April, 2008

The Economic Situation in Europe, North America and the CIS in 2007-2008

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

United Nations E/2008/16

Economic and Social Council

Distr.: General
1 April 2008

Original: English

Substantive session of 2008
New York, 30 June-25 July 2008
Item 10 of the provisional agenda*
Regional cooperation

The economic situation in the Economic Commission for Europe region: Europe, North America and the Commonwealth of Independent States in 2007-2008

Summary

Economic growth in the Economic Commission for Europe (ECE) region declined to 3.2 per cent in 2007 from 3.6 per cent in 2006, but this still reflected solid performance in all the major subregions. Every country in the region experienced positive economic growth in 2007; this had also been the case in 2006. The region as a whole has now experienced four consecutive years of real growth at or above 3.0 per cent. However, an economic slowdown which began in the United States of America in the final quarter of 2007 is likely to extend into most of 2008 and spread to most of the region, as well as the rest of the world. Real growth in the region is expected to decline to 2.1 per cent in 2008. Significant vulnerabilities in parts of the region include overvalued real estate, rapid and perhaps unsustainable credit growth, large current account deficits, increasing inflation, and financial market strains.

Composed of the 56 ECE member States, the region accounted for 53.5 per cent of real world output in 2007, down from 57.8 per cent in 1998. The only subregion of ECE that has substantially increased its weight in the world economy over the period under review is that of the Commonwealth of Independent States (CIS), whose share increased from 3.4 to 4.5 per cent of world output; more than half of that increase is due to the increased share of the Russian Federation. The world share of Germany and the United States, respectively, declined by over one percentage point. Economic trends in the region over the past several years reflect recent global trends, in that the emerging markets have grown considerably faster than those in the more advanced economies. During 2007, real growth averaged 8.4 per cent in CIS, 5.3 per cent in non-European Union South-East Europe, 6.0 per cent in the European Union new member States, 2.7 per cent in the “old, pre-2004” 15-member European Union, and 2.2 per cent in North America.

* E/2008/100.

08-29158 (E) 070508

The United States experienced a major financial crisis beginning in late 2007, which, without the very aggressive response of the United States, and to lesser degree European, central banks and Governments, could have deteriorated into one of history's greatest financial crises. The fact that this occurred during a period of exceptionally high real economic growth is noteworthy.

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

A. Long-run trends

1. The overall economic environment in the Economic Commission for Europe (ECE) region has been quite supportive of growth and poverty reduction since 2002. Over the six-year period, real annual growth has averaged 3.0 per cent in the European region; in the subregions, it was 7.3 per cent in the Commonwealth of Independent States (CIS), 6.6 per cent in non-European Union South-East Europe, 5.1 per cent in the 12 European Union new member States, 2.6 per cent in North America, and 2.0 per cent in the "old" 15-member European Union. In 2007, real growth in the ECE region at 3.2 per cent was above this trend, being led by growth in CIS (8.4), the 12 new European Union member States (6.0), and the 15-member European Union (2.7), but below the trend in North America (2.2) and non-European Union South-East Europe (5.3).

2. Due to the effects of globalization, technological change, labour-market reforms, and less progressive tax structures, income inequality has been increasing in North America and Europe, especially in those economies that follow a more market-oriented model. The growth in income of the richest 1 per cent or the richest 0.1 per cent has been particularly high (relative to average wage levels) over the past decade. For example, in the United States, the income of the top 1 per cent increased by 238 per cent, over 10 times that of the middle 60 per cent of the population (21 per cent) between 1979 and 2005. Inequality increased considerably in the economies in transition during the 1990s and, while it has recently stabilized in some, it continues to deteriorate in others. The fact that globalization and technological change affect all countries, and that the increase in inequality has varied extensively, suggest that institutional factors and the policy environment for dealing with these changes are quite important in limiting the rise of inequality.

3. The recent robust growth experienced in the former planned economies of Eastern Europe and CIS has represented an important turnaround from their difficult transition to market economies, which was characterized by dramatic declines in real income and significant increases in inequality. The income declines during the early transition for the 12 new European Union member States were less severe than for the others and their gross domestic product (GDP) is now approximately 50 per cent higher than in 1989 (smaller gains for Bulgaria and Romania); however, most of the States created out of Yugoslavia (except Croatia and Slovenia) and the energy-poor CIS countries continue to have real GDPs below what they had in 1989, and Moldova is estimated to have a real income of only about half of what it had before the transition. The Russian Federation is now at about the level it obtained in 1989, while some of the energy-rich CIS countries, including Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan, are significantly above their 1989 levels. Two non-resource rich CIS economies, Armenia and Belarus, have also performed relatively well.

4. Growth in the region over the last six years has been broad-based and this has contributed to poverty reduction through a number of channels, including employment generation, tax revenue creation and thus fiscal expenditures, and wage growth. Job creation has been particularly high in the 12 new European Union

member States, where it had been quite sluggish for some time, despite rapid economic growth. Despite these generally favourable trends, inequality remains quite high in North America and CIS and has been increasing in the new European Union member States and many of the economies in Western Europe. The Nordic economies continue to stand out as having economic models capable of producing growth with equity.

5. This rapid economic growth has allowed some progress in terms of achieving the Millennium Development Goals in the emerging ECE economies. However, there is a lag of several years before reliable data for most of the Millennium Development Goal indicators becomes available; thus a reliable assessment of how this recent growth spurt has impacted the prospects of achieving the targets of the Goals is not yet fully available. Within the poorer economies, the problems of poverty and social exclusion have a strong regional and ethnic dimension. Trends for several of the Goals that are especially relevant for the region, such as those connected with the AIDS and tuberculosis epidemics, seem unrelated to income trends; for example, HIV infection has more than doubled in the CIS countries since 2001, despite robust growth. Therefore, with growth slowing down and some Millennium Development Goal indicators invariant to growth, significant further progress will require more explicit policy changes in a number of areas if the Goals are to be achieved by 2015.

6. The gap between Europe and the United States in terms of per capita income and productivity, which had been narrowing for most of the post-Second World War period, reversed in the 1990s, due to a productivity surge in the United States. This led the European Union to launch the Lisbon agenda, which had the goal of closing this gap. To date, the initiative has only been partially successful. The gap in per capita income is no longer widening, but neither is it closing. Productivity per hour in the 15-member European Union has recently been increasing at a rate slightly below 1.5 per cent, which is similar to what had been achieved over the last decade. Progress has been made on some of the specific goals such as increasing labour force participation, but in other areas, such as increasing research and development, the situation has not improved. Research spending has remained at about 1.8 per cent of GDP for the past 20 years and has not converged towards the Lisbon target of 3 per cent. Not one of the European Union member States has increased public funding of research and development to the Lisbon target of 1 per cent of GDP.

B. Macroeconomic developments in 2007

7. In 2007, economic growth declined in the ECE region from the 3.6 per cent rate experienced in 2006 to 3.2 per cent and is expected to decline further in 2008 to 2.1 per cent. This decline occurred throughout most of the region, with the exception of CIS, where it increased slightly (from 8.1 to 8.4 per cent), owing to the robust 8.1 per cent growth in the Russian Federation. Azerbaijan continued its recent impressive growth performance with a rate of 25 per cent in 2007, making it the fastest growing economy in the world. Armenia and Georgia also experienced double-digit growth in 2007.

8. The economic slowdown in the region that began in the second half of 2007 was primarily a response to the slowdown in the United States which resulted from the collapse of its housing bubble and the associated financial problems in the

sub-prime mortgage market. The collapse in the value and marketability of United States mortgage-backed securities was due to increasing default rates on sub-prime mortgages in the United States, as the price of housing there began to decline following an historic increase in prices over the previous decade. Although the initially affected securities were generally those backing United States mortgages, European banks, especially those in Germany and Switzerland, had purchased sizeable quantities of those assets, and thus the financial problem rapidly spread to Europe and beyond. Uncertainty about who owned the affected assets and the solvency of financial institutions holding them created a credit crisis and a "classic" scramble for liquidity. In addition, the financial problems spread to many other financial asset classes through often unanticipated and innocuous channels. For example, the market for United States municipal bonds became disrupted owing to concerns about the bond insurance industry; in addition, since market participants realized that they had underestimated the risks involved with mortgage-backed assets they reappraised the riskiness of all assets, which generally resulted in an upward repricing of almost all risks. The sovereign credit spreads for most of the emerging markets of ECE increased beginning in late 2007.

9. Rapid global growth has put upward pressure on commodity prices, especially oil, metals and food; and these price increases were beginning to be incorporated into inflation expectations and possibly wage demands. A significant decline in the value of the United States dollar has magnified the increase in commodity prices when valued in dollars. The changing prices of commodities and exchange rates has represented a significant change in the global terms of trade between the advanced economies, which are primarily in the ECE region and the developing world, which is primarily outside the region.

10. Inflation remained relatively low in the advanced ECE economies by historical standards; however, given the very low target rates (about 2 per cent) that have been established by the region's central banks, there were inflation concerns. By early 2008, core inflation in the United States and eurozone was about 2.5 per cent with headline inflation slightly over 4 per cent in the United States and slightly over 3 per cent in the eurozone. In CIS, however, inflation remains relatively high (double-digit rates) and has been increasing in a number of the economies, owing to monetary growth from exchange market operations and rapid credit growth from their banking systems.

11. The central banks in the ECE economies have had the difficult task of reconciling higher inflation driven by tightening commodity markets and a slowing world economy. The return of 1970s stagflation increasingly is being recognized as a possibility. Due to different economic conditions and different mandates, the various central banks have responded to these circumstances differently. The United States Federal Reserve responded to the credit crisis and economic slowdown by cutting interest rates by three points, to 2.25, by early 2008. The European Central Bank, however, maintained a less accommodating position and kept rates fixed at 4.0 per cent. The Bank of England pursued a slightly more activist monetary policy and cut interest rates by a quarter percentage point, to 5.25 per cent, in early 2008. Although Europe was not hit with the same intensity of negative shocks as the United States, the current macroeconomic situation provides a clear contrast between a very active macroeconomic policy management as practised in the United States and the more passive and stable management of the Europeans.

12. Despite the slowdown in growth near the end of 2007, unemployment in most of the region was relatively low, due to the robust growth over the past four years. Unemployment in the eurozone was at a record low (since its creation) of 7.1 per cent in January 2008. Unemployment declined significantly in the 12 new European Union member States after remaining quite high for a number of years, despite rather rapid economic growth. January unemployment was still fairly low (4.8 per cent) in the United States, although total employment declined during the first two months of 2008.

13. The recent robust growth has allowed the fiscal balance to improve in the 27 European Union member States and in the United States. However, deficits remain and, given the longer-term demographic problems facing those economies, a surplus on the fiscal balance would be the appropriate long-run target. The energy-rich CIS countries, which have had generally good fiscal balances, increased spending as they reoriented their economic policy from reserve accumulation towards domestic growth.

C. Forecast and vulnerabilities

14. Economic growth in 2008 in the ECE region is likely to fall to 2.1 per cent from the 3.2 per cent rate registered in 2007. Likewise, all the subregions of ECE are likely to experience a significant decline. As of early 2008, it is uncertain whether the United States is, or is likely to be, in a recession. Nevertheless, the expectation is that the United States economy will respond to the monetary, fiscal, and exchange-rate stimulus and should begin to improve in the second half of 2008. Growth is forecast to be below trend in most of Western Europe (1.7 per cent) and North America (0.9), and below trend, but still relatively solid, in CIS (7.1), 12 new European Union member States (5.1) and non-European Union South-East Europe (4.2). Only a few economies are likely to experience an actual increase in growth in 2008 from 2007 levels; these include Hungary, which had a significant slowdown in 2007 due to fiscal tightening.

15. Many of the ECE economies have significant current account deficits. Although 85 economies in the world had current-account deficits (in 2006), the 36 ECE economies with deficits accounted for 91.3 per cent of total world current account deficits. For only the emerging and developing economies, 25 ECE economies accounted for 61.0 per cent of the total deficits for emerging markets. The situation in 2007 and 2008 is likely to be similar.

16. There are a number of explanations as to why the ECE region has larger current account deficits, but given the fact that investment rates are mostly normal, the primary explanation is that savings are unusually low. This is not due to particularly large government deficits — although they are a contributing factor — but rather to low private savings, which is due to a number of reasons, including the rapid escalation of asset prices and the easy availability of credit. Total credit of the banking system in many of the emerging ECE markets grew by over 30 per cent annually during 2006 and 2007 and is highly correlated with the size of the current account deficits, which have nevertheless allowed the region to consume and invest considerably more than it produces.

17. This foreign borrowing is essentially inconsistent with some basic economic fundamentals facing the region. Except for those in Central Asia, all the ECE

countries, face the long-term problem of an ageing population and there will be actual population declines in a number of them. As a result, the ratio of workers to dependants is projected to decline in the coming decades, a trend which has important implications for desired saving rates, fiscal policy and long-term growth. A practical economic approach to dealing with the situation would be to lend to the rest of the world now and repatriate those savings in the future (as, for example, in Japan); however most of the economies in the region are doing the exact opposite. Since the option of consumption smoothing through external financial flows is not being used, proactive policy reforms to address the ageing issue are needed in terms of pension plans, health-care systems, and programmes to encourage lifelong learning. Fiscal surpluses could provide additional national savings.

18. A significant financing component of emerging Europe's current-account deficits consists of large inflows of foreign direct investment. These averaged 4.9 per cent of GDP during 2006 in emerging Europe and the magnitudes in each of the subregions were generally similar, with slightly higher rates in the 12 new European Union member States (6.3 per cent) and a lower rate of 3.1 per cent in the Russian Federation. Foreign direct investment in non-European Union South-East Europe reached 4.7 per cent (but was 9.4 per cent, excluding Turkey). Worrisome is the fact that, in some cases, a large percentage of this foreign direct investment has been in the real estate sector.

19. This reliance on external capital inflows and the corresponding current account deficits have created a significant vulnerability for some of the ECE emerging markets, especially those where currency arrangements foreclose the option of depreciation. A large percentage of foreign currency denominated loans in a number of economies further compounds the risks. For those with flexible exchange rates there has been some increased volatility. For example, relative to the euro, the Turkish lira declined by 19 per cent, the Romanian leu by 5 per cent and the Icelandic krona by 20 per cent during the first three months of 2008. Most of the CIS economies continue to have highly concentrated export baskets, which exposes them to more potential instability than would be the case were they more diversified economies.

20. A number of the transition economies receive significant inflows of remittances. In some cases, such as Albania, Armenia, Bosnia and Herzegovina, Kyrgyzstan, Moldova, Serbia and Tajikistan, these are quite large, amounting to over 10 per cent of GDP. Azerbaijan, Bulgaria, the former Yugoslav Republic of Macedonia, Georgia, Romania and Uzbekistan have remittance inflows that amount to above 3 per cent of GDP. Flows of these magnitudes are having a significant effect on family incomes and their ability to avoid poverty and on the funding of family enterprises. Data on remittance flows in non-European Union South-East Europe and CIS are of poor quality and are subject to a large degree of uncertainty; in some cases, remittances may be twice what are commonly reported. Remittance inflows have been important, but much less so, in the Russian Federation, Turkey and the 12 new European Union member States.

21. Not all of the ECE economies are running current-account deficits. Those which export significant amounts of non-renewable resources are running surpluses in order to smooth consumption through the commodity pricing cycle, as well as for intergenerational equity purposes. This includes primarily Norway and the Russian Federation, although Azerbaijan and Kazakhstan are beginning to fall within this category.

II. Europe

A. Macroeconomic developments

22. Economic growth was relatively high in Europe in 2007 by recent historical comparisons, as well as relative to the United States which it has lagged behind for the last decade. To a large degree, this is due to cyclical considerations with the economic expansion moderating in the United States prior to that in Europe. It is less clear whether the structural reforms that have been implemented in Europe to improve its longer-term growth prospects have had any significant effect. For example, current growth projections for 2008 and 2009 show the eurozone growing below the average rate over the 1995-2006 period. Medium-term projections forecast eurozone economic growth for 2007-2013 to average 1.9 per cent a year, which is slightly below the previous decade and considerably below the estimate for the United States of 2.8 per cent.

23. Growth in the "old" 15-member European Union and the eurozone was quite respectable at 2.7 and 2.6 per cent for 2007. However, it slowed considerably near the end of the year; in the fourth quarter of 2007 growth in the eurozone was 0.4 per cent, which was only one half of the rate in the third quarter. The forecast for growth in 2008 is 2.1 per cent in the 27-member European Union, 1.7 per cent in the 15-member European Union, and 1.7 per cent in the eurozone. The new European Union member States are expected to keep growing at well over twice the rate as those of Western Europe.

24. The unemployment rate in the European Union was 6.8 per cent in January 2008, down from 7.5 per cent a year earlier. It had remained at about 9 per cent for most of 2003 and 2004 before beginning a slow continual decline. Unemployment was at 7.1 per cent in the eurozone in January 2008, which was down from 7.7 per cent a year earlier. In France, the International Labour Organization (ILO) unemployment rate, which had been in double digits for most of the 1990s, fell to a 25-year low of 7.5 per cent in the last quarter of 2007. Unemployment has fallen quite significantly in the new European Union member States after remaining quite high for a number of years, despite rapid economic growth. Large decreases in the rate were observed during 2007 in Poland, where it fell from 11.1 to 8.6 per cent, and in Bulgaria and Latvia, where the rate fell by 1.6 percentage points. However, unemployment increased by over 1 percentage point in Estonia and remains in double digits in Slovakia. Significant labour emigration to the more advanced economies has resulted in a number of shortages of skilled workers in some of the new European Union member States. Unemployment remains quite low in several of the non-European Union Western European economies: the December 2007 (Organization for Economic Cooperation and Development standardized) rate was 0.8 per cent in Iceland, 3.5 per cent in Switzerland, and 2.4 per cent in Norway.

25. The 2008 forecast for inflation in the 27 European Union member States is 2.9 per cent, with the highest rates being in the new member States; inflation in early 2008 was at double-digit rates in Bulgaria and the Baltic States. Eurozone inflation in March 2008 was 3.5 per cent (year-over-year), which is the highest since the introduction of the euro, with a forecast of 2.8 per cent for 2008. The rate in the eurozone varies considerably among the countries, with the highest rates being in the newest members; inflation in energy and food, reflecting global price trends, has been especially high. Since its creation, inflation in the eurozone has generally been

above the European Central Bank target rate of 2, or slightly below, 2 per cent. Inflation remains low in Switzerland, with a rate of 0.7 per cent in 2007, although it picked up in the final months of 2007 and is expected to more than double in 2008.

26. The economy of Iceland was under considerable financial strain in 2007 and in early 2008, with exceedingly high interest rates (15 per cent) which were needed to prop up the krona in the face of the country's large current account deficit of 16 per cent of GDP in 2007. The currency depreciated by 23 per cent against the euro between mid-November 2007 and mid-March 2008. Rapid credit growth was a fundamental factor, as banking assets increased from approximately 100 per cent of GDP to almost 1,000 per cent between 2000 and 2008.

B. Institutional developments

27. The European Union increased to 27 members in 2007 with the addition of Bulgaria and Romania. This enlargement increases the population of the European Union to 495 million, which makes it 65 per cent larger than the United States. The market-based GDP is now 10 per cent larger than that of the United States, while purchasing power parity (PPP) per capita income is about two thirds that of the United States. Approximately two thirds of the trade of the European Union economies is intra-European Union trade and the European Union continues to enact policies to further increase intra-European Union integration. In early 2008, it enlarged the scope of the mutual recognition of product standards principle, which should increase internal European Union trade for the approximately 25 per cent of products that had not previously been covered.

28. Those regions of the European Union with per capita incomes below 75 per cent of the European Union average receive co-financing for some investment projects from several European Union funds. The new European Union member States are likely to receive one half of those funds, with transfers amounting to 2.5 per cent of their GDP over the 2007-2013 planning period. Although contributing to long-run investment and growth, the transfers may further exacerbate overheating in some of those economies.

29. The new European Union member States now have a PPP per capita income of 56 per cent of the 27-member European Union average and have been converging by slightly over 1 percentage point per year, a rate that is slightly above that experienced by the Southern European Union members over the past two or three decades. Cyprus and Slovenia, the richest new European Union member States, now have a per capita income above that of Portugal, the poorest of the 15-member European Union.

30. The membership of the eurozone increased to 15 in 2008 with the addition of Cyprus and Malta, who entered with the same exchange rates as when they joined the Exchange Rate Mechanism II in May 2005. The two economies are small and do not alter significantly the economic characteristics of the eurozone. The accession date for most of the remaining new European Union member States is being pushed back, owing to their difficulties in satisfying the Maastricht criteria; only Slovakia is likely to be eligible to join in the next few years (January 2009). Of the criteria, the inflation target has been particularly problematic and has been particularly high in the new European Union member States with fixed exchange rates or currency boards. Reducing government deficits to below the Maastricht threshold of

3 per cent of GDP remains difficult for some of the new European Union member States; the problem is generally not excessive government expenditures — although some reforms are needed — but, rather, low government revenues.

C. Financial vulnerabilities

31. Given the decline in house prices in the United States, which started in 2007, and the financial problems associated with it, there are concerns about European housing markets, because the price appreciation in those markets in some countries was even greater than in the United States. Housing prices increased considerably in both Western and Eastern Europe for the past five years, but the period of rapid appreciation appears to have ended in the second half of 2007. Although commercial property in many of the Eastern and South-Eastern European economies remained healthy throughout most of 2007, weakness is being forecast for this sector in 2008.

32. The European banking sector seems less exposed to a financial crisis than the United States, in that mortgages were not extended to risky borrowers who had limited income or poor credit histories. In Europe, unlike the United States, homeowners are liable for negative equity if they return the property to the bank; they thus have a greater incentive to continue paying the mortgage. In Spain, where real estate is under stress, the banks created few off-balance sheet vehicles for their mortgages.

III. Non-European Union South-East Europe

A. Macroeconomic developments

33. Despite significant uncertainty surrounding future accession to the European Union for most of these economies and some continuing political instability, economic growth and foreign investment remained strong in the region in 2007, although below the levels of the last several years. South-East Europe had been growing more rapidly than the new European Union member States, but growth fell in 2007 to below the level of the new European Union member States for the first time since 2001, when Turkey was experiencing a currency crisis. Real growth in South-East Europe was 5.3 per cent in 2007, with much of the decline due to the decline in growth in Turkey to 5.1 per cent. However, Turkey revised its procedures for estimating its GDP in early 2008 so as to better capture the activity in its informal economy. As a result, its GDP series increased by about a third.

34. South-East Europe (excluding Turkey) has been receiving sizeable amounts of official development assistance; these flows are much larger than what would be expected given their per capita incomes. However, the size of these flows relative to GDP has been declining from over 6 per cent in 2000 to just over 2 per cent in 2006. An additional financial inflow that has been quite important for South-East Europe (excluding Turkey) has been remittances, which were valued at over 9 per cent of GDP in 2006.

B. Institutional issues

35. The "regionally owned" Regional Cooperation Council was established in early 2008 as a successor to the Stability Pact for South-Eastern Europe, which had been created in 1999; this group includes all of South-East Europe (except Turkey), plus Bulgaria, Romania and Moldova. All of South-East Europe (except Turkey), with the addition of Moldova, have also joined the Central European Free Trade Agreement.

36. The transition process is still not complete in much of South-East Europe as the process of privatizing publicly owned firms continues. In February 2008, Serbia announced a three-year planned privatization of $44 billion of State assets in the telecom, electric utility, pharmaceutical, airline and airport sectors.

37. Croatia is expected to join the European Union as its twenty-eighth member in 2010; although the Former Yugoslav Republic of Macedonia and Turkey are also European Union candidates, it is unclear if and when they will join. Croatia has a per capita income significantly above Bulgaria and Romania, which are already European Union members. Albania and Montenegro have signed Stability and Association Agreements with the European Union; this is the basic pre-candidate agreement. Progress has been made in concluding a Stability and Association Agreement with Bosnia and Herzegovina. Kosovo declared its independence from Serbia in February 2008 and this development may reduce economic and political cooperation in the region and may ultimately slow down or even derail Serbia's ambitions for joining the European Union.

IV. North America

A. Macroeconomic developments

38. The United States had real growth of 2.2 per cent in 2007; however, there was a significant decline towards the end of the year with fourth quarter growth reaching only 0.2 per cent. The decline in growth in the United States was led by a decline in residential investment, which began to fall at the beginning of 2006 and fell each successive quarter through the end of 2007. If estimates of a further decline in the first quarter of 2008 prove true, this will be the longest period of declining residential investment in the United States in the last 50 years. Real growth is likely to be flat in the first half of 2008 and then pick up in the second half as the monetary, fiscal and exchange stimulus take hold, with growth for the year likely to be slightly below 1 per cent.

39. The policy response to the projected slowdown in the United States was rapid and large. The United States federal funds target rate was reduced from 5.25 per cent in the summer of 2007 to 2.25 per cent in mid-March 2008 (including two unusually large three-quarter point drops). However, this easing of short-term rates did not significantly impact the average interest rate on the standard 30-year mortgage. Nevertheless, it should limit the resetting of interest rates for adjustable rate mortgages and should stimulate the economy in other sectors to compensate for the weakness in the housing sector. The Federal Reserve also implemented a policy that allowed banks to borrow (from its Term Auction Facility) using lower-quality assets (i.e. untradeable mortgage-backed securities) as collateral than had previously

been allowed. A fiscal expansion of $170 billion (or about 1 per cent of GDP) was implemented in February in a fairly proactive way; two thirds of it comprised tax rebates for consumers and the remainder was tax incentives for business investment.

40. The United States Government also implemented a number of regulatory changes to help stabilize its housing and mortgage markets. Of particular importance were the increases in the upper limits on the size of mortgages which Fannie Mae and Freddie Mac could purchase. Additional regulatory changes reduced the capital requirements of these two Government-chartered mortgage financiers and will thereby allow them to purchase an additional $200 billion of mortgages. The Federal Housing Administration also increased the number of mortgages that it insures.

41. Inflation in the United States during 2007 increased to 4.1 for the consumer price index and 2.4 per cent for the core rate; rates picked up slightly in the latter part of the year. In January 2008, consumer prices were 4.3 per cent above the level a year earlier. The price of imports, which had been a constraining factor on price increases, began to increase towards the end of the year. Fast-rising components in the core rate included medical care, which was up 5.2 per cent and education, which was up 5.6 per cent. This is the highest inflation in the United States in 17 years.

42. The United States has had a large current account deficit for over a decade and a real depreciation of the dollar provides the only practical mechanism for bringing it down to a more sustainable level while maintaining full employment. Although the dollar had been slowly drifting downward, the credit crisis, by leading to a significant reduction in United States interest rates, resulted in a rapid dollar depreciation in early 2008. It had been the interest rate differential favouring the dollar that had partially been supporting the currency. On a trade-weighted basis, by March 2008 the United States dollar had fallen by 10 per cent over the last year and by almost 25 per cent since 2002, and relative to a basket of key currencies declined to its lowest rate since the dollar was floated in 1973. It appears that the euro, by reaching $1.59 in March 2008, has had to bear a disproportionate amount of the adjustment, while the Asian currencies only experienced minor appreciations versus the dollar. A further depreciation, if orderly, and combined with appreciations in Asia, will contribute towards reducing the problem of global imbalances. Given that there are sizeable amounts of United States dollar-denominated assets and liabilities held throughout the world, a significant decline in the dollar creates significant redistributions of global wealth and income. A rapid decline in the dollar, however, would likely result in significant increased volatility for many other asset classes and could have a negative impact on financial markets and global growth.

43. Employment growth in the United States during 2007 declined to 95,000 a month from 175,000 a month in 2006. Nevertheless, unemployment had remained relatively low in the United States, fluctuating between 4.4 per cent in December 2006 to 5.0 per cent in December 2007. Total employment in the United States economy declined by 85,000 during the first two months of 2008; private sector jobs declined by 127,000. The job losses have been concentrated in manufacturing and construction, while health care, Government and restaurants have been gaining jobs. An unusually high percentage (17 per cent) of the unemployed have been that way for over 6 months; these are increasingly composed of the white-collar college-educated. Almost 500,000 “discouraged” workers left the United States job market during the first two months of 2008 and thus are not considered as unemployed.

Employment during the 2001-2007 economic recovery expanded by only 5.5 per cent, compared with increases of over 20 per cent in the two previous recoveries. Average hourly real earning declined in 2007 as earnings rose by 3.7 per cent in December 2007 (year over year), while the consumer price index increased by 4.4 per cent over the same period. Median United States family pre-tax income was lower in 2007 than it was at the end of the last recovery in 2000.

44. Productivity per hour of work in the United States increased at only about 1 per cent in 2007, which was similar to its increase in 2006; these increases are less than half of the rate obtained over the previous decade (1995-2005).

45. Real economic growth in Canada was 2.0 per cent in 2007 as it declined considerably near the end of the year, with fourth quarter growth of only 0.2 per cent. Growth in 2008 is being forecast to be 1.4 per cent. The Canadian dollar appreciated by 77 per cent versus the United States dollar between 2002 and late 2007, owing to its export concentration in commodities; since that time, it has declined by 10 per cent and was at parity by March 2008. The current Canadian trade surplus is forecast to decline in 2008 owing to the appreciation of the Canadian dollar and the slowdown in the United States economy, which purchases three quarters of its exports. Timber exports, which accounted for 8.3 per cent of Canadian exports in 2006, are experiencing a significant decline owing to the contraction in United States and Canadian housing construction. Unemployment is also expected to increase in 2008 from its 5.8 per cent level in 2007.

46. In response to the economic slowdown and financial problems associated with the worldwide tightening credit situation, the Bank of Canada has gradually lowered its reference interest rate from 4.5 per cent down to 3.5 per cent in March 2008; the United States is a significant source of financing for Canadian corporations. The housing market has weakened in Canada, with housing starts down to their lowest level in five years. Inflation was only 1.4 per cent in January 2008; monetary growth has also been low. Canada has been running a budget surplus for the last 11 years and that is expected to continue in 2008 despite a tax cut in October 2007.

B. The United States housing market

47. United States housing prices doubled between 1997 and 2006 and at the beginning of 2007 were historically high compared to standard yardsticks such as the ratio of house prices to rent, or house prices to income, or total household real estate assets to GDP. The latter was almost twice the level observed in the early 1970s. These high prices stimulated investment in new housing and by the end of 2007 the supply of unsold new homes reached its highest level since 1981 and inventory was twice the normal level. As a result, United States housing starts declined 25 per cent to 1.36 million homes in 2007, which was the largest annual percentage fall since 1980. In February 2008, housing starts were at a seasonally adjusted rate of 1.1 million, which was 28.4 per cent below the level a year earlier. Existing home sales fell 12.8 per cent in 2007 over 2006 levels; this was the largest one-year fall in 25 years. In January 2008, home sales were down almost 25 per cent from their 2006 pace to an annual rate of 4.9 million, while new home sales fell to an annual rate of 588,000, which was less than half of the level reached during the peak of 2005.

48. The median national price of an existing single family home fell 1.8 per cent; this was the first annual decline since records began in 1968 and is likely to have been the first nationwide decline since the Great Depression. In January 2008, the median price was $201,000 or 4.6 per cent below the level in January 2007. The S&P/Case-Shiller house price index for the 10 leading cities experienced a 9 per cent decline in 2007 and futures contracts on the Chicago Mercantile Exchange suggest that another 18 per cent decline is to be expected in 2008. At the end of 2007, 2.04 per cent of United States mortgages were in foreclosure and 5.82 were past due; the combination of the two was the highest rate since records began in 1979. For sub-prime mortgages, 13 per cent were in foreclosure and 20 per cent were past due. The foreclosures have been concentrated in several states with California and Florida accounting for almost a third of new foreclosures. The United States commercial property market has also experienced some weakness.

49. The current United States housing decline is different from previous ones, not only in terms of its scale but because it began during a generally robust macroeconomic situation with quite moderate inflation, low unemployment, and reasonably solid economic growth. The relatively moderate inflation rate has given the Federal Reserve considerable flexibility in addressing this crisis by being able to lower interest rates.

C. The financial crisis in the United States

50. The United States experienced a major financial crisis beginning in late 2007, owing to the inadequate regulation of its financial industry combined with the bursting of its residential property bubble. The ultimate cost of the crisis is currently unknown but is likely to be at least several hundred billion dollars. Mortgage lenders made overly risky loans to questionable borrowers without requiring sufficient collateral. In 2007, the median down-payment was only 2 per cent of the home value and 29 per cent of borrowers put no money down. Due prudence was not exercised as the originators of the loans were able to securitize these mortgages and sell them in a manner that concealed their true level of risk. Credit rating agencies and the bond insurance industry improperly calculated the riskiness of these assets by using inadequate techniques. The purchasers of these assets failed to fully realize that the originators had lost any incentive to monitor the true risk underlying these securities. Many of the large financial institutions in the United States that had owned these assets had to raise additional equity from outside sources in order to compensate for their sub-prime losses. Some institutions, such as Bear Stearns, were forced into near bankruptcy.

51. There has been insufficient time to properly analyse the fundamental causes of the current United States financial crisis; however, it is apparent that financial market innovation has been occurring faster than the financial regulatory systems can keep up. Undoubtedly, regulators will need to be more proactive in anticipating these developments. The need for more global supervision of financial markets will need to be addressed as well.

52. The current United States financial crisis is one both of a lack of liquidity and insolvency. As such, policy adjustments aimed at increasing liquidity have proved to be of limited effectiveness. The underlying house values and the financial assets based upon them are worth less than what was paid for them. The real value of the

debt must be reduced to resolve this insolvency. This can be achieved by a difficult and disruptive process of bankruptcies, write-downs and government bail-outs to reduce the value of the debt, as happened in Japan in the 1990s, or alternatively, the real value of the debt can be reduced through higher inflation. In the latter case, the higher incomes and prices would then be able to justify the nominal value of the existing debt. Nether alternative is desirable but it is less clear which one would have the lower social costs. Higher inflation would have the additional advantage for the United States of reducing its large external debt accumulated over the last two decades through its current account deficits, but this might prove disruptive to global financial markets especially given that the dollar has been the major international reserve asset.

V. Commonwealth of Independent States

A. Macroeconomic developments

53. Growth in CIS, which reached 8.4 per cent in 2007, was the highest since 2000; this increase was due largely to the increase in growth in the Russian Federation from 7.4 per cent in 2006 to 8.1 per cent in 2007. Growth was remarkably high in the Caucasus with all three experiencing double-digit growth; Azerbaijan's growth of 25 per cent was the highest in the world. Elsewhere in CIS, growth was fairly uniform, reaching between 7 and 9 per cent. The record high prices for energy have acted as a stimulus for the region; the income gains have then spread to the other sectors including services and construction, and through increased imports to the other non-energy-rich economies of CIS.

54. Inflation has remained a problem in a number of the CIS economies. The trade surplus resulting from the energy exports has led to monetary growth from exchange market intervention and the developing banking sectors have created sizeable amounts of new credit, often from funds borrowed abroad. The ability to neutralize the monetary growth from exchange market intervention is limited by the shallow markets for government debt. During 2007, inflation in the Russian Federation was 11.9 per cent due principally to the 47.5 per cent growth in M2 money. Real GDP growth (8.4 per cent) and inflation absorbed only about one half of monetary growth, with the remainder due to increasing money demand from financial deepening and de-dollarization. Imports are forecast to increase by 36 per cent in 2007, while export growth will be only half that rate; nevertheless, there is likely to be only a small decline in the trade surplus. The Russian Federation's federal budget is projected as having a surplus of over 5 per cent, down from 7 per cent in 2006. The central government surplus has been an important tool especially given the limited effectiveness of monetary policy to neutralize the monetary stimulus resulting from exchange market intervention.

55. The Russian rouble appreciated by 5.3 per cent in 2007 on a trade-weighted basis. The excess supply of foreign currency is due not just to the large trade surplus but large capital inflows in the forms of both loans and foreign direct investment. The higher nominal exchange rate for the rouble raises concerns about the competitiveness of the non-energy export sector.

56. The Russian Federation has received very little official development assistance over the past five years and has recently made significant non-Development Assistance Committee donations in the form of debt forgiveness. The remaining CIS

countries had been receiving official development assistance at about 2 per cent of their GDP but that has declined significantly in the last three years and amounted to less than 1 per cent of GDP in 2006. Several economies, however, have continued to receive sizeable amounts of official development assistance, including Armenia, Georgia, Kyrgyzstan, Moldova and Tajikistan.

57. Disputes about the price of energy products, especially natural gas, continued in 2007 and 2008 in the region. The Russian Federation and Ukraine had a dispute over the price and distributional control of gas in early 2008, and Turkmenistan and the Islamic Republic of Iran also had a pricing dispute. The Russian gas company, Gazprom, is increasingly attaining a global presence in the energy market. Not only is it responsible for the development and export of most of Russian gas but it agreed in 2008 to develop gas fields in the Islamic Republic of Iran and Kyrgyzstan. The Central Asian economies largely sell their gas to Europe through Gazprom and there are pricing disputes regarding these deliveries as well.

58. Foreign direct investment has increased significantly in CIS with approximately two thirds going to the Russian Federation, which is estimated to have received more foreign direct investment in 2007 ($55 billion) than all the new European Union member States combined ($51 billion). Foreign direct investment inflows into CIS amounted to 4.5 per cent of GDP in 2007; this is similar to the level of inflows into the new European Union member States. Inflows were over 10 per cent of GDP for Georgia and Moldova. After many years of exceedingly high foreign direct investment, inflows have turned negative in Azerbaijan by an amount estimated to be over 10 per cent of GDP.

59. The significant vulnerability facing Tajikistan's financial situation developed in the first quarter of 2008 when it was revealed that the Government had guaranteed loans by international commercial banks to cotton farmers who had provided little or no collateral. If the Government should have to honour this commitment, which represents a significant proportion of its international reserves, the net external sovereign debt of the country would increase considerably.

60. Central Asia's economic development was hampered in 2007-2008 by weather-related natural disasters, including the harshest winter in three decades and subsequent spring flooding that destroyed infrastructure and farmland. Increased attention needs to be directed towards governmental and regional strategies for dealing with these natural disasters and their prevention.

B. Institutional developments

61. Improving financial intermediation remains a significant challenge for many of the CIS countries. Capital inflows into CIS have increasingly consisted of private borrowing by banks in international capital markets which are then used to extend credit domestically, but with the tightening of liquidity on global credit markets in the second half of 2007, domestic banking systems are more dependent on domestic deposits. However, there is a reluctance to deposit money in the banking systems as they generally pay negative real interest rates. Due to low financing costs and the limited options for savings, the price of real estate and financial assets have escalated. Generally, there has been an increase in the percentage of deposits and loans denominated in local currency.

62. Foreign exchange reserves of the Russian Federation should exceed $500 billion in early 2008. In February 2008 the Russian Federation split its

(sovereign wealth) Stabilization Fund estimated to be worth $157 billion (about 12 per cent of GDP) into two funds; the Reserve Fund, which is designed to limit the impact of volatility in oil prices, was allocated $125.4 billion, while the intergenerational Wealth Fund was provided with $32 billion. Azerbaijan and Kazakhstan also have stabilization funds.

63. Ukraine signed its World Trade Organization (WTO) accession agreement in February 2008. Negotiations between Ukraine and the European Union on a free trade agreement have also begun. In addition to increasing market access in both directions, the agreement is likely to further liberalize investment flows and align regulatory standards. The Russian Federation's accession to WTO membership is advanced, although a significant problem remains with the European Union over its recently enacted export taxes on raw wood, which it implemented in order to stimulate the development of its forest products industries. Given the Russian Federation's existing free trade agreement with Ukraine, the latter's accession should not introduce any significant problems for the Russian Federation's accession. Trade in the Caucasus remains hampered by long-simmering political conflicts.

64. Intra-CIS trade as a percentage of the total trade of the CIS economies has been on a slightly downward trend over the last decade, while trade with the 27-member European Union has been growing rapidly. The Russian Federation's imports from the European Union tripled between 2000-2006 and exports more than doubled; the Russian Federation is the Union's third largest partner after the United States and China. It provides almost one half of the European Union's natural gas imports and one third of its oil imports.

65. Several of the CIS oil-rich economies, like many developing economies, have been attempting to increase public control or ownership over their energy resources; these had been previously privatized as a way to attract foreign direct investment. This includes Kazakhstan and the Russian Federation, where State ownership of "strategic" industries has been increasing, with the private share of GDP declining to approximately 65 per cent in 2007. There are now 43 sectors of the Russian Federation's economy classified as strategic, including the recently added telecommunications sector; Government permission is required before foreign concerns can obtain a controlling interest in companies in these sectors.

66. In Ukraine, privatizations of large-scale State enterprises (telephone, power distribution, machinery) are proceeding after being on hold for the last two years due to the political stalemate. In 2008 Azerbaijan is planning the sale of the State's share of the largest mobile phone operator and one of the State-owned banks.

67. Only 3 of the 12 CIS economies (Georgia, the Russian Federation and Ukraine) have direct access to the world's shipping lines. Thus the economic problems associated with landlocked economies are central to the long-run development prospects for most of CIS. Empirical research has found that being landlocked reduces an economy's per capita GDP by over 40 per cent. Given this dependence on their neighbours' transportation networks, there is a particularly strong case for a regional approach towards transport infrastructure development. Estimates are that entirely feasible road upgrades in Eastern Europe and Central Asia could increase trade by almost 50 per cent. Problems remain and progress has been disappointing in addressing customs and border crossing issues.