional spending (including $150 billion for infrastructure projects in energy, transport, and technology) and $282 billion in tax cuts. However, much of the spending, especially the infrastructure component, will not actually be spent until 2010. This was additional to the stimulus package of 2008, which included $168 billion of tax cuts and spending increases; it was also separate from the $2.5 trillion plan for the financial system. Critical to containing the crisis is the need to establish a price for US mortgaged-backed securities, and this will only be possible once US house prices and mortgage defaults have stabilized. Recognizing this, the US government has implemented a number of programs to support the housing sector and assist mortgage holders experiencing difficulty in making their payments.

The Europeans were much more restrained in their use of fiscal policy. Although some European governments, including those of Ireland, Spain, and the U.K., readily embraced large deficits as the most effective way to maintain aggregate demand and employment, others, led by Belgium, the Czech Republic, and Germany (and later joined by France), criticized this approach. They described this policy option negatively as "crass Keynesian" or the "road to hell." The European Commission proposed in late November 2008 a European Economic Recovery Plan which included a fiscal stimulus of €200 billion or 1.5 per cent of GDP. The boost in demand was to be "in full respect of the Stability and Growth Pact" but there was some uncertainty about what this meant since a number of economies (France, Greece, Latvia, Malta, and Spain) were already over the 3 per cent deficit limit in 2008 and even more countries were likely to do so in 2009. Thus despite some disagreements within the EU about the desirability of fiscal packages, the size of the actually implemented stimulus packages in the major EU economies was quite similar. In the three largest economies, the proposed stimulus for 2009 is slightly over one per cent of GDP; $29.7 billion (1.1% of GDP) in the UK, $33.0 billion (1.2%) in France, and $66 billion (1.5% or €49.25 billion) in Germany. The non-EU European advanced economies also implemented fiscal stimulus packages; for example, Norway passed a $2.9 billion plan (2.3% of GDP).

The European rationale for this bias against fiscal policy is due to legitimate practical historical experience, anticipated future economic conditions, and ideology. For a small economy, a fiscal expansion is not particularly effective since much of it will leak out to the rest of the world. Thus, historically, the use of fiscal policy by individual European governments has been limited. Although the effectiveness of fiscal policy would be much greater for a coordinated EU-wide fiscal expansion, this bias against fiscal policy is nevertheless ingrained into the European policy culture. Also, the European economies have more extensive safety nets and as a result the automatic stabilizers are approximately twice the size of those in the United States; thus the need for discretionary fiscal spending is less. The fact that European societies are aging to a much greater degree than the US means that they should rationally be more concerned about the debt created by fiscal deficits. These future debt obligations were also a primary concern for some of the already indebted European economies which were already experiencing problems in rolling over their existing public debt. Rather large spreads opened between the interest rates for German bonds and those for Greece (243 basis points), Ireland (174 basis points), and Italy (140 basis points).

The European fiscal packages, like that of the US, consisted of a combination of spending increases and tax cuts. For example, the German plan included about €8 billion in investment projects, €18 in income tax cuts, and additional subsidies for health care, child care, and purchases of energy efficient cars. The Germans also created a €100 billion credit guarantee fund to provide credit to sound companies whose private sector funding had dried up. The French package of €26 billion (of which €20 billion was to be spent in 2009) included €11 billion for businesses, €11 billion for public projects with an emphasis on social housing, and €4 billion for infrastructure improvements in the transport, energy and postal service sectors.

The percentage of the fiscal packages that are allocated to environmentally supportive projects varies between the 10-20 per cent range in France, Germany and the US to only about 5 per cent in Spain and the UK. Generally the ECE region compares unfavorably on this score relative to China and South Korea. The need for fiscal stimulus, however, implied that it was not the time for additional taxes. This fact had negative repercussions for US environmental policy as the support for a carbon emissions tax (to address global climate change) declined.

The fiscal positions of the European emerging economies have also deteriorated considerably. However for them, this was generally not the result of increases in government spending but decreases in tax revenues. Because of the deficits, the government sectors are technically providing more of a net stimulus, but in many cases the actual level of government spending may have declined. In Russia there has been a massive swing in the federal budget from a surplus of 4.1 per cent of GDP in 2008 to a deficit of 7.4 per cent of GDP in 2009. The NMS which were not in the eurozone had to cut back government spending to try to keep within the 3 per cent of GDP deficit limit of the Maastricht criteria for future euro accession. Several other economies were under IMF programs that required spending cutbacks as a condition for obtaining funds.

Monetary policy

Interest rates in the advanced ECE economies have been reduced to historic lows; in the US, UK and Switzerland rates fell effectively to zero, and in the eurozone, although they were still above one per cent in the early spring of 2009, they are expected to fall further in the coming months. As with fiscal policy, European monetary policy was eased later and more slowly. The ECB remained fixated on inflation (mostly from external commodity markets) and was still raising interest rates one year into the crisis, before beginning a series of cuts in late 2008 and early 2009. Overall, the loose monetary policy of the advanced economies, however, has not proven to be especially simulative since the financial sector, through which it operates, is not functioning properly. With interest rates near zero, traditional monetary policy has reached its limit. As a result, the US, UK and Switzerland have implemented additional measures, referred to as quantitative easing, to inject additional liquidity into their financial systems. Although the ECB currently appears opposed in general to quantitative easing, if it ultimately needed to implement this type of policy, it would face a number of implementation issues not faced by national central banks. For example, it is not clear what assets it should purchase, as there are 16 different types of government bonds from which to choose, and if it decided on purchasing private sector assets, the jurisdictions of the companies will likely prove to be politically controversial. Any discussion of the use monetary policy for addressing a cyclical downturn in the eurozone raises the question of the effectiveness of the “one size fits all” monetary policy when economic conditions vary significantly across countries. This remains a problem for the eurozone and stems from a number of factors including the absence of an overall fiscal authority whose redistributions would tend to even out the economic cycle throughout the eurozone.

Comparison of the monetary policy of the ECB and the US Fed is complicated because the two regions are in somewhat different economic situations and have different structural characteristics. More specifically, European corporations rely more on bank lending for financing and thus the ECB needs to be more focused on ensuring that the banks have adequate liquidity. Support for this position is provided by the fact that although the US has had a more aggressive monetary policy with lower short-term and medium-term government rates, medium and longer term maturities for corporate rates (including mortgages) are actually lower in the eurozone.

Once the crisis had firmly extended its way into the European emerging economies (including the NMS) by mid-2008, the central banks of these economies had very limited monetary policy options for addressing the crisis. Given the flight to quality, interest rates had to be kept high to avoid capital outflows. Those that had fixed exchange rates or currency boards had to set monetary policy to maintain the exchange rate. Foreign currency-denominated loans were prevalent in a number of economies and thus, even in those with flexible rates, monetary policy had to be cautious to avoid large exchange rate depreciations that would have created “balance sheet” effects for the borrowers. A significant increase in the domestic costs of servicing these debts would increase non-performing loans and potentially threaten the stability of their banking systems. Thus although interest rates were near zero for most of the advanced economies (except, Iceland whose interest rate was 17 per cent in the spring of 2009), they were often quite high in the emerging economies.

Exchange rate policy

One of the standard tools for addressing a financial crisis is a currency depreciation which can eliminate the fear of a further depreciation while also improving the trade balance. For example, this was part of the policy package for Russia in 1998, the Asian economies in the late 1990s, Sweden and Japan in the early 1990s, and the Latin American economies in the early 1980s. Obviously this is not an option for addressing the current world-wide crisis since the world can not depreciate; however, an individual country can. The exchange rate dimension has proven to be important in several different contexts in the wider European region during this crisis.

The different monetary policies in the advanced economies (USD, UK pound, euro) produced some currency volatility. More specifically, the tighter monetary policy in the eurozone led to a significant appreciation in the euro especially in the first half of 2008 (when it reached $1.60) which negatively impacted the European export sector. However by the spring of 2009, the euro was back to a rate more consistent with its medium term trend (about $1.30). In the spring of 2009 the UK pound, because of the UK’s aggressive monetary policy, was about 25 per cent lower versus the USD and 15 per cent lower versus the euro; this provided some additional stimulus for the UK economy. The Swedish krona and Danish krone also have depreciated slightly versus the euro.

With the decline of capital flows into the European emerging economies (including the NMS) there was pressure for their exchange rates to depreciate. This created an acute funding problem for those attempting to maintain fixed exchange rates and especially those with currency boards. Those with more flexible exchange rates had the theoretical option of allowing their currencies to depreciate, but the large volume of foreign-currency denominated loans in some countries meant that that option had extensive negative balance sheet effects for those that had taken out these loans. For example, in Poland over half of all mortgages were denominated in foreign currency, often Swiss francs. Nevertheless those economies with flexible rates generally allowed their currencies to depreciate a considerable amount. For example, the Polish zloty depreciated by a third versus the Swiss franc between July 1, 2008 and Feb 5, 2009. Thus someone with a mortgage or loan denominated in Swiss francs had their monthly payments in zloty increase by 50 per cent during this period. Expectations about currency depreciations in the emerging economies have also led depositors to withdraw their funds from local banks and deposit them abroad. This loss of domestic deposits has been particularly harmful for the banks, given their source of funds has already been constrained by their limited access to global capital markets. In the beginning of the crisis some governments tried to maintain their currency's value by intervening but ultimately had to let the currency fall. For example, the Russian government tried to support the rouble but after spending about a quarter ($150 billion of $600 billion) of its sizeable foreign exchange reserves had to adopt a more flexible policy. Some, such as Armenia were forced to return to a flexible exchange regime as part of their IMF agreement, but Latvia was not required to do this. Those countries that depreciated did get the positive benefit of improving competitiveness for their export industries.

Those countries with fixed rates, and even Slovenia and Slovakia who were in the eurozone, experienced a loss of competitiveness relative to their neighbors. Nevertheless the assessment has been that being in the eurozone was a net positive since it eliminated currency speculation. As such several NMS and the IMF (in a confidential unpublished report) recommended that the NMS be allowed to bypass the usual procedures and requirements (Maastricht criteria) and be allowed to join the eurozone quickly as unofficial (non-voting) members. The current eurozone members and even several non-member NMS strongly objected to loosening the requirements although Lithuania stated that it was prepared to join under these conditions. It is therefore noteworthy that the current eurozone members continue to insist that any new member satisfy the Maastricht criteria while a number of existing members exceeded these targets considerably. For example, the required fiscal deficit must be less than 3 per cent of GDP, but the consolidated eurozone fiscal deficit is forecast to be 6 per cent in 2009, and Ireland's deficit is projected to be over 10 per cent of GDP. Likewise any new member is expected to have national debt below 60 per cent of GDP while several, including Ireland's, are likely to be over 100 per cent in the next year.

As the crisis developed in the spring of 2009, the Swiss franc, being regarded as a safe haven currency, appreciated slightly relative to the euro which prompted the Swiss National Bank to lower interest rates close to zero, to intervene on the foreign exchange market, and to begin a form of quantitative easing by purchasing corporate bonds. As a result, the franc depreciated significantly; this raised the issue as to whether it represented a "competitive devaluation" which could be interpreted as a protectionist policy. However, the depreciation of the Swiss franc did have an important benefit for the region; all of the east Europeans with Swiss franc-denominated mortgages benefited.

Industrial policy

Some sectors have been more negatively impacted than others or were more vulnerable for a variety of reasons. Government attempts to support individual sectors, other than the financial sector or the non-traded real estate sector, generally ran into objections from foreign governments over their competitive implications. The large number of trade and investment agreements that cover the ECE economies have severely constrained the ability of governments to aid specific sectors, but they did help keep more overt trade protectionism under control. In the EU, the provision of state aid to support domestic industries was largely considered to be a violation of existing EU agreements, and any provision of EU-wide aid was financially impossible and any coordinated government response proved to be too complicated and controversial to undertake. The European Commission agreed to some emergency measures (only valid through 2010) that relaxed the rules on state aid by increasing the ceiling on aid that required Commission approval and by loosening the restrictions on state guarantees and subsidized loans.

The crisis especially impacted the automobile sector, and policies initiatives to subsidize that sector were the first to appear, and the conflicts that arose there largely limited government attempts to aid other sectors. The US government provided large subsidies to two of its big three domestic automobile firms so that they could avoid bankruptcy. As part of the French stimulus package, the government established a €6 billion package of assistance for the domestic automobile industry (Renault and Peugeot) if they agreed not to close any French factories for the next five years; the Italian, Spanish, Swedish and United Kingdom governments also provided government aid to their automobile sectors. The Swedish government, however, decided not to bail out or buy Saab once GM decided it could no longer continue to carry the company. The German government established a €1.5 billion subsidy program for consumers to buy a new car if their old car (over 9 years old) was scraped; there was no preference for buying a German car. Because of its popularity, this program was tripled to €5 billion in the spring of 2009.

Russia and a number of the CIS which are not members of the WTO were less constrained, but the European emerging economy governments generally did not have the financial resources to provide much aid to industrial sectors.

Social protection and labour policies

Although the advanced economies in the ECE are implementing fiscal stimulus programs that often have a component for providing additional assistance to those most harmed by the crisis (i.e., extended unemployment insurance as in the US), the European emerging economies have been forced into fiscal retrenchments and as a result are having to reduce funding for social and safety net programs. The decline in economic growth is especially critical in the European emerging economies because the primary policy mechanism for addressing poverty in them has been one based upon “trickle-down economics” from increased growth instead of policies to promote pro-poor growth and redistribution.

Regional responses

Given the severity and extent of the crisis, the need for cooperation amongst the countries of the ECE has been great. The major economies of the region were involved in the G-20 process which required a number of compromises as their initial positions often varied. A surprisingly large number of stresses developed within the EU that had to be resolved, and a number of other difficult issues arose concerning the EU's relationship with wider-Europe.

The crisis has created new political tensions within the European Union. In a number of cases countries being subject to new or especially stressful developments requested changes in existing EU agreements or requested its domestic industries to provide some national preference. These suggestions, rightly or wrongly, were generally characterized as protectionist policies. For example, there was the issue of immigration of east European workers into the UK; the UK had been, in the more prosperous years, one of the most liberal on this score. The French President suggested that French automobile companies should return car production back to France from their newly established east European plants. This led to a strong public rebuke by officials in the NMS; Slovakia threatened to force the French gas company GDF Suez out if the French incentives resulted in automobile firms moving production back to France. France ultimately retreated and agreed not to tie its aid to a commitment that automobile firms would keep their production in France or purchase components from companies operating in France. In response to these developments, the EU had two "anti-recession" summits in the spring of 2009 to clarify EU rules on industry subsidies, to limit other "protectionist" policies, and to maintain political solidarity in addressing the economic crisis. The EIB provided about €7 billion in loans to European automobile firms in 2009, which was up from its average of about €2 billion in prior years. The European competitive and disorderly response to assistance to its car industry should be compared to the more rational distribution of burden sharing that was adopted in North America. The US and Canadian governments agreed early on that each government would contribute to any bailout in proportion to each country's size of the industry; thus the US would contribute 80 per cent and the Canadian government 20 per cent.

In early 2009, EBRD (€6 billion), EIB (€11 billion), and the World Bank (€7.5 billion) put together a €24.5 billion package of support for the European emerging economies, especially their financial sectors. The degree to which the EU and ECB would come to the aid of the NMS if they were to have a serious financial or currency crisis had been debated as a hypothetical issue long before the crisis actually began. Generally it was concluded that assistance would likely be provided although there was no existing understanding or agreement that would require this. There is a well established pattern of regional assistance as the EU had been providing structural assistance to the NMS and to its eastern neighbors even before the crisis. Thus for the EU or one of its affiliated institutions such as the ECB or EIB not to provide crisis assistance would be highly unprecedented. The EU enlarged its balance of payments assistance fund for non-euro economies to €25 billion in early 2009 and then doubled it to €50 billion in March. As previously discussed, the issue of early euro accession for the non-members was raised but rejected by the existing members.

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 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. Even Ukraine, which had been having rather tense relations with Russia, especially in the winter of 2009 over gas pricing and transit issues, has turned to Russia (in addition to the US and EU) for assistance.

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. Although these plans were much further in the future and more hypothetical than euro enlargement, the crisis could affect the desire for a currency union that could provide more stability. Unfortunately the Russian rouble as well as all the other currencies of the region experienced significant declines, and the crisis provides no evidence that a larger currency union would necessarily have provided any additional stability.

Multilateral support

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 March 2009, six economies (Hungary, Latvia, Ukraine, Belarus, Georgia, and Armenia) already had IMF programs and others were close to concluding an agreement (Bosnia, 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.

Regional participation in global reforms

The economies of the ECE region are well represented, arguably over-represented, in the global forums and international organizations that have been central to addressing the crisis. Outside of the IMF itself, the G-7 had traditionally been the center of power in shaping the world's international macroeconomic policy. However, given the perceived need to enlarge representation, the G-20 was given an increased role for addressing the current financial crisis. Included in this group are the United States and Canada, four western European countries (France, Germany, Italy, and the U.K.), and two European emerging economies (Russia and Turkey); the European Union is also one of the twenty. Joining the G-20 summits (both in Washington in October 2008 and London in April 2009) were the Netherlands and Spain; also present were the Managing Director of the IMF, who by agreement is a European, the current European head of the Financial Stability Forum, and the American head the World Bank. Thus regardless of how it is calculated, about one-half of countries or one-half of the people at the table were from the ECE region. The ECE accounts for slightly over one-half of the world's GDP (PPP).

Within the ECE members of the G-20, however, there were a few significant disagreements about what should be emphasized. For the US the most important objective has been to increase the macroeconomic stimulus for getting out of the crisis; the UK was also somewhat sympathetic to this view, but they have faced institutional and economic constraints on what is possible. The continental Europeans, led by Germany and France, have been far more cautious regarding macroeconomic stimulus and have instead preferred to focus on regulatory reform of the financial sector by increasing transparency, accountability, and oversight. The US attempted to get the Europeans to increase their stimulus packages at the G-20 meeting in London but was not successful in getting larger commitments from them.

Within the ECE there is broad agreement on what needs to be done in terms of regulatory changes in the financial sector but there remains debate about the details. 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.

There is, however, a significant difference, in the view of the US and Europe, regarding what specific institutional changes or creations are needed to implement these reforms. The Europeans have generally favored the creation of global structures to manage financial regulation while the US has generally opposed giving increased supervisory powers to global institutions. The US primarily views these as national issues that require changes in national legislation, although this does not eliminate the need for international cooperation and/or coordination. The Europeans favor creating new, and enhancing the power of existing, international financial institutions. For example, the UK has proposed creating a global college of supervisors for multinational banks and enlarging the surveillance mandate of the Financial Stability Forum (FSF) and IMF; [3] other options that have been raised include the creation of an International Bank Charter or a World Financial Organization. One issue that the Europeans have pushed in the global forums on the financial crisis, and that has been followed up with some commitments, is the issue of tax havens. Although a valid issue that may have required more global cooperation, it was not an issue substantively related to the cause or the solution of the financial crisis.

Although significant enhancement of regulatory authority in international institutions is unlikely, limiting reform to separate national responses within the EU is also not realistic, given the tight integration of these economies and the fact that the fragmentation of regulatory structures within the EU has made addressing the crisis more difficult and less effective. Thus at the regional level of the EU, there are likely to be significant institutional changes in financial sector regulation. There have already been several studies that have explored the question as to how the governance of Europe's financial system should be changed. Foremost amongst these has been the Larosiere Group, the Turner Review, and the Geneva Report on the Fundamental Principles of Financial Regulation. Overall there is general agreement that some type of prudential agency needs to be established at the EU level which is independent and has authority over national supervisors. The best approach to addressing cross-border banking crises remains open to debate. Some believe that crisis resolution must remain national, and thus the authority of the responsible government (either host country or that of the parent) must be strengthened so that they can address potential vulnerabilities. Others think that crisis resolution should be at the level of the EU, but this will require some agreement on how it could be financed.

[3] The Chinese joined the US in limiting significant enhancement of the surveillance role of the FSF and IMF; this is noteworthy given that these two had the excessively large current account imbalances which many considered to be at the core of the crisis.

The ECE economies have been in general agreement about the need to increase the resources available to the IMF. The US favored this because it was consistent with their emphasis on expanding world aggregate demand. The western Europeans were somewhat hesitant on this initially, but after it became apparent that the European emerging economies would be recipients of much of this, and, if it was not forthcoming from the IMF, the EU or western European governments would be forced to provide this finance, they acquiesced. None of the advanced ECE economies were particularly enthusiastic about the suggestion of the Chinese (and supported by several developing countries) that a central topic of the April G-20 meeting in London should be on how best to replace the dollar as the world's reserve currency. Although the advanced ECE economies have historically resisted efforts to increase the allocations of SDRs (the US vetoed the proposed 1997 increase during the Asian crisis), given the current need for more resources within the region and requests by the other G-20, they agreed to increase SDR allocations by $250 billion, but most of that will go to the advanced economies.

Another issue that has been central to the discussions about needed reforms has been the issue of increasing the representation of the developing world in the management of the international financial institutions. As it is to be expected, those with power in an organization are reluctant to give it up and as a result reform of governance has been quite limited. If there is one group of countries that would appear to be over-represented in the IMF it would be the European economies, especially those in the eurozone. The eurozone is smaller than the US with about the same level of external trade, yet the eurozone economies have 32 per cent of IMF quotas while the US has 17 per cent. Essentially increasing the representation of the emerging economies will require reducing the representation of western Europe; its share of IMF quotas (and power) may need to decline by perhaps as much as 10 percentage points. Although the Europeans appear to have agreed in principle on the need for a rebalancing of global influence, they have so far generally been unwilling to commit to specific changes that would bring this about. It is generally believed that the Europeans were primarily responsible for the 2008 IMF quota review which produced little redistribution of quotas. None of the major or minor European countries have offered to reduce their strength in international organizations or give up their seat at the table of the G-7 or G-20; nor has the US agreed to give up its IMF veto.

IV. The way forward

Prospects for economic recovery

The current economic situation in the spring of 2009 appears to have plateaued; the rapid falls in output, trade and financial flows that occurred in the last quarter of 2008 and the first of 2009 appear to have mitigated. It remains uncertain whether this will be a temporary landing to be followed by another downward plunge as was the case with the stability experienced in the summer of 2008 or whether this represents the bottom from which a recovery can begin. If there is a shoe left to fall, there is a high probability it will involve the economic vulnerabilities that currently exist in the European emerging economies. Growth may resume in the US in the second half of 2009, but the recovery will likely be delayed in Europe because of their much weaker policy response.

Once the 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 probably prove to be very tricky, 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.

Region specific recommendations for crisis resilience

In theory, the creation of the sophisticated financial instruments based upon the underlying subprime mortgages was basically a model designed to take risk 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 was to distribute the risk to those who did not understand what they were assuming and were often least prepared to deal with it. In this sense this financial securitization model was a complete failure in that it did not achieve what was stated to be its primary objective. The crisis, however, has revealed not just a few inadequacies in the design and regulation of financial markets that can be easily fixed but a long list of failures that will require a comprehensive redesign of national, regional and the global financial systems. Although much of this reform will need to be implemented at the national level, it will nevertheless require increased intergovernmental cooperation to harmonize policies; this is especially the case within the EU or in some broader European areas that are tightly integrated economically.

The crisis has also exposed once again the international monetary systems' inadequacy in being able to provide emerging markets external finance in order to promote their development. Although many countries had abandoned this policy option after previous crises, the European emerging markets had embraced this as a way to speed up their development. However, with many of these economies experiencing major downturns which are some of the most severe in the world, it is now apparent that the international monetary system as currently designed can not carry out this function. This will have important implications for some European emerging economies, particularly those in south-east Europe since it will mean that they will not be able to follow in the footsteps of the NMS and copy their development model. There is therefore a need to redesign the international financial architecture so that emerging economies can safely rely on external capital, or alternatively, some mechanism must be established that will keep large imbalances from developing. The actions of the G-20 or individual governments have so far not addressed this important concern.

In order to address the recession that accompanied this financial crisis, the ECE economies have been implementing a vast array of economic policies. The European emerging economies have been largely required to implement pro-cyclical fiscal and monetary policies to keep the crisis from having an even larger negative impact on them. This demonstrates how the current international economic system is fundamentally "development unfriendly" and how the standard macroeconomic tools for addressing crises are not available to them. The tripling of IMF resources was one very important and useful reform that has been significant in minimizing the negative consequences of this crisis for the European emerging economies.

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. Nevertheless, the crisis will require a reappraisal of the policy response and design of many European Union institutions; but this is nothing new. When European Union institutions have been tested before and found to be inadequate, the result has been major reforms or initiatives to address the defect. For example, the creation of the euro arose from the failure of earlier European monetary arrangements.

Finally, the advanced economies of the ECE have dominated the world's international economic organizations over the last half century. This situation is no longer consistent with the underlying economic realities of the world economy. The ability of the international economic institutions to continue to play their coordinating and regulatory role, which is required for a well functioning global economic system, will require further reform (including reduced European representation) to make them more effective and legitimate. More generally, with increased globalization comes the need for increased global governance; over the long-term the two will either increase or decrease together.