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# Economic situation in the Economic Commission for Europe region: Europe, North America and the Commonwealth of Independent States in 2012-2013

*Summary*

Economic growth in most of the Economic Commission for Europe (ECE) region remained subdued in 2012 and the first half of 2013; it has been low by both historical standards and by global comparisons. Growth has been strongest in the Commonwealth of Independent States (CIS), and although they sustained severe downturns in 2009, they have experienced reasonable growth over the past three years and now have gross domestic products (GDPs) considerably above their pre-2008 crisis peaks. Growth has been more moderate in North America, and although GDP is above pre-crisis peaks, unemployment remains quite elevated and is likely to remain so for several more years. The economic situation in Europe continues to deteriorate; a number of these economies currently have real GDPs below those achieved prior to the crisis and several are in a depression. Unemployment is high and rising throughout much of Europe, reaching historically high levels in the eurozone and remaining at quite high levels throughout South-East Europe. Although the debt-to-GDP ratio continues to rise in many European economies, financial markets have stabilized and the threat of a dissolution of the eurozone has diminished owing largely to new policy initiatives from the European Central Bank.

The experience of the ECE advanced economies over the past three years has provided or reconfirmed a number of important economic lessons for future policymaking. Their modest recovery clearly demonstrates the well-established macroeconomic principle that austerity in a depressed economy is largely self-defeating. Once monetary policy nears the zero interest rate bound, fiscal multipliers become quite high, and fiscal consolidation thus has a significant and detrimental

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impact on economic growth and employment. Austerity thereby further reduces tax revenues and increases government spending on automatic stabilizers, and although there may be some small net improvement in the current fiscal deficit, that improvement comes at a very high cost in terms of social welfare, employment and growth and, in most cases, the debt-to-GDP ratios continue to rise.

# I. Economic Commission for Europe region in global perspective

1. For analytical purposes, the 56 members of the Economic Commission for Europe (ECE) region, which has a population of over 1.2 billion, are divided into three major subregions: (a) North America with a population of 346 million, composed of Canada and the United States of America; (b) the European advanced economies, with a population of 525 million, composed of 35 economies, including the European Union, the European Free Trade Association, Israel and four European micro-States, with fewer than 100,000 people; and (c) the European emerging economies, with a population of 376 million, composed of 19 economies in East and South-East Europe, the Caucasus and Central Asia. The latter includes all the economies in transition as well as Turkey. The term “advanced ECE economies” refers to North America and the European advanced economies.

2. The ECE region remains quite diverse. Although it contains most of the world’s advanced economies, 27 (or one half) of its member States have a per capita income below twice the world average; 14 of these are below the world average and 6 are below one half the world average. Currently, the average per capita income of the economies in transition is approximately equal to the average for the world economy. Nine of its economies are considered United Nations landlocked developing countries.

3. The ECE region accounted for over one half of world economic output (on a purchasing power parity basis) for over a century but in 2009, its share fell below 50 per cent owing to the more rapid growth in the developing economies. A decade ago, the European advanced economies and North America each accounted for over a quarter of world output and the European emerging economies accounted for another 5 per cent. The world shares of the European advanced economies and North America have now declined to a fifth each while that of the European emerging economies has increased to 6 per cent. The share of the ECE region in world output is expected to continue to decline by about half a percentage point each year in the coming decade since its growth in population and per capita income are both below world averages.

4. In 2011, the ECE economies accounted for 55.0 per cent of world exports; 73.4 per cent of those exports (or 40.4 per cent of world exports) went to another ECE economy. In addition, 33.1 per cent of exports from non-ECE countries (or 14.9 per cent of world exports) went to an ECE economy. Thus, 69.9 per cent of 2011 world exports had an ECE economy as either the source or destination. Almost 77.6 per cent of exports from European advanced economies, 70.5 per cent of exports from European emerging economies and 51.8 per cent of North America exports went to another ECE economy. The economies in transition, which became partially segmented from the rest of the global economy in the decades after the Second World War and since 1990 have encountered problems in obtaining normal tariff treatment owing to slow progress in obtaining World Trade Organization (WTO) accession, accounted for 4.7 per cent of world exports in 2011.

5. The ECE economies are a major global source of outward foreign direct investment (FDI); in 2011, their FDI outflows increased by almost 20 per cent, accounting for almost $1.18 trillion in FDI outflows or over 69 per cent of the world’s total FDI outflows. Despite the increase in 2011, ECE FDI outflows were

still only about two thirds of their level in 2007 before the financial crisis; by comparison, FDI outflows from non-ECE economies increased by almost 27 per cent between 2007 and 2011. Of the world's top 20 sources of FDI, 14 are ECE economies; the United States is the largest source of FDI in the world.

6. The ECE economies were the destination for almost $813 billion in FDI inflows in 2011; this represented over 53 per cent of world FDI inflows. However, ECE FDI inflows in 2011 were still down by almost 40 per cent compared with 2007; by comparison, non-ECE inflows increased by 14 per cent between 2007 and 2011. Of the world's top 15 destinations for FDI, 9 are ECE economies; the United States is the largest recipient of FDI inflows in the world. Overall, the ECE region is a net investor (namely, outflows exceed inflows) of FDI and in 2011, it supplied approximately $364 billion in net FDI to the rest of the world. However, the European emerging economies are a net recipient of FDI (namely, inflows exceed outflows) and in 2011, had net inflows of over $32 billion. Nevertheless, the Russian Federation, the European emerging economies' largest source and destination for FDI, is increasingly coming to resemble an advanced economy in that its FDI outflows were $14.4 billion greater than its inflows in 2011. The inward stock of FDI in the European emerging economies has increased by over 1,000 per cent since 2000.

7. Average life expectancy (based upon the period 2005-2010) at birth in many of the ECE economies is considerably above the world average of 65.7 years for men and 70.1 years for women. In Canada, it is 78.2 for men and 82.8 for women, for the European Union 76.1 and 82.1, for the United States 75.4 and 80.5, and for Turkey 70.7 and 75.3. In the Russian Federation, life expectancy for men (61.6) is significantly below the world average, while for women (74.0), it is significantly above the world average.

## II. Long-term perspective for the region

8. In the first two decades after the Second World War, the countries of Western Europe and the Soviet Union grew faster than the United States; thus, there was some convergence in the per capita incomes of these regions. By the early 1970s, Western Europe had a per capita income of approximately 70 per cent of that of the United States, while the Soviet Union had a per capita income of about 35 per cent of that of the United States or one half that of Western Europe. Since 1972, there has been no further convergence between Western Europe and the United States, while the average income of the States of the former Soviet Union has declined to only a fourth of that of the United States and a third of that of Western Europe. Therefore, in the past 40 years, there has been no convergence, but in fact some additional divergence, in the living standards of the three major geographical subregions of the ECE region.

9. The difference in per capita incomes between the United States and Western Europe is owing, in large part, to differences in hours worked. Europeans generally work fewer years (starting later and retiring earlier), take longer vacations, and work shorter days. The United States advantage in productivity per hour worked is much smaller than the income differential. However, the convergence in productivity levels that occurred during the 1960-1995 period ceased and has actually reversed

since 1995 owing to the more intensive use of information technology in the United States.

10. Western Europe has had a high unemployment problem for three decades. The average unemployment rate in France, Germany, Italy, and the United Kingdom of Great Britain and Northern Ireland averaged 3.5 per cent in the 1970s but more than doubled in the 1980s to 7.6 per cent, 8.9 per cent in the 1990s, and 7.7 per cent in the first decade of the twenty-first century. In the United States, the overall trend in unemployment has been more stable in the last four decades; however, in the past 50 years, the unemployment rate for African Americans has generally been above 10 per cent, almost double that of whites.

11. The very long-term growth in real income per capita has been remarkably similar in the United States and Western Europe and has been stable over time. During the 1970-2010 period, real GDP per capita increased at an average annual rate of 1.8 per cent in the United States and Germany, 1.9 per cent in the United Kingdom and 1.7 per cent in France. These growth rates are also quite similar to the even longer-term rates in the 1870-2010 period when they increased by 1.9 per cent annually in the United States and 1.7 per cent in Germany and France.

12. Ageing of the population is a characteristic of most of the ECE economies except those in Central Asia. The percentage of the population in the ECE region that is 65 years or older is projected to increase from 14 per cent today to 23 per cent in 2050. Already, older workers account for an increasing proportion of the workforce in many ECE economies; for example, the percentage of United States workers 55 or older has increased from 17.5 per cent in 2006 to 21.5 per cent in 2012. The working age (20-64) population of the European Union peaked at 308.2 million in 2012 and will begin to slowly decline in the next half century, while the number of older people will continue to increase. As a result, the dependency ratio (a ratio of the two) will double over this period and is forecast to reach 58 per cent by 2060. Although the ageing process is less advanced in the European emerging economies than in the European advanced economies, the old-age dependency ratios in many of the European emerging economies are projected to double or even triple between 2010 and 2050. The adverse impact of ageing on effective labour supply is expected to be particularly strong in the non-Central Asian European emerging economies. Owing to ageing, numerous changes in the design of pension systems are likely, including raising the retirement age and increasing pension contribution rates.

## III. Economic and financial crisis

13. A major lesson from the financial crisis is that the financial credit cycle, if not mitigated by robust countercyclical monetary policy, will create a boom-bust cycle that will have significant and detrimental impacts. Relying solely on inflation rates to steer monetary policy is a poor guide for creating economic stability. A number of policy reforms steering the monetary authorities towards more emphasis on systemic macro-prudential risks have been implemented in the region.

14. After the financial crisis of 2008-2009, a report was commissioned in each of the major financial areas (Eurozone: Report of the European Commission’s High-level Expert Group on Bank Structural Reform; United Kingdom: Independent Commission on Banking: The Vickers Report; United States: Dodd-Frank Wall

Street Reform and Consumer Protection Report) as to how to make their financial systems more robust and less likely to need public sector bailouts. Numerous recommendations in these reports have been or likely will be implemented; however, overall, the recommendations were generally watered down as the legislation moved through the political process and, as a result, the reform of these financial sectors may ultimately prove to be insufficient for avoiding future crises. An important political justification for weakening this legislation was to keep the financial industry internationally competitive; this dynamic reveals the need for greater intergovernmental cooperation in setting financial standards.

15. The financial systems in the ECE advanced economies have been made moderately more stable in the past several years by increasing their capital base, upgrading the quality of their assets, and altering their compensation and management structures to reduce the incentive to engage in overly risky endeavours. One important financial vulnerability revealed by the 2008-2009 financial crisis was the problem of “too big to fail” financial institutions; however, little has been achieved in addressing this vulnerability as the concentration of the banking sector is greater today than in 2007.

16. In the aftermath of the financial crisis and the 2010-2013 eurozone crisis, the European financial system has become less integrated and more balkanized and the financial health of European banks has deteriorated. Intra-European financial flows have declined as Northern European banks have reduced their presence in Southern Europe and Western European banks have reduced their presence in Central and Eastern Europe. Net banking flows to the European emerging economies and the new European Union member States, which had been relatively large prior to 2008, have been negative each quarter since the beginning of 2009. The declines would have been even larger if not for the 2009 Vienna Initiative and the 2012 Vienna 2.0 Initiative, which provided assistance from international financial institutions conditional upon commitments from the banks not to undertake large-scale withdrawals from the region. Although foreign banks with European Union parents have been exiting from some countries (namely, Ukraine), those with Russian parents have been increasing their presence.

17. The 2008-2009 financial crisis raised policy concerns about the global shadow banking system and the risks it posed to the stability of the world economy. The shadow banking industry includes a host of financial intermediaries, including money market funds, investment banks, insurance companies and hedge funds. The shadow banking system in the ECE economies holds assets of approximately $57 trillion and accounts for 84 per cent of the world total (world total is based upon countries accounting for 86 per cent of world GDP). The United States has assets of $23 trillion (35 per cent of the world total), the eurozone $22 trillion (33 per cent of the world total), and the United Kingdom $9 trillion (13 per cent of the world total), while Canada and Switzerland combined account for about 3 per cent of the world total. Improvements in flow of funds statistics are needed to properly measure and monitor this sector in the Russian Federation. The United States and Canadian shares of the world total have declined since the financial crisis while the eurozone and United Kingdom shares have risen. This sector’s share of domestic GDP is especially large for the United Kingdom and Switzerland.

18. Three of the region’s traditionally most highly rated sovereigns (France, the United Kingdom and the United States) lost their AAA rating by one or more of the

rating agencies in the last two years; however, all three continue to be rated AAA by at least one rating agency. Several other countries, including Ireland and Spain, lost their AAA status earlier in the financial crisis. The global supply of AAA-rated sovereign debt has declined by over 60 per cent since early 2007.

19. Since the 2008-2009 financial crisis, the world economy has experienced a period of insufficient aggregate demand, which has led to high unemployment in much of the world, especially in the advanced economies. Trade surpluses provide one mechanism to maintain or increase aggregate demand at the national level; currency intervention to depreciate a currency will increase a trade surplus and allow that country to export its unemployment to others. In the ECE region, several countries have been intervening extensively in the foreign exchange market, which has kept their currencies from appreciating; this includes Azerbaijan, Denmark, Kazakhstan, Norway, the Russian Federation and Switzerland.

20. Switzerland intervened significantly in the foreign exchange market to limit the appreciation of the franc during most of 2012 despite having a large current account surplus and a low unemployment rate. The Swiss National Bank spent $199 billion in 2012 purchasing foreign exchange, which resulted in its reserves increasing to $534 billion (about 75 per cent of GDP) in early 2013, the fifth largest in the world.

# IV. Eurozone crisis

21. The eurozone crisis was the result primarily of several design defects in the eurozone; most importantly, there were no institutional mechanisms to adjust for cyclical changes in aggregate demand and there was no lender of last resort for its sovereign debt. The Stability and Growth Pact severely constrained fiscal policy (as does the new “fiscal compact”) and the mandate of the European Central Bank specifically restricted it from considering growth and employment in conducting monetary policy. As a result, when the region was hit by a major financial shock in 2008-2009, it did not have in place sufficient mechanisms to correct for the decline in private sector spending. As Governments attempted to address the developing crisis, they diagnosed it as being due to lack of fiscal discipline and therefore concluded that there was a need to restore such discipline. The resulting austerity programmes caused GDP to decline further (the eurozone fell back into a recession in the autumn of 2012) and, as a result, the debt-to-GDP ratios continued to increase in Greece, Italy, Portugal, Spain and the United Kingdom (as well as the European Union overall) up to the fourth quarter of 2012.

22. Although the eurozone’s collective sovereign debt to GDP increased in 2012, its deficit declined to approximately 3.5 per cent of GDP in 2012, down from 4.2 per cent of GDP in 2011 and 6.2 per cent in 2010. Nevertheless, many of the countries implementing austerity programmes have been unable to meet deficit target levels owing to their deteriorating economic conditions. Greece, Portugal and Spain have had their target dates for reducing their budget deficits to under 3 per cent of GDP reset several times. The intermediate targets set by the European Union/European Central Bank/International Monetary Fund (IMF) troika also needed to be adjusted.

23. One of the most important design defects in the eurozone was that there was no lender of last resort as generally exists in most advanced economies. This resulted in rising interest rates on the sovereign debt of several eurozone economies

and, as a result, IMF needed to provide $103 billion in assistance to Greece, Ireland and Portugal. This was three times the amount provided to the Asian economies during their crises in the late 1990s. However, even this assistance was insufficient for maintaining stability until the European Central Bank essentially agreed to be the lender of last resort for the banking sector in 2011 and for the sovereigns in 2012. The European Central Bank's long-term refinancing operation provided unlimited liquidity to the banking sector and its outright monetary transactions provided (conditional) backing for sovereign debt. Without those two programmes, the eurozone monetary system might have collapsed.

24. Largely as a result of the European Central Bank's conditional backing of the sovereign debt of the European Union periphery economies announced at the beginning of August 2012, the yield spread of the sovereign debt of these economies relative to Germany's fell by approximately half over the following seven months. The spread declined from 5.3 to 2.6 percentage points on Italian debt and from 6.4 to 3.4 percentage points on Spanish debt. The commitment of the European Central Bank was all that was required; it did not have to actually make any purchases under this programme.

25. The integration of the financial sector in the eurozone established a need for a single supervisory mechanism but that mechanism was created only at the end of 2012. The European Central Bank has been given oversight of the eurozone's largest financial institutions, while smaller banks (with assets under €30 billion) will continue to be supervised by national authorities. Nevertheless, the creation of this mechanism raises a number of unresolved issues for non-eurozone European Union economies and non-European Union economies in East and South-East Europe with a significant eurozone bank presence. In addition, there are a number of unresolved issues such as the need for a common authority to recapitalize banks and provide deposit insurance.

26. The banking system in Cyprus became extremely large, with deposits almost four times its GDP; approximately one third of those deposits were foreign-owned by Russians. With the European Central Bank not acting as lender of last resort and the Government unable to do so, its banking system became insolvent in early 2013 owing significantly to large losses on its holdings of Greek sovereign debt. Its major banks were closed temporarily and restrictions were placed on bank withdrawals and capital outflows. Cyprus became the fifth eurozone member to negotiate a European Union/IMF bailout; its conditions were unique in that it required that depositors with more than 100,000 euros take a significant haircut while the shareholders and bondholders of the two major banks were largely wiped out.

27. One aspect of the eurozone crisis was that it represented a balance of payments disequilibrium. In order to address this, there is a need for real wage increases in surplus and growing economies and decreases in deficit and recessionary economies. Some rebalancing has already occurred, as unit labour costs in Spain and Portugal have declined by about 5 per cent since 2008 (and even more in Greece); significant additional adjustments will be needed and are likely to occur over the next several years. However, wage deflation is an especially inefficient adjustment mechanism for correcting current account imbalances.

28. The human welfare and social costs associated with the European austerity programmes have not been distributed widely throughout the population but have been largely concentrated on smaller segments of the population, that often were

already economically disadvantaged. For example, the Government of Spain reduced free lunches for low-income students, while the number of hungry people doubled between 2007 and 2012. In 2012, Spain and Greece increased their retirement age from 65 to 67 and froze or reduced most public sector wages. In 2012, the Portuguese Constitutional Court ruled that some planned public sector wage and pension cuts were unconstitutional since they discriminated against public sector workers who had already experienced wage cuts.

29. Although the existence of significant social welfare programmes has mitigated the negative social consequences of these large income declines and unemployment increases, there are several other institutional or legal standards that have amplified the negative social consequences. This includes the widespread use of recourse mortgages and the exclusion of mortgage debt from bankruptcy. As a result, the bursting real estate bubbles in the eurozone periphery have had much larger and more lasting implications for poverty and homelessness than in economies such as the United States, which have (mostly) non-recourse mortgages and mortgage debt write-downs during bankruptcy. The European Court of Justice struck down Spain’s foreclosure law after nearly 400,000 houses and offices were repossessed between 2007 and 2012.

30. The eurozone current account and sovereign debt crisis has temporarily reduced the appeal of the euro as an international reserve and transaction currency. In order to enhance its appeal, the eurozone economies must address their debt problems, restore competitiveness and growth, recapitalize their banks, and strengthen the political solidarity behind the euro. This will require fundamental changes in the institutional design of the eurozone, with a stronger fiscal union which in turn will require a stronger political union.

## V. Current economic crisis

31. Real GDP in the ECE region is expected to increase in 2013 by 1.5 per cent, which is up slightly from 1.3 per cent in 2012 but below the rate in 2010 and 2011. Growth in the European advanced economies is likely to be close to zero in 2013 as many of its economies experience recessions; the eurozone entered into a double-dip recession beginning in the second quarter of 2012. Growth in North America should be about 2.0 per cent in 2013 as they continue to recover slowly while growth in the European emerging economies strengthens to 3.4 per cent. Growth is forecast to pick up in the second half of 2013 and in 2014 in all three subregions and improve slightly further in 2015. Despite modest growth in North America and the European emerging economies, there will continue to be significant unused labour resources in these economies in 2013 and 2014. The employment situation continues to deteriorate in the European advanced economies and there is likely to be high unemployment in many of them for at least several more years.

32. The extended economic downturn in North America and the European advanced economies has not only lowered growth in the past several years but is also likely to lower longer-term productivity growth over the next decade, since it has significantly reduced both public and private sector investment. For example, while real GDP in the European Union was 0.6 per cent lower in 2011 than in 2007, real private investment was 14.5 per cent lower and government investment was 4.2 per cent lower.

33. Although there has been solid growth in the economies in transition in the past three years, these growth rates and those being forecast for the next several years are significantly below the rates achieved in the five years prior to the global crisis. This is owing to less external finance, less slack in labour markets, less labour force growth and slower productivity growth owing to reduced investment during the crisis period. Nevertheless, despite its large downturn in 2009 and its meagre labour force growth, the Russian Federation still managed to have the fourth highest growth rate among the Group of 20 nations between 2000 and 2010.

34. The relatively improved growth and employment performance achieved by the United States relative to the European Union in the past several years is the result of the former's slower fiscal retrenchment. The United States and the eurozone both addressed the financial crisis with countercyclical fiscal policy but there were significant differences in their degree. In the eurozone, the cyclically adjusted primary fiscal balance fell to about negative 2 per cent of GDP in 2009 and 2010 but has risen to a surplus of almost 2 per cent by 2013. In the United States, the deficit increased to almost 7 per cent in 2009 and 2010 and remains in deficit of 3 per cent in 2013.

35. Within the European Union, there is a strong empirical relationship between the extent of austerity imposed and the degree to which real GDP declined during the 2009-2012 period. The largest austerity programme was adopted by Greece and it has experienced the largest economic decline, about 18 per cent; more moderate levels of austerity were imposed by Ireland, Italy, Portugal and Spain, and they all experienced GDP declines of about 5 per cent of GDP during this period. Countries that did not implement any significant austerity programme generally experienced growth during the period.

36. The region's main monetary authorities have significantly increased their balance sheets since the crisis began. Central bank assets as a per cent of GDP tripled in the United States and United Kingdom from about 6 per cent of GDP in early 2008 to about 20 per cent by 2012. In the eurozone, assets doubled from 15 per cent of GDP to over 30 per cent during the same period. In addition, the region's central banks have made numerous commitments to maintain their easy monetary policy until there is a solid recovery. In September 2012, the United States Federal Reserve committed to keep its interest rates near zero and to buy $45 billion in Treasury bills and $40 billion in mortgage bonds a month until the unemployment rate falls to 6.5 per cent or inflationary expectations exceed 2.5 per cent. The Federal Reserve estimated that the unemployment rate was not likely to fall to 6.5 per cent until mid-2015 at the earliest.

37. Interest rates on United States and United Kingdom Government (10-year) bonds that were close to or above 5 per cent in the second half of 2007 were down to under 2 per cent by the beginning of 2013. These low interest rates mean that the burden of their increased sovereign debt was actually quite moderate; for example, in 2012, the United States was spending only 1.4 per cent of its GDP on net interest payments on its debt, which was close to the lowest per cent in the post-World War II period.

38. The economic slack in the region should keep domestically generated inflation in check, although higher commodity prices from a more robust global economy could keep inflation close to the target levels of the region's central banks. Inflation in the United States has been below the general Federal Reserve target of 2 per cent;

between January 2012 and 2013, the consumer price index rose 1.6 per cent. In the eurozone (as well as the other European Union economies), although inflation in 2012 was slightly above the 2 per cent target, it has been running below the target in early 2013. Inflation in most of South-East Europe is likely to stay low at about 3 per cent since most of their currencies are tied to the euro; however, in Turkey it is running considerably higher at about 9 per cent. Inflation in the Russian Federation is forecast to be about 5 per cent, significantly below the average rate in the past decade; inflation in Central Asia and Belarus is likely to be higher.

39. Many of the ECE economies followed the global financial cycle of significant housing price increases prior to 2007 and large declines after 2008. Some of the largest price declines (pre-crisis peak to post-crisis trough) occurred in Latvia (-76 per cent), Estonia (-64 per cent), Ukraine (-52 per cent), Lithuania (-45 per cent), Bulgaria (-33 per cent) and the United States (-30 per cent); large declines also occurred in Hungary, Ireland, the Russian Federation, Slovakia and Spain. Overall, European Union real housing prices declined almost 12 per cent between their peak in early 2008 and the end of 2012. In most of these economies, prices appear to have now stabilized. However, housing markets remain somewhat idiosyncratic and in a number of ECE economies, housing prices avoided the post-2008 downturn and instead have been increasing. In Austria, Canada and Switzerland, housing prices have increased by over 20 per cent since 2007; in Canada, they have risen by 127 per cent since 2000. In a number of ECE economies (including Canada, France, the Netherlands, Spain and the United Kingdom), housing prices appear overvalued when compared with their long-term relationship to rents.

40. Although the European Union had yet to agree upon its 2014-2020 long-term budget (multi-annual financial framework) as at April 2013, it is likely to be roughly similar in size to the 2007-2013 budget or, on a yearly basis, about 1 per cent of the European Union’s GDP. Germany, France, Italy and the United Kingdom are the largest net contributors while the major recipients include most of the new member States, Greece and Portugal. Agricultural and structural programmes account for a majority of the spending; however, the share of agriculture has declined from about 75 per cent of the budget in 1980 to about 40 per cent.

# VI. Employment

41. Unemployment has reached an historic high of 11.9 per cent in the eurozone and continues to increase; the unemployment rate is 8.7 per cent in the non-eurozone members of the European Union and unemployment has reached depression levels in several eurozone economies. Although the European Union has generous unemployment and social assistance programmes, the fact that unemployment has been rising steadily since the beginning of 2008 suggests that many workers have by now exhausted their benefits and depleted their precautionary savings. Unemployment in South-East Europe remains extremely high at double-digit rates throughout the region and above 20 per cent in most of them; unemployment in Turkey is slightly below 10 per cent. In the United States, unemployment doubled between 2005 and 2010, reaching almost 10 per cent, but by 2013 declined to slightly below 8 per cent. Since 2010, unemployment has declined significantly in many of the Commonwealth of Independent States, reaching an historic low in the Russian Federation, which had essentially achieved full employment before unemployment began increasing in early 2013.

42. The share of the long-term unemployed in total unemployment in the United States more than doubled from about 20 per cent prior to the crisis to over 40 per cent in 2010-2012. High levels of unemployment are more costly for United States workers than for those in the European advanced economies because its social safety net is less extensive. For example, 40 per cent of the unemployed in the United States do not qualify for unemployment benefits because they were not working full-time or had not been in their jobs long enough to qualify. Long-term unemployment is associated with a persistent reduction in earnings (20 per cent less) even 20 years later, increased mental and physical health problems, lower life expectancy and even reduced earnings for their children.

43. Unemployment remains high in much of Europe; although this is largely owing to inadequate aggregate demand, there is nevertheless a need for some type of structural reform of labour market institutions. The Scandinavian model of flexicurity has worked reasonably well and as a result France proposed its own version of this model in early 2013, whereby firms would have greater flexibility in hiring and firing but workers should have greater overall financial security. France also proposed tax changes to reduce the incentive to hire workers under short-term contracts.

44. Unemployment is exceptionally high in Spain and Greece, at over 25 per cent in 2013; before the crisis in 2007, each of these economies had unemployment below the eurozone average. Total employment in both these economies is over 15 per cent lower than in 2007. However, GDP in Spain (in the third quarter of 2012) was only 4.2 per cent below that of 2007 while in Greece, it was 19.3 per cent lower. Thus, relatively small declines in GDP have led to very large decreases in employment in Spain, while in Greece the changes in GDP and employment have been roughly proportional. This is likely the result of the much more flexible labour markets in Spain. Prior to the crisis, approximately one third of Spanish workers had temporary contracts whereas in Greece, only a tenth had such contracts. In Spain, the rate of job losses for those with temporary contracts has been about six times greater than for those with permanent contracts.

# VII. Inequality and poverty

45. Inequality has been increasing throughout the ECE region in the past two decades. It is especially high in Israel, Italy, Portugal, the Russian Federation, Turkey, the United Kingdom and the United States. The shares of the top 1 per cent of the population have grown especially fast. Inequality has been increasing even in the European economies with strong social welfare models, such as Denmark, Germany and Sweden; France, however, is a notable exception to this trend. Inequality increased substantially in most of the economies in transition after their transition to market economies. Despite these recent trends, inequality in the advanced ECE economies is still lower than in most developing economies, while inequality in the Russian Federation is similar to that in many developing economies, such as China, although lower than in much of Latin America.

46. Generally, market incomes (before taxes and transfers) are more equally distributed in Europe than in North America and government redistributions of income (through taxes and transfers) are greater in Europe than in North America;

owing to both factors, the distribution of consumption is more equal in Europe than in North America.

47. The increase in inequality in the ECE region is owing to globalization, skilled-biased technological change and government policy changes. Although taxes and social transfers can reduce the inequality of market-based incomes considerably, over time these redistributions have been scaled back as marginal taxes on the richest have declined. In the United States, the top statutory rate declined from 90 per cent in 1958 to 70 per cent in 1980 and only 35 per cent in 2009, and the current tax rate is lower for every income level (relative to 1958). The top income tax rate in the United Kingdom declined from 83 per cent in 1979 to 40 per cent in 1990.

48. The ability for Governments in the ECE region to address economic inequality with progressive income taxes and to raise tax revenue to address budget deficits is increasingly constrained owing to the globalization of these economies. The international mobility of capital and, increasingly, of labour makes it more difficult to tax these factors, and taxes on businesses can harm an economy through competitive pressures. Therefore, there is increasingly a need to harmonize or at least coordinate various tax policies to limit these “race to the bottom” type of effects.

49. In some cases, labour market policies have weakened workers’ employment protection and/or unions through regulatory or institutional changes. In the past few decades, union membership or union coverage (compensation determined by union bargaining regardless of individual membership) has declined in many of the advanced ECE economies; the latter remains above 50 per cent in most of Europe but is only 13 per cent in the United States.

50. The United States continues to be a society with significant racial differences in economic outcomes. The median household wealth of whites is almost 20 times that of African Americans; whereas in 1983, it was 15 times that of African Americans. The unemployment rate for African Americans is over twice that of whites. Employer-provided health insurance and pension coverage are lower for African Americans and Hispanics than whites. African Americans remain slightly underrepresented as a percentage of those in college. The life expectancy of whites is approximately five years longer than that of African Americans but, counter-intuitively, is over two years shorter than that of Hispanics.

# VIII. Achieving the Millennium Development Goals

51. The economic crisis of 2008-2009 had the largest impact on the growth of the transition economies compared with any of the other subregions of the ECE or of the world economy. This was true both in terms of their absolute decline in output in 2009 (minus 6.5 per cent) and their decline in output from trend levels (a decline of 13 percentage points). These economies “lost” about three years of economic growth and, as a result, progress in achieving the Millennium Development Goals was pushed back by several years.

52. Many of the Millennium Development Goals targets have not been achieved in the ECE economies primarily owing to the fact that the targets have not been achieved for specific disadvantaged groups, including certain ethnic communities

and geographical subregions. Thus, progress in achieving these objectives could benefit in particular from more focused targeting of these specific vulnerable groups. This is especially true for the Roma in some of the new European Union member States and South-East European economies, whose relative plight in terms of employment and education outcomes has deteriorated since the transition to market economies. Integration of this group requires increased public support for housing, education and health care and better implementation of anti-discrimination employment policies. Increasing their employment in the formal sector would increase tax revenues and social security contributions and, as a result, increased assistance could be largely self-financing.

53. Health outcomes are highly correlated with the level of per capita income; however, the United States, the Russian Federation and several other economies in transition have health outcomes that are significantly worse than what would be expected based upon their level of development. Although the United States has a higher per capita income than most of the other advanced economies, it has one of the highest rates of infant mortality, traffic fatalities, homicides, heart and lung diseases, diabetes, teen pregnancy and sexually transmitted infections of any advanced economy. Their poor health outcomes are owing to the large uninsured population and the high level of poverty and are especially notable given that the country spends a significantly larger percentage of its GDP on health care than any other economy. However, even those who are white, affluent, college-educated and with health insurance have inferior health outcomes. About half the United States lower life expectancy (relative to other advanced economies) is owing to higher mortality for persons under 50; persons over 75 have lower mortality than their peers in other countries.

54. In the Russian Federation, life expectancy for men declined by one tenth of a year between 1990 (63.2 years) and 2010 (63.1 years). There has also been a large and unprecedented decline in the life expectancy of poor white people in the United States; between 1990 and 2008, the life expectancy of white women without a high school diploma declined by five years and, for similar white men, by three years. The underlying causes of these declines are somewhat uncertain but appear to be related to increasing inequality, reduced health insurance and more risky behaviours such as drinking and smoking.

55. The life expectancy of women in Europe is 80.0 years while that of men is only 72.5 years; this gap is the greatest in Eastern Europe, including Belarus, Estonia, Kazakhstan, Montenegro, the Russian Federation and Ukraine, and the smallest in Western Europe, including the Netherlands, Sweden and the United Kingdom. Given this gap, the challenges confronting the region regarding ageing have a significant gender dimension.

## IX. Progress in creating innovative and dynamic economies

56. The level of innovative capabilities of countries is estimated each year, by the global innovation indicators jointly produced by the World Intellectual Property Organization and INSEAD. Innovative capacity increases with, and is highly correlated with, GDP per capita. After controlling for the level of per capita income, innovative capacity appears high in Denmark, Estonia, Latvia, the Republic of

Moldova, Sweden, Switzerland, Ukraine and the United Kingdom and particularly low in Azerbaijan, Belarus, Greece, Kazakhstan and Uzbekistan.

57. Research and development spending is an important factor in sustaining long-term economic growth not only in the advanced ECE economies at the technological frontier but also in the emerging economies, which need to assimilate and adapt technologies to their particular circumstances. The ECE region accounts for 62 per cent of global research and development, but its share has declined from over 70 per cent in 1999. Since 1999, the United States global share has declined from 38 per cent to 32 per cent and the European Union’s share from 27 per cent to 23 per cent.

58. Several of the economies in transition are highly dependent on natural resources, with relatively small manufacturing sectors. In order to improve their longer-term growth prospects, further diversification will be required. Although oil and gas account for 30 per cent of the Russian Federation’s GDP, almost 70 per cent of merchandise exports and over 40 per cent of government tax revenues, manufacturing value-added accounts for 13 per cent of GDP in the Russian Federation, which is similar to the 12 per cent in the United States.

59. In order to create innovative and diversified economies in the countries with economies in transition, governance and competition must be improved; education and training needs should more closely match the needs of business; the investment climate needs to encourage more FDI in non-commodity sectors; incentives are needed to limit the emigration of skilled workers while encouraging their immigration; access to financing is needed especially for early stage companies; the financial sector needs development; private sector research and development needs to be increased through more favourable tax treatment; and intellectual property laws require improved enforcement.

60. Research and development can be carried out either by the public or private sector; large positive externalities from research and development activities provide the justification for public research and development and for subsidies and special tax treatment for private sector activities. Over the long run, there has been a shift in many ECE economies from government to private sector research and development. For example, although research and development in the United States was about 3 per cent of GDP in the 1960s and in the 2000s, the Government accounted for two thirds of this in the 1960s but only one third more recently. United States Government research and development is concentrated in the defence and health sectors; United States private sector research and development is concentrated in the services sector. The European Union has had lower overall rates of research and development, which currently amounts to only 1.9 per cent of GDP despite a target of 3 per cent; European Union private sector research and development is concentrated in machinery and equipment. Canada devotes 1.9 per cent, the Russian Federation 1.2 per cent, and Ukraine 0.9 per cent of GDP to research and development. Improved intellectual property rights can increase research and development in countries where they are especially weak, but in countries with basic intellectual property rights, strengthening them further does not affect the level of research and development.

61. The economic crisis in the eurozone has resulted in a relative decline in investment and research activity in the periphery, which will further widen the disparities between the eurozone core and the periphery in the next decade. For example, as a percentage of GDP, research and development spending in Spain is

one half that of Germany; this is owing mostly to differences in private sector research and development although public sector research and development in Spain received large cuts in 2012 and 2013 while it increased in Germany. In 2010, 242 international patents were filed by Spanish residents and firms while 5,600 were filed by German residents and firms.

62. An important ingredient for economic development is the creation of a stable and modern financial sector. By improving financial intermediation, such a sector can increase investment and growth, and by providing bank accounts for individuals and businesses, it can increase their economic security and improve economic efficiency. Increasing the number of people with bank accounts is often promoted as a way to increase the developmental impact of remittances. In the European emerging economies, less than one half of adults have a bank account; this is below the world average. In some of the Central Asian economies, only a very small percentage of adults have a bank account.

63. After 40 years of negotiations, 25 of the 27 European Union countries approved a single European Union patent regime (the European Patent Organization; a non-European Union body), which will replace the 25 national patent systems; Italy and Spain will keep their national systems for the time being. Patent applications will need to be made in English, French or German, but some assistance with translation will be provided. A common patent court will be located in Paris, London and Munich and is tentatively set to become operational on 1 January 2014. This is expected to lower the costs of patenting inventions throughout the European Union.

# X. Regional integration and trade

64. The European Union, including its earlier institutional forms, has been the primary driver of economic integration in Europe in the last half century. In recognition of its role in fostering integration and economic cooperation and the contribution of such integration/cooperation to promoting peace and security, the European Union was awarded the 2012 Nobel Prize for Peace.

65. Croatia becomes the twenty-eighth member of the European Union on 1 July 2013; this may result in the loss of some exports to Croatia by the other Balkan economies as their relative preferences decline. Iceland, Montenegro, Serbia, the former Yugoslav Republic of Macedonia, and Turkey are official candidate countries for European Union membership, and Albania, Bosnia and Herzegovina, and Kosovo[1] are potential candidates. Latvia has formally applied to be the eighteenth member of the eurozone beginning in January 2014.

66. In April 2012, Montenegro formally joined WTO; the Russian Federation joined in August 2012 and Tajikistan in March 2013. Seven of the former transition economies, Azerbaijan, Belarus, Bosnia and Herzegovina, Kazakhstan, Serbia, Tajikistan, Turkmenistan and Uzbekistan, remain non-members; however, the accession of Azerbaijan and Kazakhstan is relatively close to being finalized.

[1] References to Kosovo shall be understood to be in the context of Security Council resolution 1244 (1999).

67. The Russian Federation became a member of WTO after an 18-year accession process. It was the largest economy and only Group of 20 member not in WTO. In joining, the Russian Federation agreed to reform the role of the Government in the economy, including its subsidy programmes, strengthen its intellectual property rules and lower its trade barriers. It will lower its tariffs in several stages over the next eight years but most reductions will occur within five years (namely, by 2017); about one third of its commitments were implemented with the accession. The average weighted Russian tariff will decline from 13.0 per cent to 5.8 per cent; applied rates are slightly lower than bound rates for a significant number of products. Industries with significant declines include timber, pulp, paper, food products and numerous manufactured goods such as automobiles, clothes and consumer electronics. The Russian Federation’s liberalizations were generally comparable with that of other economies that have joined WTO and its final average unweighted bound rate (8.6 per cent) will be slightly higher than those of most other transition economies that have joined WTO. Best estimates are that WTO accession may raise the Russian Federation’s GDP by about 3 per cent in the next decade.

68. The Belarus, Kazakhstan and the Russian Federation Customs Union, established at the beginning of 2010, generally used the Russian tariff as the common external tariff; the Russian Federation’s tariff level was the highest of the three and, therefore, the common tariff resulted in only a minor increase in the average Russian tariff but almost doubled Kazakhstan’s average applied tariff. The customs union has so far resulted in very limited trade creation as the total trade flows among the three were only 13.7 per cent higher in 2011 than in 2008 in nominal terms, which suggests a real increase of only about half as much. Kazakhstan appears to have experienced some trade diversion especially from China.

69. The European Union and the United States have initiated discussions under the Transatlantic Trade and Investment Partnership to create a free trade and investment agreement between the two regions. Central to any agreement would be regulatory cooperation and/or harmonization which, given the importance of the region, would likely have significant global implications for shaping global product standards. There are, however, numerous obstacles, especially in the politically sensitive areas of agriculture standards and subsidies, that will make an agreement difficult to achieve. Simulations estimate that such an agreement would increase the GDP of these regions from one quarter to one half percentage point depending on how extensive the agreement is. An agreement would affect the rest of the world through trade creation and diversion; the harmonization of United States-European Union standards would likely have trade creation effects for the rest of the world. Simulations suggest that the Association of Southeast Asian Nations (ASEAN) economies might actually experience a greater increase in GDP than either the United States or the European Union. Both the European Union and Japan, and Switzerland and China, have initiated discussions about creating free trade agreements.