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The economic situation in the Economic Commission for Europe region: Europe, North America and the Commonwealth of Independent States in 2009-2010

Summary

During 2007-2009, the Economic Commission for Europe (ECE) region experienced its worst financial crisis since the Great Depression of the 1930s; the accompanying economic slowdown during 2008-2010 was the worst since the Second World War. Despite the severity of the financial shock, the aggressive use of monetary and fiscal policy, a relatively high level of economic cooperation among the region's Governments, and assistance from international and regional financial institutions allowed the crisis to be contained. Fifteen of the region's economies were forced to turn to the International Monetary Fund for some form of assistance. A slow to moderate recovery is forecast for 2010 but most of the region's economies will not return to their 2008 income levels until 2011 or 2012. However, several of the most affected economies will continue to experience further declines in gross domestic product (GDP) in 2010. Unemployment, which reached 10 per cent in much of the region, may remain above trend through 2014. The fiscal budget and debt situation of the region's advanced economies has deteriorated considerably and in some cases has become problematic.

The ECE region has accounted for over one half of world economic output (on a purchasing power parity basis) for over a century. However, in 2010 its share of world GDP is expected to fall below 50 per cent, owing to the more rapid growth in the developing economies. As recently as 2000, the European Union and North America each accounted for over a quarter of world output and the European emerging economies of Eastern and Southern Europe, the Caucasus, and Central Asia accounted for another 5 per cent. The world share of the European Union and North

* E/2010/100.

America has now declined to just over a fifth each, while that of the European emerging economies has increased to 6 per cent. The share of the region in world output is expected to continue to decline in the coming decade as its growth in population and per capita income are below world averages.

The ECE region, composed of 56 member States, remains quite diverse. Although it contains most of the world's advanced economies, 26 (or almost one half) of its member States have a per capita income below twice the world average, while 12 of these are below the world average and 5 of these are below one half of the world average. Nine of its economies are considered as United Nations landlocked developing countries. Owing to the severity of the economic and financial crisis, a significant number of the Millennium Development Goals in a number of these economies are unlikely to be achieved without a much more focused effort, including a sizable increase in funding.

I. The overall economic situation

1. Of the five United Nations regions as defined by the regional commissions, the Economic Commission for Europe (ECE) region was the most negatively impacted by the financial crisis. Real growth for the region declined from 3.2 per cent in 2007 to 1.2 per cent in 2008 to minus 3.6 per cent in 2009. The current forecast is for growth of 2.3 per cent in 2010 and 2.6 per cent in 2011. However, 11 or about one fifth of the region's economies, are expected to have negative growth again in 2010.

2. Of the three subregions of ECE, the decline in gross domestic product (GDP) growth was the largest in the European emerging economies both in terms of its actual level in 2009, which was minus 6.4 per cent, and in terms of the decline relative to recent historical experience; the growth rate in 2009 was minus 13.7 percentage points less than the five-year average of 2003 to 2007. Western and central Europe (which includes the European Union new member States) had a growth rate of minus 3.9 per cent in 2009, which represented a change of minus 6.5 percentage points from 2003 to 2007. In terms of GDP, North America was the least impacted ECE subregion, with growth of minus 2.4 per cent in 2009 and a decline of minus 5.2 percentage points from the 2003-2007 average. Despite the fact that the emerging economies were the most severely affected subregion, eight of them had positive growth in 2009; Poland was the only remaining ECE economy in the other two subregions (and the only European Union economy) to have positive growth in 2009.

3. Despite the severe economic downturn during the crisis, political and social stability were maintained throughout the region, unlike the situation that developed in the 1930s. This was due importantly to the well-developed social safety nets that have been created in those economies.

4. The economic recovery for the region in 2010 and 2011 is forecast to be moderate owing to the effects unemployment will have on constraining consumer expenditures, the need for Governments to withdraw fiscal stimuli prematurely in some cases because of increasing debt levels, and owing to the fact that the financial systems in these economies remain partially impaired because of their need to recapitalize and deleverage. Growth for the European emerging economies is likely to be stronger as they bounce back from steeper declines; the outlook for these economies is especially sensitive to global economic developments. Considerable uncertainty surrounds the potential impact of an extended series of eruptions of the Eyjafjallajokull volcano.

II. Economic situation in the advanced ECE economies

5. Both the United States of America and Europe experienced a severe financial shock; although it is difficult to quantify the size of this shock for comparative purposes, the United States shock was certainly equal to or greater than that for Western Europe. Nevertheless the economic downturn was smaller in the United States and the recovery has been more rapid. This was due largely to the much more aggressive policy response of the United States both in terms of monetary and fiscal policy. One of the key lessons to come out of the crisis has been to emphasize the importance and effectiveness of discretionary macroeconomic policy. However, there are long-run implications of having a more aggressive macroeconomic policy

in terms of potential inflation and debt repayment difficulties, and only after several more years will it be possible to fully evaluate whether the greater macroeconomic response of the United States was preferable to the more cautious European approach. In addition, some of the difference in the policy stances may have been the result of differences in the structural characteristics of the two regions.

6. Although the Canadian economy largely avoided any financial crisis owing to its better regulatory framework, it nevertheless experienced an economic downturn similar to that in the United States owing to extensive trade and financial linkages with the United States; quarterly growth in the two economies has closely tracked each other for the last several years.

7. Interest rates in the advanced ECE economies remained at or below 1 per cent through most of 2009 and the first half of 2010; in addition, the central banks maintained extraordinary measures (i.e., quantitative easing or some variation of it) to ensure sufficient levels of liquidity. Between mid-2007 and the beginning of 2010, the balance sheet of the United States Federal Reserve increased by more than 150 per cent while that of the European Central Bank increased by 50 per cent. In terms of discretionary fiscal stimulus, the United States implemented a programme equivalent to 6.8 per cent of GDP while the aggregate eurozone package was 2.5 per cent of GDP and the package in the United Kingdom of Great Britain and Northern Ireland was 1.4 per cent of its GDP. However, Europe is estimated to have significantly larger automatic stabilizers. Using the deterioration (from 2007) in the fiscal position as a proxy for the overall fiscal stimulus, the United States and the United Kingdom had a stimulus of 10 per cent of GDP in 2009, while that of the eurozone was 6 per cent.

8. An important factor in limiting the scale of the economic downturn was the extensive use of increased fiscal deficits. Fiscal deficits in a number of the ECE economies are projected to be in double digits in 2010. This includes the United Kingdom (13.5 per cent of GDP), Spain (11.6), the United States (11.1), and Ireland (11.0); the Greek deficit is forecast to be 9.5 per cent of GDP. The timing and composition of the packages varied as some types of spending proved to be more stimulative than others. For example, the United States implemented a massive $787 billion stimulus programme in early 2009, but only 34 per cent of it was actually spent in 2009, while most of the remaining is being spent in 2010; it was composed of infrastructure investment (30 per cent), tax cuts (30 per cent) and transfers to local and state governments and benefit increases (40 per cent).

9. However, as a result, the debt levels increased significantly in most of the advanced economies in the region. By 2014 the major economies will have debt-to-GDP percentages close to 100 per cent. More specifically, the debt-to-GDP ratio is forecast to be 1.29 for Italy, 1.08 for the United States, 0.98 for the UK, 0.96 for France and 0.89 for Germany. The situation has been aggravated by the fact that those economies were running deficits during the boom years prior to the crisis and they face a long-run demographic ageing problem where the provision of pensions and medical care for the retired will negatively affect the budget situation.

10. Although addressing the debt problem will become an important objective of economic policy in those economies in the coming decade, a premature withdrawal of the expansionary fiscal policy before the private sector is able to fully compensate will lengthen the economic downturn and could result in an even worse debt situation. Thus from a policy perspective, what is required is the need for those

economies to design and credibly commit to a long-run plan that addresses the fiscal imbalance but the spending cuts and/or tax increases should not actually be implemented until the economic recovery is complete, which may not occur until the second half of 2011.

11. Poland was the only European Union country to avoid negative growth in 2009. This was due to the fact that it minimized vulnerabilities prior to the crisis by having a flexible exchange rates, limited its current account deficit, controlled credit growth and foreign currency loans. An additional significant factor was its expansionary fiscal policy, which increased the deficit from less than 2 per cent of GDP in 2007 to almost 7 per cent in 2009. However, current projections suggest that it will exceed its legal limit on the size of its public debt by 2014, so some consolidation is likely after 2012.

12. The economic crisis exposed some fundamental weaknesses in the institutional design of the European Union and in particular in the design of the eurozone. At the most general level, economic coordination among its members proved inadequate for crisis management and there appears to be no adequate mechanism to address large current account imbalances within the eurozone. The difficulties faced by the Baltic economies (whose currencies are fixed to the euro) and Greece have revealed significant downsides to being in the eurozone.

13. Global imbalances are considered to be one of the root causes of the economic crisis. The United States current account deficit exceeded 6 per cent of GDP during 2006 but has declined to 3 per cent of GDP at the end of 2009. The uneven recovery, whereby the developing economies, including especially China, have grown much faster in 2009 and 2010 than the United States, has had the desirable effect of keeping global imbalances from returning to their levels prior to the crisis. However, once a global recovery is fully achieved, it is likely that imbalances, and the vulnerabilities they create, will return to undesirable and unsustainable levels if not properly addressed with exchange rate adjustments.

III. Economic situation in European emerging economies

14. Residents and financial institutions in the European emerging economies owned few of the subprime assets at the heart of the global financial crisis; instead their vulnerability resulted from large declines in exports owing to the significant declines in GDP in their major trading partners, a rapid fall-off in remittances, the collapse in the price of commodities, but most importantly from their dependence on external capital markets for financing their economic development. Many of them experienced a classic “sudden stop” once capital markets froze after the bankruptcy of Lehman Brothers. One vulnerability which these economies did not have, that is often associated with a sudden stop of this type, was a fiscal budget deficit; the external borrowing had been largely undertaken by the private financial sector.

15. There was considerable variation in the performance of the European emerging economies; South-East Europe (minus 3.1 per cent) did better than the Commonwealth of Independent States (CIS) (minus 7.0 per cent). Within South-East Europe, Turkey (minus 5.6 per cent) experienced a larger decline than the others (minus 3.1 per cent). Two of the CIS countries, Armenia and Ukraine, experienced double-digit GDP declines in 2009, while the Central Asian CIS economies, especially those with energy resources and limited exposure to foreign capital

markets, did relatively well. In fact three of those economies — Azerbaijan, Uzbekistan and Turkmenistan — had growth over 6 per cent in 2009 and are forecast to be among the fastest growing economies in the world in 2010. The Russian Federation experienced the largest slowdown of any of the Group of Twenty (G20) economies.

16. The crisis was particularly acute in many of the former transition economies (including the new member States) and was greater than that experienced in much of the CIS after the Russian crisis of 1998/99. Nevertheless the GDP declines during the 2009 crisis were only a fraction of the declines suffered by those economies during the 1990s transition recession. Even in Latvia, which has been the hardest hit economy in the region, the economic decline, which is forecast to be about minus 27 per cent of GDP over the period 2007-2010 is only about one half of what it experienced during the 1990s; nevertheless its economic decline has been large as it is roughly similar to the economic decline experienced by the United States during the Great Depression of the 1930s (which was -29 per cent).

17. Unlike emerging markets during typical economic crises, the European emerging economies were generally able to implement quite large macroeconomic stimulus packages, especially fiscal expansions. The ability to use expansionary monetary policy was more constrained because of exchange market considerations. Social spending was generally maintained or even increased while significant funds were committed to rescue the ailing banking sectors.

18. Those economies with large sovereign wealth funds were also able to use these resources to mitigate the impact of the crisis. Azerbaijan, Kazakhstan, and the Russian Federation had funds going into the crisis equal to 23.6, 20.6, and 15.9 per cent of GDP, respectively. However, uncertainty over the length and severity of the crisis resulted in countries being somewhat conservative in their use. Although there was no legal obligation to do so, a reluctance to commit these funds towards supporting the private sector in addressing their external debts further increased uncertainty and further reduced the private sector’s ability to access funds on global capital markets during the crisis.

19. All of the CIS economies are expected to have positive growth in 2010, although the average rate of 3.9 per cent is likely to be significantly below the trend level obtained during the period 2002-2007. The banking sectors remain impaired in several of the larger economies and that will limit investment in the near term. The return of relatively high energy prices is likely to boost growth in the energy-rich economies although currency appreciation in some of them could limit growth and harm diversification efforts; the Russian rouble was at a 14-month high in March 2010. Inflationary concerns may return to some of those economies with the strongest growth, although currency appreciation may limit this to a degree. Growth should increase further in 2011 with a forecast rate of 4.7 per cent. However, further economic diversification and institutional reform will be necessary for restoring robust economic growth in the medium term.

IV. Specific economic trends

A. Employment

20. Because of the global crisis, unemployment rose in most of the ECE economies throughout 2009 but appears to have stabilized in the early part of 2010; in the United States and the European Union, the rate peaked at slightly over 10 per cent. In the first quarter of 2010, the rate remains above 15 per cent in Estonia, Georgia, Latvia, Serbia and Spain and above 30 per cent in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia. The forecast is that the unemployment rates in most of the ECE region will remain above trend for another three to four years.

21. Given the declines in GDP that did occur, the declines in employment were greater than what would be expected in the United States and smaller than expected in Western Europe. Thus, although the decline in GDP was lower in the United States than in the eurozone, unemployment increased more in the former. This was due largely to the differences in labour market flexibility between the subregions. However, some European countries such as Germany, Italy and the Netherlands implemented a number of emergency or short-term labour market policies whose intent was to minimize job losses and a number of those policies proved to be quite successful. For instance, Germany experienced little change in unemployment as the rate in the spring of 2010 was similar to the rate two years earlier.

22. The United States economy lost 8.4 million jobs (or 6.1 per cent of the non-farm payroll) during the current economic downturn, which as a percentage of total employment was the largest of any recession since the Second World War. By the beginning of 2010, over 15 million people were jobless as the unemployment rate increased to just over 10 per cent. This was below the rate in the 1981/82 recession because unemployment had been quite low prior to the beginning of the current crisis. In early 2010, over 11 million people were collecting unemployment benefits. The underemployment rate, which includes discouraged and part-time workers wanting full-time work, peaked at over 17 per cent. The medium duration of unemployment increased from 8.8 weeks in February 2007 to 19.6 weeks in February 2010. The number of workers who were out of work for six months or more, which reached 6.3 million in January 2010, was twice the number previously recorded at any time in the last 50 years.

23. The increase in unemployment in the United States was geographically widespread with all 50 states having higher unemployment in December 2009 than a year earlier. About a fifth of the states had unemployment over 10 per cent in early 2010. Owing largely to the fact that during this downturn, the United States employment declines were much larger than what would be expected given the output declines, the level of productivity increased substantially. In the final quarter of 2009, productivity was 5.8 per cent above the level of a year earlier and as a result unit labour costs were down 4.7 per cent (year over year), which was the largest yearly decline since that statistic began to be calculated in 1948.

24. The annual unemployment rate in the 27-member European Union for 2009 was 8.9 per cent; although rather high, the European Union has had relatively high unemployment for a considerable period of time. For example, the European Union annual unemployment rate was at or above 8.9 per cent between 2002 and 2005. The

rate for males (9.0 per cent) was slightly above that for females (8.8 per cent). However, the employment losses in much of Europe were primarily for men; for example, in Germany 220,000 of the 230,000 jobs lost during the crisis through 2009 were men's jobs. Unemployment in Europe continued to increase in the early part of 2010. In February 2010, unemployment was 9.6 per cent in the 27-member European Union (over 23 million workers) and 10.0 per cent in the eurozone, the latter being the highest rate since August of 1998. The unemployment rate for youth in the 27-member European Union was over 20 per cent in early 2010. Total employment fell 1.9 per cent in the 15-member European Union during 2009.

25. There was significant variation in unemployment in Western Europe (including the new member States), with a 2009 annual rate above 15 per cent in Spain (18 per cent) and Latvia (17.1 per cent) and rates below 5 per cent in the Netherlands (3.4 per cent) and Norway (3.1 per cent). Unemployment was higher in every European Union member State in February 2010 compared with February 2009.

26. Unemployment rates increased in most CIS countries (including in Georgia). Armenia, the Republic of Moldova and Ukraine witnessed a significant deterioration in labour-market indicators. Moreover, the return of migrant workers who had lost jobs in the Russian Federation further increased unemployment, especially in the low-income CIS countries. In early 2010, unemployment in the Russian Federation reached 8.6 per cent and in Kazakhstan, the unemployment rate was 6.5 per cent; the annual unemployment rate for Ukraine was 8.8 per cent in 2009.

B. Inflation

27. Because of the economic slowdown, inflation has been subdued throughout the region, but by early 2010 it began to increase in a number of economies. Inflation in the advanced economies was considerably below their central banks' general targets of about 2 per cent in 2009. In 2010, inflation should be closer to the target in these economies but may still be marginally below it in the eurozone. Latvia is expected to experience deflation of several per cent during 2010 and that may also happen in some of the highly indebted eurozone economies such as Greece. Inflation has been higher in the European emerging economies, especially in the CIS, where it was about 9 per cent in 2009 and is expected to be about 7 per cent in 2010. Ukraine has had and is expected to continue to have inflation in the low double digits; households in the energy importers are facing higher utility bills as fuel prices become more market-based. In February, inflation reached a double-digit rate of 10.1 per cent in Turkey due to a steep increase in the food index.

28. Monetary growth has been quite low for the advanced economies of the region throughout 2009. In early 2010, the broad money supply in the eurozone was slightly below its level a year earlier while the increases in the United States and the United Kingdom over the same period are below 5 per cent. As a result, anticipated inflation remains low. A potential downside risk concerns the possibility that the higher growth in Asia could cause the commodity price boom of 2007-2008 to return, which might pressure central banks to tighten monetary policy before solid growth is achieved.

C. Trade

29. A key vulnerability for many of the European emerging economies prior to the crisis was their large current account deficits. The current account deficit was over 10 per cent of GDP for several groupings, including the new member States, South-East Europe (except for Turkey), and the resource-poor CIS in 2008. At the same time, the resource-rich CIS had a current account surplus of almost 15 per cent of GDP. Although the deficits narrowed in 2009 and 2010, especially in the new member States, the deficits remain problematic in much of South-East Europe and the resource-poor CIS.

30. Trade flows declined dramatically throughout the region between the autumn of 2008 and the spring of 2009 owing to the decline in national incomes and to the absence of trade finance. Trade protectionism, which characterized the 1930s crisis, was largely avoided, although attempts by countries to capture the effects of their own fiscal expansions and industry subsidies proved controversial. Global governance of trade, primarily through the disciplines of the World Trade Organization (WTO) proved to be quite successful in containing most forms of protectionism. Within the European Union, restrictions on State aid were severely tested but appear to have worked reasonably well. There were significant exchange-rate movements and generally those that depreciated experienced a smaller reduction in exports. Although a few countries actively used policies to depreciate their currencies, they largely avoided being labelled as protectionist.

31. Trade for the ECE economies, as for much of the world, declined significantly during the crisis especially in the first half of 2009. In 2009, exports of the 27-member European Union declined by 16 per cent, while imports declined by 23 per cent over 2008 levels. There was significant variance with exports from Finland, down by 32 per cent while those of Ireland were down by only 4 per cent. Over a fourth of the European Union had imports that declined by more than 30 per cent in 2009 over 2008 levels. Extra-European Union exports were up 8 per cent in January 2010 from a year before.

32. United States exports of goods and services declined 15 per cent in 2009 over 2008, while imports declined 23 per cent. January 2010 exports were up 15 per cent from a year earlier, while imports were up 12 per cent. Canadian merchandise exports were down 27 per cent in 2009 over 2008, while imports declined 16 per cent. Canadian merchandise exports were up 3 per cent in January from the year before, while imports were down 4 per cent.

33. In January 2010, exports of the CIS countries (and Georgia) were 45 per cent above their level of one year earlier, while imports were 11 per cent higher. Russian exports and imports had declined by approximately 50 per cent between the first half of 2008 and the first half of 2009. CIS countries have succeeded to some degree in diversifying their trade geographically. For none of the CIS countries do a majority of their exports go to the other CIS economies, but several of the CIS countries get more than one half of their imports from the rest of the CIS.

34. Most of the major economies that remain outside WTO are European emerging economies. The failure to obtain WTO accession for the 10 former transition economies has hindered their ability to diversify their exports into higher-value manufacturing and create more dynamic economies. Although the new member States and to some degree South-East Europe have been successful in promoting

regional economic integration, the CIS economies have encountered more problems. Progress in creating a customs union by the members of the Eurasian Economic Community has been limited.

35. The Russian Federation, Belarus and Kazakhstan have continued to advance their aim of establishing a customs union. This will likely require significant tariff reductions by the Russian Federation, which had higher tariffs than the other two countries. The creation of a customs union involves a number of complex institutional adjustments since each of these economies has a significant number of bilateral trade agreements which will need to be harmonized and each is still in the process of acceding to WTO.

D. Capital and remittance flows

36. During the period 2000-2008, the European emerging economies were receiving very large net capital inflows and those were quite significant in contributing to the strong growth of that period. Those external inflows allowed these economies to achieve investment rates much higher than would have been possible otherwise. Net inflows of capital to these economies, which had reached over 8 per cent of GDP prior to the crisis, were over twice the percentage level for other developing areas, including even fast-growing Asia. In 2006 and 2007, the CIS also had capital inflows greater than in any other major developing world region. However, this reliance on external capital proved to be the most important underlying factor that caused the region to experience the economic crisis of 2007-2010 to a greater degree than any other region of the world economy.

37. During the crisis, net capital inflows into emerging Europe (including the new member States) fell from almost 8 per cent of GDP in the years prior to the crisis to near zero in 2009. Portfolio debt and equity and bank loans proved to be particularly volatile with net inflows of over minus 4 per cent of GDP in 2009. Even countries such as the Russian Federation that were net capital exporters had their private financial sectors lose access to global capital markets and this proved to be highly disruptive. Foreign direct investment was more stable but still declined to about half of its pre-crisis level; foreign direct investment had been over $100 billion during 2007 and 2008, but declined to only about $50 billion in 2009. Although official flows were quite important in providing temporary and emergency financing, they were able to counteract only a small share of the decline in private inflows. Medium-term forecasts for capital inflows over the next several years are that inflows will be only about half of the pre-crisis level. Thus the basic development model of the region that had relied on external capital to finance a large share of development is no longer a viable model.

38. Many of the European emerging economies are heavily dependent on remittances. Remittances have been greater than 10 per cent of GDP in many of these economies; Tajikistan and the Republic of Moldova have had remittances in some years greater than 30 per cent of GDP, which is the largest of any countries in the world. For many of these economies, remittances are greater than foreign direct investment inflows and official development assistance (ODA) combined. In the CIS, 31 million people have emigrated to work in another country; in nine of the CIS countries, more than 10 per cent of the population has emigrated. Due to the economic crisis, remittances have fallen quite significantly in the range of about

30 per cent. The Russian Federation has been a major host country for many of the workers in the region and in the first half of 2009, remittances outflows fell by 31 per cent. Given the strong growth prior to the crisis, this represented a decline of 39 per cent from trend. The fall in remittance inflows has been a significant factor in increasing poverty in the Caucasus and Central Asia.

E. The financial sector

39. As the crisis developed into 2009, it was necessary for the Governments of many of the region's economies to continue to provide financial support or guarantees for their banking sectors. In the United States, 140 banks (out of approximately 8,000) failed during 2009, which was up from the 25 in 2008 (the bankruptcy of Lehman Brothers in September 2008 was the largest in United States history). The forecast is for an even greater number of banks to fail in 2010. The Canadian financial system escaped from the global financial crisis relatively well; their banks had avoided making extensive subprime-type loans and had faced stricter regulations regarding leverage and securitization.

40. A significant difference between the 2007-2010 financial crisis and that of the 1930s or the more limited crises such as the Russian debt crisis of 1998/99 was that the region's Governments provided large-scale guarantees for their bank sector deposits, and although a number of banks failed, depositors were generally protected. In addition, the central banks in the advanced economies provided quite cheap financing, often at close to a zero interest rate, as a means of maintaining liquidity and improving the solvency of their financial system.

41. In the spring of 2010, the financial sectors in the advanced economies remain partially impaired. Loan growth has been low but it is unclear if this is due primarily to a lack of demand for loans owing to the economic downturn or due to the unwillingness of banks to supply credit as they attempt to deleverage. The solvency of many medium-sized banks in the United States is still to be tested as they hold the bulk of commercial real estate loans, and estimates suggest that almost one half of those banks are underwater. In Ireland, the Government has had to assume control of most of its large banks.

42. Iceland experienced a severe financial crisis as its major banks collapsed. As many of the depositors in its banks were foreigners, the question of who is responsible for compensating depositors revealed the current inadequacy of European Union cross-border financial regulations. As of the spring of 2010, there was yet to be an agreement on how the costs of compensating depositors would be distributed, as 93 per cent of voters rejected an initial proposal that its Government had made. The Icelandic authorities had poorly regulated its banking sector and had allowed it to grow excessively large; its banks had assets over 10 times the GDP of the country, which was multiple times what is viewed as prudential. The banks engaged in a number of questionable practices such as making excessive loans to its owners and related-party clients.

43. The banking systems remain impaired in the CIS and credit growth has been weak. State assistance was needed for a number of banks in the larger CIS economies, especially the Russian Federation and Kazakhstan (two of its four largest banks defaulted), where a number of banks failed. The bank losses revealed a number of poor governance issues such as a tendency to have made excessive loans

to related-party clients. Despite the financial problems, depositors were largely protected from losses. Non-performing loans have increased in most of the CIS economies, and in some cases such as Ukraine and Kazakhstan are reaching levels that may become problematic. Nominal interest rates remain considerably higher in the European emerging economies relative to the advanced economies; for example, the main Russian central bank rate only declined to 8.5 per cent in 2010 after 12 rate cuts over the previous year.

44. There was considerable concern about how the high level of foreign bank presence in many of the new member States and the European emerging economies would affect their stability during the crisis. However, foreign ownership generally proved to be a stabilizing force as none pulled out of the region entirely and the only one that failed was Parex Bank in Latvia.

45. Financial sector reform to avoid a repeat of the 2007-2009 crisis is proceeding in the region on many fronts and at different speeds, depending on the issue. However, concerns about regulatory arbitrage have limited the scope for national action and have tended to weaken reforms as countries have proven to be quite sensitive about lowering the international competitiveness of their financial industries. The process has emphasized the importance and necessity of intergovernmental cooperation in setting a consistent, if not harmonized, set of regulations. The likely establishment of a European Systemic Risk Board and a European System of Financial Supervisors should improve the oversight of European financial markets and thereby increase their stability. Progress in addressing the issue of how to resolve failing systemically important cross-border banks has been more limited; the Financial Stability Board is expected to provide a set of guidelines. There has been less consensus on how to address the problems of “too big to fail” institutions and pre-emptively limiting global systemic risks.

F. Housing markets

46. The immediate cause of the financial crisis was the collapse in the value of United States mortgage-backed securities after United States house prices began to fall; the future evolution of United States house prices still has important implications for the resolution of this crisis. By the spring of 2010, United States house prices have declined approximately 30 per cent from their peak in 2006, although they appeared to have stabilized in 2009. However, the elimination of the tax credit for first-time home buyers at the end of April 2010, a continuing high level of foreclosures, and a large stock of unsold houses, and high unemployment suggest that sales and prices may stay weak for some time. United States new home sales fell in February 2010 to an annual rate of 308,000, which was the lowest since records began in 1963; this was down 78 per cent from the peak in July 2005. The inventory of new homes reached 9.2 months at current sales rates, which was about 50 per cent greater than average. Throughout 2008 and 2009, the percentage of mortgage delinquencies continued to increase, reaching almost 10 per cent by the end of 2009; even prime loans had delinquency rates approaching 7 per cent. About 2.8 million homes were foreclosed in 2009 and the forecast is that foreclosures could reach 3 million in 2010. In the spring of 2010, approximately 12 million mortgages, or about a quarter of mortgages, were underwater.

47. Overall European house prices appreciated even more than those in the United States in the decade prior to the crisis but have declined far less since the crisis began. However, in a few of the worse-hit economies, including Ireland, Latvia, and Spain, house prices have declined significantly and this has contributed to the reduced solvency of their domestic banks. In some European economies, even ones that have experienced significant economic downturns such as the United Kingdom, house prices have remained firm; in the United Kingdom, prices in March 2010 were 9.0 per cent higher than the year before. The possibility that European house prices may still be overvalued remains and this poses a downside risk for Europe's economic recovery. Owing to the recent change in ownership structure and limited historical data, it is more difficult to access house price levels in the European emerging economies.

G. Emerging debt problems

48. Current debt levels and projected future levels increased substantially in Western Europe owing to the crisis-induced fiscal expansions, which have come on top of debt resulting from longer run demographic developments. In 2009, 13 of the 27 members of the European Union had a debt level greater than the Maastricht limit of 60 per cent of GDP; this includes the four largest economies — Germany, France, the United Kingdom and Italy. The only new member State to do so was Hungary. In 2009, only 5 of the 27 European Union members had a budget deficit below the Maastricht limit of 3 per cent of GDP; 4 had deficits above 10 per cent, including Greece (13.5 per cent of GDP), Ireland (12.5), the United Kingdom (12.1) and Spain (11.2). The eurozone is projected to have a general government fiscal deficit of 7 per cent of GDP in 2010.

49. Concerns about the sustainability of Government deficits in Greece (and to a lesser degree in Portugal and Spain) created a minor sovereign debt crisis. Greek yields on 10-year bonds rose to 7.5 per cent in early 2010, with a spread of 4 per cent over equivalent German bonds; this was the largest spread since 1998, which was before Greece joined the eurozone. Currently Greek debt to GDP is approximately 114 per cent, with a forecast that this will be over 150 per cent by 2012. At current interest rates, the interest cost just to service that debt would amount to 9 per cent of GDP. Approximately 80 per cent of Greek debt is foreign owned. The interest spread was also over 3 per cent in Hungary and over 2 per cent in Poland; it was approximately 1.5 per cent for Portugal and Ireland.

50. Ireland, the United Kingdom and the United States also have similar deficit levels (about 12 per cent in 2009), although somewhat lower debt (about 80 per cent of GDP), but the interest spread on their sovereign debt has remained stable. This is due to varying factors; for the United Kingdom and the United States the central banks or Government agencies purchased much of their Government debt, their central banks can print the currency in which the debt is denominated, and their default risks are viewed to be much lower. However, private debt levels in the United Kingdom are extremely high and, as a result, the United Kingdom total public and private sector debt has reached 380 per cent of GDP, which is the second highest in the world after Japan.

51. The implied probability of a default by Greece over the next five years based upon the price of its credit default swaps reached over 25 per cent in the spring of

2010. A default by Greece would have serious ramifications not only for Europe but for the world economy. A Greek default would be the largest sovereign default since the Second World War. By comparison, Greek debt is now approximately $375 billion, while Argentina defaulted on only $100 billion in 2001 and the Russian Federation defaulted on $70 billion in 1998. A default by Greece would likely create sovereign debt problems for several other economies such as Spain and Portugal. Forecasting models estimate that a default by Greece would lower the growth rate of the entire eurozone by 1 percentage point for the next three years and lower world growth by one half a percentage point for the next three years. The European emerging economies, which are especially dependent on capital inflows, would be particularly negatively impacted by a Greek default.

52. It is widely recognized that a default by Greece would represent a serious European policy failure. The European Union and the International Monetary Fund (IMF) agreed on a joint assistance programme; the European Union Governments agreed to provide up to €30 billion in bilateral loans at below market interest rates, with the expectation that IMF would provide another €15 billion; however, even that sum may prove to be inadequate given the potential needs. The potential for a crisis was also partially diminished when the European Central Bank reversed its decision on reverting to its pre-crisis minimum credit rating for acceptable collateral; without that change, Greek bank liquidity and solvency would have been further reduced.

53. Although ensuring continuing financing for heavily indebted Governments such as Greece is the most immediate concern, the longer-run adjustments in terms of budget retrenchment and real exchange rate depreciation that will be needed in these economies are substantial. For example, Greece has already increased national sales and excise taxes, cut public sector bonuses and frozen pensions. Greece proposes to reduce its fiscal deficit from over 13 per cent of GDP in 2009 to 3 per cent by 2012, and it is estimated that a price deflation of 20 per cent will be required to adjust its real exchange rate. As a result, these high-debt economies face significant spending cuts, higher taxes and most likely wage and price deflation for years. Even if these adjustments can be made, which is somewhat problematic, economic growth in these economies is likely to be low or below trend for an extended period of time.

V. Multilateral crisis support

54. Fifteen of the ECE economies turned to IMF for varying degrees of assistance during the recent crisis. This included several countries in each of the subregions; it included two of the advanced economies, four of the new member States, seven in the CIS and two in South-East Europe. Generally the packages were on the order of 5 to 10 per cent of GDP of the recipient economy, but some countries such as Poland only requested a contingent Flexible Credit Line, which it did not need to access. Tajikistan obtained IMF resources through a three-year Poverty Reduction and Growth Facility, and Kyrgyzstan was given access to the Exogenous Shocks Facility. Overall, IMF has provided over $80 billion in support for the European economies (not including Greece). There was significant cooperation between IMF and the European Union in designing and funding programmes for the European Union members. The decision by the G20 to quadruple the resources of IMF in the spring of 2009 was a critical turning point in the evolution of this crisis and helped to stabilize the region at an especially critical moment.

55. The conditionality that IMF required during this crisis was considerably less stringent than what has been required during previous crises. Generally the recipient countries were given a greater degree of flexibility in maintaining some macroeconomic stimulus than had normally been the case and their programmes were often adjusted as the global economic situation deteriorated. However, IMF programmes in some economies such as Ukraine had to be put on hold after failing to meet fiscal retrenchment targets. Turkey was unwilling to accept IMF conditions on its fiscal policy and withdrew from negotiations for a standby loan.

56. The financial sector in the new member States and the European emerging economies benefited considerably from the support of the European Bank for Reconstruction and Development (EBRD) and the World Bank. Overall, EBRD increased its investments by 55 per cent in 2009 to $10.7 billion; this higher level of activity is expected to persist through 2010. The European Investment Bank also provided significant loans for specific projects, especially in the new member States.

VI. Achieving the Millennium Development Goals

57. The Millennium Development Goals remain quite relevant for the region; a significant share of the populations of many of the emerging economies are living in poverty and have inadequate access to health resources, whether it is for maternal or child care or access to treatment for tuberculosis or HIV/AIDS. Although there is still room for significant improvement, the European emerging economies have established relatively good educational systems and have come close to achieving gender equality in them. However, the broader gender issues regarding the workplace and political systems, along with a number of environmental challenges, are a concern for all of the economies in the region, including the most advanced. The advanced economies also have committed to help the developing world to achieve their targets through making the world economic system more development-friendly.

58. Many developing countries do not have the domestic resources that are required for achieving their Millennium Development Goals objectives. The advanced economies that are able to provide this needed financial assistance are primarily located in the ECE region, as those economies provide almost 90 per cent of total ODA provided by the Development Assistance Committee countries. Although the European economies provide a higher percentage of their GDP towards ODA than the other advanced or donor countries, many of them will not meet their 2010 targets. The European Union, which had committed to raise its ODA from 0.35 per cent to 0.59 per cent, will provide only 0.48 per cent in 2010. The United States will meet its 2010 target, although it is lower than the European Union target.

59. The degree to which the indicators incorporated into the Millennium Development Goals have improved or declined over the period 1990-2009 is closely related to the overall economic performance of the particular country during that period. The depth and length of the transitional recession varied quite significantly. Two decades after the transition period began, some of these economies (the energy-rich Central Asian CIS, the central European new member States, and Albania) have increased their national incomes approximately 50 per cent above their 1989 levels,

but many (European CIS, the former States of Yugoslavia in South-East Europe, and the Baltics) have only returned to something similar to the 1989 level, while a few economies (Georgia, the Republic of Moldova, Serbia, Tajikistan, and Ukraine) remain 30 per cent or more below the earlier level. Turkey, which did not have to go through the transition process but still had a severe currency crisis in 1999, has more than doubled its real GDP over this period.

60. The economic crisis has impacted the various Millennium Development Goal indicators through a large number of different channels. The most direct channel has been the effect of increased unemployment on increasing poverty. Much of the progress in poverty reduction made between 2000 and 2008 has been reversed during the economic crisis. Projections suggest that the number of people living in poverty in the region may increase by 50 million between 2008 and 2011. Already, the number of Russians living in poverty has increased from 18.5 million at the end of 2008 to 24.5 million (or 30 per cent) during the first three months of 2009. The increase in unemployment and the fall in wage incomes have reduced the quantity and quality of diets, which has increased hunger and health outcomes, including specifically maternal health, child mortality and the susceptibility towards diseases such as tuberculosis. The increase in poverty is likely to increase risky behaviours such as drug use and prostitution associated with HIV transmission. Lower family incomes in the poorest regions of ECE may result in lower school attendance, as parents cannot afford to send their children to school or may need them to drop out of school in order to work. The deterioration in Government fiscal positions is likely to reduce the provision of social services and lead to cut backs in programmes that address environmental and public health objectives.

61. Given that GDP income levels in many of the European emerging economies may not return to 2008 levels until 2012 and given the high correlation between progress in achieving the Millennium Development Goals and national income growth, the economic crisis is likely to set back progress by four years for a large number of the targets. In other words, many of the Millennium Development Goal indicators in 2015 are likely to be at the levels they would have been in 2011 if the crisis had not occurred.

62. The most important factor that will determine the degree to which the region is able to achieve the Millennium Development Goals by 2015 will be the region’s growth rate over the next five years. A return to the vigorous growth of the period 2000-2007 would be a quite important development; that remains problematic, however, given the damage caused by the current economic slowdown to the region’s financial systems and Government fiscal positions. Nevertheless within the constraints of national income there are a vast number of policy improvements that could be implemented which could speed up progress on a number of fronts.

VII. Other major regional developments

63. The United States enacted a major reform of its health-care system in the spring of 2010, although most of the provisions of the reform will not be implemented until 2014. The United States had been spending considerably more on health care than other advanced economies, with no significant improvement in health outcomes; approximately 30 million additional people who had been without health insurance will be covered once the programme becomes operational. The

legislation opens up channels that may allow government-paid health expenditures in the long run to be better contained, which may improve long-run fiscal sustainability.

64. The need for policy reforms to increase the longer-run dynamism and competitiveness of the European economies remains. Most of the objectives set for 2010 in the Lisbon Strategy were not achieved. It is to be replaced by the new Europe 2020 strategy for jobs and growth. It focuses on many of the same objectives such as increasing the employment rate and research and development, improving education, and addressing poverty and climate change.

65. European regional integration continues to increase through both widening and deepening. Estonia appears on track to satisfy the Maastricht criteria for euro accession in 2011 as it, unlike most of the European Union economies, has been able to keep its fiscal deficit below 3 per cent of GDP. Bulgaria is likely to enter the European Union exchange rate mechanism II in the summer of 2010, with a target of joining the eurozone by 2013. Poland has set a target date of 2015 for entry into the eurozone. The fact that several of the new member States had to turn to IMF for external financing may ultimately delay their eventual accession date even if they meet the Maastricht criteria. Agreement to use international arbitration for resolving a border dispute between Slovenia and Croatia has removed the last remaining major obstacle in Croatia's accession process to the European Union and membership is probable by 2012. The remaining countries in South-East Europe either are candidate countries or have Stabilization and Association Agreements. Wider European cooperation and integration is occurring under the institutional framework of the European Union Neighbourhood Policy for the European CIS (excluding the Russian Federation) and the Caucasus.

66. Twelve of the European emerging economies are landlocked, and improving the physical regional transport infrastructure and border and customs procedures remain important objectives for further integrating those economies into the world economy. Recently, significant progress has been made in the development of gas and oil pipelines from those economies to Western Europe and East Asia. The pipelines not only provide additional financial resources for the exporting countries but are important in providing importers greater diversification of suppliers or transport routes, which is able to increase their energy security.