UNITED NATIONS ECONOMIC COMMISSION FOR EUROPE
Geneva, Switzerland

DISCUSSION PAPER SERIES

No. 2007.3

June 2007

THE ECONOMIC SITUATION AND OUTLOOK IN MID-2007 FOR THE UNECE ECONOMIES - EUROPE, NORTH AMERICA AND THE CIS

■ Robert C. Shelburne

UNITED NATIONS

I. The global context

World GDP increased by an impressive 5.4 per cent in 2006, the largest increase since the early-1970s, and is likely to be only slightly less at around 4.9 per cent in 2007.[1] Since the slowdown in 2001, the world economy has now experienced six years of good growth with the last four being exceptionally strong. Overall, this is the best extended performance of the global economy since before the first oil shock in 1973. This expansion has been led by the stellar performance of the emerging market and developing economies which account for approximately one-half of world GDP and grew by 7.9 per cent in 2006 as compared to the 3.1 per cent growth rate in the advanced economies which account for the other half. The developing world has outgrown the advanced economies consistently since 1990 and the gap has been slowly increasing through time. The economic performance of the developing world was led by China which continues to grow at rates above 10 per cent and by India whose growth rate has picked up appreciably in the last few years and topped 9 per cent in 2006. The CIS minus Russia also ranks amongst the fastest growing regions having achieved a 9.5 per cent increase in GDP in 2006 and was led by Azerbaijan's 31.0 per cent increase in GDP which makes it the fastest growing economy in the world. Growth was strong elsewhere in the developing world including Latin America and Africa. In the advanced economies growth picked up in 2006 in all the major regions including the U.S., Western Europe, and Japan, although growth appears to be moderating in 2007 especially in the United States. For the ECE region overall (i.e., the ECE-52) which accounts for 48.5 per cent of global GDP, growth was 3.7 per cent in 2006 but is expected to fall to 3.1 per cent in 2007 which is about what it has averaged over the last 8 years. Thus not only has world growth been surprisingly robust but it has been spread quite evenly around the planet and is likely to persist through the remainder 2007 and into 2008 although there are a number of possible downside risks that could derail this expansion.

Inflation throughout most of the world has been low and averaged just 2.3 per cent in the advanced economies and 5.3 per cent in the developing economies. Unemployment throughout much of the world has also been on a downward trend for the last several years although this is expected to stabilize in 2007. This strong economic growth combined with generally low inflation and unemployment is all the more remarkable given that this has occurred during a time when oil and commodity prices increased substantially. This favourable outcome reflects the changing economic structure of the world economy and the improved performance of economic policy making since the oil shocks of the 1970s.

---

[*] Robert C. Shelburne (robert.shelburne@unece.org), United Nations Economic Commission for Europe, Geneva, Switzerland. Jose Palacin provided useful input. A modified version of this report is published in the economic developments section (chapter 3) of the UNECE/FAO *Forest Products Annual Market Review for 2007*.

[1] These growth rates are GDP weighted averages adjusted by using purchasing power parity exchange rates; world growth would be lower at about 4 per cent if based upon market exchange rate measures.

The current global expansion has been particularly favourable for emerging markets which have benefited from an abundance of liquidity due to the accommodating monetary policies in the advanced economies and the carry trade that they allow, monetary expansion by current account surplus emerging markets from their foreign exchange interventions, and the recycling of petrodollars and the foreign exchange reserves of the Asian central banks. This has created a global search for yield that has resulted in an appetite for risks which has decreased the interest rate spread on emerging market debt (relative to risk-free U.S. bonds) to an all-time low in April 2007 based upon the widely used JPMorgan EMBI index. Emerging market bonds which as recently as five years ago had interest spreads of five or more percentage points are now below two percentage points while those of many of the ECE emerging markets are below one per cent. Despite these positive trends in the availability of funds, the emerging market economies continue, as they have for the last several years, to be net suppliers of credit to the advanced economies; this runs counter to the basic objective of the Financing for Development goals of the Monterrey Consensus which is concerned with transferring real resources from the advanced to the developing economies. However, a significant number of the ECE resource poor emerging markets have defied this global trend and continue to benefit from net capital inflows.

World trade continued to grow, as it has for the last several years, about twice as fast as world GDP during 2006 and is likely to do so again in 2007. While progress has been slow in concluding the Doha Round of multilateral trade negotiations, there has continued to be a significant increase in the number of regional and bilateral preferential trade agreements. These include the further expansion of the EU to include Bulgaria and Romania, the U.S.-- South Korea FTA (signed but not ratified), and the expansion of the Central European Free Trade Area to include all the remaining non-EU countries in South-east Europe. Approximately one-third of world trade is now covered by one of these preferential agreements. Increased trade, although advancing global income, continues to be exerting downward pressure on wages in the advanced economies especially of the unskilled while the distributional consequences of globalization in the developing world are less clear-cut. China passed the U.S. as the world’s second largest exporter during the last half of 2006 and is likely to pass Germany to gain the top spot in the near future.

At the end of February 2007 there was a market downturn in all the world’s major financial markets as concerns grew about the strength and durability of the current expansion. U.S. equities suffered their largest one-day fall since September 2001 in the aftermath of the terrorist attacks; financial stocks were especially affected. Generally this market sell-off did not seem to be related to any significant change in the underlying economic fundamentals but was interpreted to be a reassessment by investors of the risks which they had assumed. However, as with the reversal in May 2006, most markets recovered rather quickly. By April 2007, U.S. equity prices as measured by the S&P 500 Index had risen to their previous all-time highs reached in the fall of 2000.

Growth picked up considerably in Japan, the world’s second largest economy, in 2006 especially near the end of the year, and the asset price deflation which has plagued the country appears to have ended with land prices increasing for the first time since 1990. However, core consumer prices fell 0.1 per cent in February 2007 showing that the deflation that has reappeared regularly in Japan for over a decade has still not been firmly eliminated from the system. There was a slight tightening of monetary policy in the spring of 2007 with rates rising a quarter point to a still very low 0.5 per cent; this raises questions about whether the central bank has begun tightening prematurely especially since it has had a tendency to do this throughout the last decade. However, low interest rates have potentially resulted in excess global liquidity by encouraging a carry trade, where investors borrow almost interest free in Japan in order to invest in other high interest rate economies. Japanese equity prices have doubled from their 2003 nadir but remain significantly below their all-time highs. Japan's fiscal deficit which has been quite high and of some concern given its long-run demographic problems has improved significantly with the pick up in the economy.

Potential threats to the sustainability of the current global expansion include the disruptions that might be caused by the realignment of four important prices. These prices are the price of the major international currency – the exchange rate of the U.S. dollar, the price of the largest traded commodity – oil, the price of the largest asset that people own –residential housing, and the basic price of time preference –the global interest rate. Businesses and individuals make important consumption and investment decisions based upon the relative price of alternative goods and activities and when there is a significant change in the price of a major item it can produce economic adjustments that may prove difficult for some, especially in cases where already implemented investment projects become unviable. As such if there was a major change in the price of any of these items-- the exchange rate, interest rate, housing, or oil, there could be significant ramifications for the global economy.

Over the last several years there has been a significant increase in interest rates in the major economic areas including the U.S., eurozone, the U.K., China, many emerging markets, and even a slight increase in Japan. Over the last 40 years, almost every time there has been a significant increase in the interest rate, especially when it has been more global in scope, it has precipitated some form of financial or currency crisis. These include the breakdown of the Bretton Woods monetary system in the late 1960s, the Latin American debt crises of the late 1970s, the savings and loan crisis in the U.S. a decade later, the Mexican tequila crisis of the mid 1990s and the high-tech stock market collapse of 2001. Figure 1 provides the one month CD interest rate over the last 40 years and for each period in which there was a significant peak in interest rates, the crisis that subsequently followed is listed. Thus it would be somewhat atypical if the current phase of low interest rates that has been even more pronounced and longer than most did not result in some form of financial crisis in the coming year or two. Nevertheless this correlation is not perfect, the Asian economic crisis which was one of the worse in all of this 40 year period, was not preceded by a significant interest rate increase (except small increases in short-term rates in the U.K. and Japan) and the 1984 interest peak was only partially associated with several minor and dispersed crises in South Africa, Chile, Singapore and Mexico.

The price of crude oil which had traded around $20 a barrel through most of the 1990s appreciated significantly in the first years of this decade and now appears to have found a trading range of around $60 to $70 a barrel. This price is not only high in nominal terms but is similar in real terms to oil's all-time high in 1981. The sustainability of this price level is probably dependent on the maintenance of the current expansion with upside risk coming from further political uncertainty or military activity in the Middle East, especially in regard to Iran. The relative ease with which the world economy adjusted to the recent increases have perhaps reduced the perceived risks associated with further price movements in this commodity.

The U.S. current account deficit, which has been quite large for some time, reached 6.5 per cent of GDP in 2006; U.S. imports are now almost twice the level of U.S. exports. A sizable real dollar depreciation of 25 to 35 per cent will ultimately be required in order to reduce this imbalance to a more sustainable level although the dollar has already fallen 39 per cent against the euro since October 2000. The speed and nature of this adjustment will have significant ramifications for the global economy with a faster adjustment likely having a more disruptive effect. Although there has been widespread recognition for several years that a significant dollar depreciation is forthcoming, it has been largely postponed due to the interest rate differential that has favored U.S. assets. However with growth slowing in the U.S. and picking up elsewhere, this interest differential has begun and is likely to further decline. As a result, the dollar began a sustained decline in early 2007. Since many of the Asian currencies are still linked to the dollar and with interest rates still quite low in Japan, much of the pressure on currency realignments has been directed towards an appreciating euro. In April of 2007 the euro reached an all-time high against the yen, and by reaching $1.37, it matched its all-time high versus the dollar previously set in December of 2004. Also in April 2007, the pound appreciated past $2 for the first time since it was forced out of the Exchange Rate Mechanism by speculators (including George Soros who made over a $1 billion) during the Black Wednesday episode in September 1992.[2] Although the depreciation of the pound in 1992 had negative short-run implications, it restored external competitiveness to the British economy and was an important factor in that economy's robust performance over the next decade; thus the possible serious effects on competitiveness of the current appreciations of the European currencies should not be underestimated.

There has been a global boom in residential real estate prices over the past 10 years and especially the first five years of this decade in most of the major markets in the world; this has been especially the case in the ECE emerging markets. Housing is a sizable sector of most economies in terms of both GDP value added and employment; changes in market demand especially for new housing can therefore have significant macroeconomic implications. In addition, given that housing represents the largest financial asset for the majority of households, significant price fluctuations in housing prices can affect perceptions of wealth and thus influence consumption decisions which then have broader macroeconomic implications as well. Since current housing price levels are in excess of a number of longer-term relationships such as between prices and income and prices and rental costs, there is a concern that there may be a bubble in many of these markets. Analysis of previous housing bubbles has found that a bust occurs after a boom in approximately half of the cases and is usually preceded by a significant increase in interest rates (as has recently occurred). A housing bust typically has a much more serious impact on the economy than a equity market bust and it takes a much longer period of time to work itself out. Thus given the rapid housing price increases and increasing interest rates, there remains significant downside risks for the overall economy from adjustments in this sector. Housing prices levelled off or even declined in some regions of the United States during 2006, however this may be only the tip of the bubble as price appreciation in some European markets such as Ireland, Spain and the U.K. were

[2] Analysis of that period suggests that the U.K. joined the ERM at an overvalued rate and did not have the market flexibility to rapidly adjust the rest of the economy to the existing exchange rate. This episode has valuable lessons for the NMS's euro accession in regard to the importance of setting the right exchange rate and having flexible labor markets.

twice as much as those in the U.S. between 1997 and 2005 and a price correction in many Western European economies may now be imminent.

In addition to the risks associated with possible changes in the four prices listed above, there are two other areas of "unknown" risks due to the fact that they deal with issues for which there is limited information and little previous economic analysis that would allow an assessment of their implications. The first concerns the explosive growth of hedge fund and derivative markets. In theory these markets should improve the stability of financial markets by allowing risks to be properly priced and distributed to those willing to accept these risks. However, the size of these markets (estimated to be over $2 trillion) have been expanding exponentially and there are legitimate questions as to whether market participants fully understand the implications of these markets and whether they are being properly regulated. The possibility that these markets could fail during extreme market adjustments are often not incorporated into the stress tests that are applied to assessing banks' exposure to risk. Concerns about these issues were raised over the last year by the European Central Bank, the NY Federal Reserve Bank, the Institute for International Finance, and even market participants such as Citigroup. The other "unknown" concerns the possible global implications of an avian influenza pandemic. The historical parallel often feared is that there could be some repeat of the Spanish flu that broke out during 1918-20 and killed approximately 5 per cent of the world's population. This disease remains quite deadly with a mortality rate of over 50 per cent and there are limited treatment options; a global outbreak could have serious economic consequences. And finally of course, there are the unknown unknowns.

Besides the global risks outlined above, the emerging markets of the ECE region have a more regional vulnerability in regard to the rapid credit growth of both domestic credit and private sector borrowing from abroad. Bank credit, especially to households, has been growing extremely fast over the last several years; most recently, in a number of countries bank loans increased between 25 to 50 per cent over the year ending in the second quarter of 2006 and for some the growth has been even higher. Despite this rapid growth in credit, many of the transition economies still have relatively low credit to GDP ratios. Although developing countries generally have lower ratios, the low levels in the transition economies are also due significantly to their historical planned economy structure which was characterised by repressed financial development as many other even poorer developing nations have much higher ratios than in Russia or the other CIS. Although rapid credit growth is a normal process and characteristic of financial deepening in developing countries, this rapid growth, even from a relatively small base, raises concerns because the regulatory and financial institutional structure is new and has yet to be seriously tested. Additional aggravating factors in some economies include a large predominance of foreign-currency denominated loans, fixed or managed exchange rates, already open or increasingly open capital accounts, and rapidly rising prices for financial and real estate assets. The extent to which these factors entail financial risks for these countries obviously varies considerably; however, in a number of cases, especially those with relatively underdeveloped regulatory infrastructures and several of these aggravating factors, the financial sector may have been allowed to grow too fast over the last five years and may now pose a significant financial vulnerability. Overall these newly developing areas of financial vulnerability are unlikely to become apparent if the global economy is able to sustain its recent growth performance along with relatively low interest rates. However deterioration in the global economy could act as a trigger which could expose this fragility in some these countries' financial systems.

II. North America

Despite a recent slowdown in the U.S. economy with a projected 2.1 per cent increase in GDP for 2007 compared to the 3.3 per cent increase in 2006, the economic situation remains generally favourable with low unemployment and inflation and generally sound government and household debt levels; however the possibility of a recession by the end of the year can not be ruled out. The U.S. slowdown is largely the result of the significant increase in short-term interest rates which began in mid-2004 and has now stabilized at 5.25 per cent since the fall of 2006; there are currently fluctuating expectations as to whether the next move will be up or down depending on the latest news about inflation or growth. The U.S. interest rate yield curve (comparing 2 and 10 year maturities) which had been inverted for almost a year, which often signals an upcoming recession, returned to a normal upward slope in March 2007 (although shorter maturities remain inverted). Longer run interest rates including 30-year mortgage rates remain low by historical standards at just over 6 per cent although they are slightly above the rates of the prior three years. The spread of 30-year mortgage rates relative to 10-year government bonds of 1.5 per cent is at its average level of the last decade. Inflation in the U.S. is approximately 2.8 per cent (y-o-y) for the period ending in March 2007, but despite this relatively low rate, inflation remains a preoccupation of the Federal Reserve.

Unemployment in the U.S. fell to 4.4 per cent in March 2007, which is close to or slightly below what is viewed to be full employment or more technically the rate of unemployment consistent with a non-accelerating inflation rate. Job growth over the first quarter of 2007 has averaged 152,000 a month which is a rate basically consistent with maintaining the current unemployment rate given population growth; nevertheless unemployment remains high for some segments of the labor market such as black teenagers where it reached 30.6 per cent in April. Given the slowdown in the U.S. housing market, it is somewhat surprising that since March 2006, employment in the construction sector increased by 21,000 due to the fact that growth in non-residential construction was more than sufficient to compensate for the decline in residential construction. However even employment in residential construction was down by only 3.0 per cent even though housing construction was down by almost 20 per cent. The nature of the discrepancy in these two declines is not clear, either there is significant labor hoarding in anticipation of a fast rebound in housing construction, a significant fall off in productivity in the sector, or perhaps the release of illegal workers which are not reflected in the official employment statistics. The manufacturing sector, which has been in long-term decline in the U.S., suffered another lost of 109,000 jobs year on year. Employment growth in the service sector, which has been the main driver of growth during the current expansion, weakened in the spring quarter. U.S. (non-farm business sector) productivity growth that began a revival in the mid-1990s appears to have fallen back to its longer-term trend level as it has increased at an annual rate of approximately 1.6 per cent since the third quarter of 2004; productivity had grown at an annual rate 1.5 per cent during the productivity slowdown of 1973-1995. Investment has also remained sluggish despite the fact that profits as a percentage of GDP reached an all-time high in 2006; housing investment has been particularly low and with the inventory of unsold houses at a rather high level, is likely to stay low for at least another year.

The two primary areas of concern for the U.S economy are its housing market with its possible economy-wide implications and the country's large current account deficit. Housing starts increased slightly in February from depressed levels although permit applications remained weak. The U.S. current account as a per cent of GDP has stabilized at slightly over 6 per cent and is unlikely to fall much more until there is a further dollar depreciation which will likely depend on a reduced interest rate differential (relative to the other major monetary zones). Despite these large current accounts, the U.S. net international investment position has only deteriorated slightly due to the fact that U.S. residents hold higher yielding assets (relative to foreign holdings of low yielding U.S. assets) and dollar depreciation has reduced the value of foreigner holdings. In a fundamental way, the housing and current account issues are related from a macroeconomic standpoint in that the current account deficit is due to low national savings, which is in turn due significantly to the fact that housing price appreciation has increased consumer wealth and thereby reduced their need to save.

It remains uncertain what will be the global implications of the slowdown in the U.S. housing market. If the weakness is confined to the housing market, then U.S. imports and thus other countries exports should be generally unaffected since housing has only a small import component. If however, declining or stagnant house prices reduce significantly equity withdrawal through refinancing then consumer spending may be negatively affected and this would likely spill over to other economies by lowering U.S. imports. In addition, if the financial problems in the U.S. subprime mortgage market remain contained within that sector then the foreign financial implications may be minor, but if the crises should spread to the broader U.S. credit market then this could spill over into global financial markets. The subprime mortgage industry provides high interest rate loans to lower income borrowers with poor credit histories. During 2006 this market of over $600 billion accounted for about one-fifth of U.S. mortgages (10 per cent of the overall stock of mortgage debt) but approximately one-half of mortgages taken out by blacks. Most of these loans begin with low teaser rates which subsequently adjust to higher rates with increases in monthly payments often in the range of 25 to 50 per cent. Currently about 13 per cent of subprime borrowers are behind in their payments but this is expected to increase as the interest rates are adjusted. Over 30 firms in this market have declared bankruptcy over the last year or had to be taken over, and even major financial institutions such as HSBC, UBS, GMAC, General Electric, and Citigroup have experienced losses in their activities related to this market. Payment problems have also begun to appear in the Alternative-A mortgage group, the next riskiest type of mortgages for questionable borrowers.

The current account deficit of the U.S. is primarily a macroeconomic problem but politically it has entered into U.S.-China bilateral trade relations; besides the question of the appropriate exchange rate, there are several other significant trade policy disagreements between these two countries including issues of intellectual property and subsidies. Noteworthy here was the U.S. reclassification of China from non-market economy status in the spring of 2007; as a result China can now be subject to countervailing duties in order to offset export subsidies and the U.S. promptly implemented this by imposing duties on coated paper products.

The Canadian economy slightly cooled in 2006 to a growth rate of 2.7 per cent and had a particularly poor fourth quarter but growth is anticipated to be about 2.5 per cent in 2007. This slowdown is due significantly to the slower growth in the U.S. which accounts for 84 per cent of Canadian exports. The policy environment in terms of monetary and fiscal policy should remain relatively neutral as growth and inflation are reasonably close to their target levels. Canada, being an exporter of numerous commodities including oil and minerals has benefited from the recent price increases for these items and this has produced a trade surplus and appreciated its currency; however, this has harmed its manufacturing sector. The slump in the construction of new houses in the U.S. has negatively impacted its timber industry.

III. Western Europe

Growth picked up considerably in Western Europe in 2006 to its best level since 2000, however it should moderate somewhat in 2007, although it is likely to remain slightly above its longer-run trend level. Eurozone GDP rose by 2.7 per cent in 2006 and was especially strong (3.3 per cent y-o-y) in the fourth quarter of the year before cooling off in the first quarter of 2007. The economic expansion of 2006 was particularly strong in Germany. Euro area growth is likely to moderate in 2007 due to the continuing appreciation of the euro (up 26 per cent against the dollar since the beginning of 2003), higher interest rates, and the slowdown in the U.S. although it seems to have weathered satisfactorily a number of recent shocks including the January increase in Germany's VAT. The non-eurozone economies of Denmark, Norway, Sweden, Switzerland, and the United Kingdom have recently performed slightly better than that of the eurozone and this is expected to continue although growth in most of these economies, except perhaps the U.K., is likely to moderate some in 2007.

Euro area unemployment has been on a downward trend for a number of years and fell to 7.2 per cent in March 2007. This is the lowest unemployment for the eurozone since Eurostat began publishing data on this in 1993; however, this is just slightly below the rate obtained at the peak of the last boom phase in 2001. Up to this point at least, the employment gains in the euro area would seem to be basically cyclical; the current recovery will need to be sustained longer with unemployment continuing its downward path before it can be concluded that the reform efforts have resulted in some fundamental improvement in the general economic malaise that has characterized the eurozone for the last two decades. Inflation in the eurozone has been moderately above the ECB's target of slightly less than 2 percent for the last several years although it achieved this target during the first quarter of 2007. Core inflation (which excludes energy and unprocessed foods) in the eurozone had been running approximately one percentage point lower than headline inflation for most of 2005 and 2006, however by March of 2007 those two had converged to 1.9 per cent. The headline rate has come down due to falling oil prices while the core rate has slightly increased due to several factors including catch-up wage increases. Inflation in the U.K. has been over a point higher than in the eurozone and reached 3.1 per cent in March 2007.

Interest rates in the euro area continued to increase over most of the last year despite the fact that inflation rates fell below the 2 per cent target for the first time in years. The ECB increased its main refinancing rate to 3.75 per cent in early March 2007 for the seventh time since December 2005 with expectations of a likely further increase to 4 per cent in June and perhaps another increase by the end of the year. The Bank of England's main interest rate has been on an upward trend reaching 5.5 per cent in the spring of 2007 with expectations of another increase sometime in the summer.

The moderately robust growth in Europe has increased tax revenues in most economies thus slightly improving their fiscal positions. The overall eurozone fiscal deficit declined from 2.4 per cent of GDP in 2005 to 1.6 per cent in 2006 with a further decline to 1.2 per cent projected for 2007. However several eurozone economies have deficits in excess of the 3 per cent limit of the Stability and Growth Pact. The budget situation has also improved in most of the other non-eurozone economies.

Financial integration within the EMU area has increased measurably over the last decade as there is now little relationship between the level of domestic savings and investment within the eurozone. There are significant capital flows from the richer areas to the poorer ones; currently the Scandinavian EU members and the Netherlands have surpluses around five per cent of GDP while Greece, Portugal and Spain have current account deficits of over eight per cent of GDP. Although these imbalances are quite large by historical standards for eurozone economies or by world standards, they do not, in general, reflect macroeconomic mismanagement nor do they pose any real vulnerability for these economies but instead reflect the way capital should flow in a financially integrated region. A further financial milestone was reached in the spring of 2007 when the total stock market capitalization of Europe’s 24 stock markets (including Russia and Turkey) topped that of the U.S. according to Thompson Financial (using more loosely defined criteria than some other financial services); Europe previously had the largest market but that was before the First World War.

IV. EU New Member States (NMS)

Economic growth in the NMS continues to be quite high averaging about 6.3 per cent for 2006 although it should moderate to about 5.7 per cent in 2007. Growth has been particularly high in the Baltic economies, especially Estonia and Latvia; Romania and the Slovak Republic have also performed well. This growth is being driven by domestic demand due to rapid credit growth and foreign investment (both FDI and portfolio flows) while the stimulus from external trade has diminished from its role in the last several years although it benefited in 2006 from the improvement in growth in Western Europe. Generally, growth has been much higher in those economies than experienced the greatest declines during the transitional recession, thus their superior performance may be due more to a bounce-back effect than to the creation of relatively better economic systems. Presently there do not appear to be any systemic problems that will significantly curtail NMS growth over the next two years although it is likely to modify somewhat as the utilization of resources approaches capacity constraints. EU assistance to the NMS under the structural and cohesion funds should provide additional resources for infrastructure development; over the previous budget period of 2000-2006, this assistance was in the range of 2 to 3 per cent of the NMS’s GDPs while it is likely to increase to about 4 per cent of GDP for the next budget cycle of 2007-13.

EU accession for Bulgaria and Romania has generally proceeded smoothly; the major adjustments have involved technical issues surrounding adoption of environmental, health and safety regulations, adjustments in tax laws (such as Romania’s registration tax for new cars) and implementing the Intrastat system for VAT payments, and output adjustments in industries which had received some trade protections (i.e., food) up until accession.

Unemployment, which has been quite significant in many of the NMS for over a decade, has finally begun to decline substantially. For example the unemployment rate in Poland has fallen from 20.6 per cent to 14.9 per cent over the last two years ending in February 2007. Throughout the region, the percentage of the unemployed that are defined as long-term remains high and this is due to the lack of employment opportunities for older unskilled men. Employment rates (per cent of those 15-64 working) remain close to or below 60 per cent for many economies; for comparative purposes this is near the bottom of the range of OECD countries. A significant factor regarding labor market adjustments in these economies is that there has been an ongoing sectoral shift in the distribution of economic activity from agriculture and industry to services; as a result there is significant structural unemployment as the workers released in the contracting sectors do not have the job skills needed for the expanding sectors. Thus there are labor shortages and unemployment at the same time. Although there has been significant migration of workers from the NMS to the EU-15, the tighter domestic labor markets, especially for some low-paid job categories, have encouraged more inward migration, often illegally, from their eastern CIS neighbors; for example there are an estimated 300,000 to 400,000 Ukrainians currently working in Poland. Although migrant workers often take jobs that domestic residents seem unwilling to take a current wages, this immigration tends to keep wage levels from adjusting upward to restore market equilibrium.

The rapid economic growth in the NMS has put upward pressure on prices with inflation averaging slightly above 3 per cent; however a component of this represents Balassa-Samuelson convergence price adjustments in the non-traded sectors. Despite the fact that inflation is currently slightly above that in the eurozone, there has been appreciation pressure on many of the NMS currencies (i.e., Polish zloty, Czech koruna, Hungarian forint) which has required central bank intervention or an official appreciation such as Slovakia's 8.5 per cent increase in the central parity rate of the koruna in March 2007 (although the currency was under attack as recently as August 2006).[3] Even the Hungarian forint, which had been under pressure in the last half of 2006, has recently appreciated against the euro. Nevertheless there are some market concerns due to Hungary's large fiscal deficit of 10.1 per cent of GDP which is the largest in the EU. The fiscal positions of most of the other NMS are in reasonably good shape as these economies attempt to move closer to complying with the Maastricht criteria in order to adopt the euro.

Although Slovenia adopted the euro in January 2007, the timetable for accession for the other NMS is progressively being pushed further into the future due principally to the difficulty in satisfying the Maastricht criteria. Government deficits and inflation appear to present the greatest challenge. Cyprus and Malta are expected to join in 2008 although both currently have debt ratios above the 60 per cent target, followed by Slovakia possibly in 2009. The Baltic economies are now targeting 2010 assuming they can reduce their inflation rates. The accession date for Poland and Hungary, both of which have fiscal deficit problems, is perhaps at least five years away. Although Bulgaria may join reasonably soon (perhaps in 2010 or 2011), Romania's accession is at least five years away. Euro accession although reducing slightly domestic macroeconomic policy flexibility is likely to be a significant positive for these economies as it will essentially eliminate the risks of balance of

[3] Slovakia has been in the ERM II since November 2005; appreciations, as opposed to depreciations, are consistent with the exchange rate stability criterion.

payment and currency crises, increase capital inflows, and lower transaction costs and thereby stimulate trade.

An area of potential vulnerability for many of the NMS concerns their relatively large current account deficits. The Baltic states and the two newest EU members –Bulgaria and Romania have deficits exceeding 10 per cent of GDP. Although the underlying pattern of foreign borrowing providing additional financing for investment is similar to that of intra-eurozone capital movements, the important distinction is that these economies currently have different currencies and thus these capital flows subject these economies to some additional risks. The Memorandum of Understanding concerning cooperation during cross-border banking crises signed in December 2006 between Sweden and the Baltic economies has provided some additional assurances for financial markets.

V. Southeast Europe

Bulgaria and Romania joined the EU in January 2007 and are now analyzed with the NMS. Despite significant uncertainty surrounding the outcome of a number of important developments such as the future political status of Kosovo, the prospects for EU membership for most of the economies in the region, or the political direction of Turkey economic growth and investment have been reasonably high in Southeast Europe. Growth moderated in 2006 to 5.9 per cent and is expected to moderate further in 2007. Growth in Turkey, the largest economy in the region, continued its five-year expansion following the financial crisis in 2001 by growing 6.1 per cent in 2006. This is that country's longest period of stable growth since 1970. This expansion, however, has also resulted in an increasing current account deficit which reached slightly over 6 per cent in 2006, relatively high inflation of slightly over 10 per cent (although it was over 40 per cent as recently as 2002), and quite high interest rates with the central bank's overnight lending rate of 22.5 per cent. The lira depreciated considerably in mid-2006 due to concerns about the current account but recovered considerably subsequently. In terms of dollar value, Turkey imported more capital in 2006 than any other emerging market economy.

Current account deficits are problematic for some of the other economies including most noticeably Bosnia-Herzegovina's deficit of 14 per cent of GDP and Serbia's deficit of 12.3 per cent of GDP in 2006; Albania's deficit was 5.9 per cent of GDP in 2006. The fiscal deficits of these economies are in reasonably good condition; Albania's projected deficit of 4.1 per cent of GDP is the largest while Turkey's budget deficit has recently worsened and is projected at about 2.7 per cent in 2007; however Turkey remains under a IMF stand-by agreement which has kept fiscal policy relatively tight. Despite solid economic growth, unemployment remains a serious problem with official rates generally above 10 per cent (9.8 per cent in Turkey) and above 30 per cent for Bosnia-Herzegovina and FYR of Macedonia. However, many of the unemployed have probably found some type of employment in the informal sector. The trend towards flat taxes so evident in the other sub-regions of the ECE has also taken hold in this region with Macedonia adopting a 12 per cent rate in January 2007. The production structures of these economies are slowly shifting from agriculture and industry to services and construction.

The Central European Free Trade Agreement (CEFTA) is undergoing a significant change in membership as it is scheduled to be expanded in May 2007 from its current membership of only Croatia and Macedonia to include Albania, Bosnia and Herzegovina, Kosovo, Moldova, Montenegro, and Serbia. It is possible that Ukraine may also join at some future date. Once implemented this agreement will replace 32 bilateral agreements but will generally not allow for free trade in agricultural items.

VI. Eastern Europe, Caucasus and Central Asia (CIS)

Growth in the CIS increased to 7.6 per cent in 2006 and is expected to remain at about 7 per cent in 2007. However, there is considerable variation in the performance of the individual economies with several (Armenia, Azerbaijan, Belarus, and Kazakhstan) having growth close to or over 10 per cent while Kyrgyzstan's was only 2.7 per cent which while low was still an improvement over its negative growth in 2005. In 2007 growth in the CIS is projected to slow down slightly in Europe and the Caucasus while increasing or remaining high in Central Asia. Russia, now the world's tenth largest economy, experienced growth of 6.7 per cent in 2006 which is equal to its average growth rate over the last seven years; Russia has now experienced its longest period of sustained growth since the breakup of the Soviet Union. Although high energy prices are an important factor, growth during 2006 was supported by healthy investment and consumption expenditures fuelled by rapid credit growth. Energy resources account for approximately one-quarter of Russian GDP and nearly two-thirds of its exports. Russia had initially used the higher tax revenues levied on its commodity exports to pay off debt and accumulate reserves but has recently begun to focus these resources on much needed infrastructure development, especially in the transport sector. Political uncertainty is likely to limit growth in several economies, especially in Ukraine during 2007 as it had previously in 2005. Despite the very favourable growth in the CIS, real income for the region is only now returning to the levels achieved before the breakup of the Soviet Union. In order for growth to become more sustainable, it will be necessary to further diversify these economies toward high valued added manufacturing and services.

The robust economic growth has slowly reduced unemployment throughout the region, reducing it in 2006 to 7.3 per cent in Russia and approximately 8 per cent in Kazakhstan; however, unemployment has not fallen throughout the region, and for instance has been increasing in Georgia despite fast GDP growth. Unemployment remains extremely high in Moldova at above 20 per cent while the official rates reported for many of the other CIS are quite low although these rates are not comparable to widely used western concepts since they are based upon the number of registered unemployed. Generally the resource intensive growth in these economies has not been consistent with significant employment creation but that appears to be changing as growth is becoming more broad-based.

Inflation in the CIS has been on a downward trend over the last five years but at 9.5 per cent in 2006 remains significant with several economies having rates above 10 per cent; expectations are that several additional economies will join this list in 2007. Given relatively moderate inflation worldwide, this region's inflation remains one of the highest in the world. Inflation in Russia fell to the single-digits (9.7 per cent) for the first time since the breakup of central planning. Inflation in the energy exporters is due both to their rapid domestic credit growth and their policy response to improved terms of trade. An increase in the price of a country's exports generally results in a real exchange rate appreciation; it is estimated that a 10 per cent increase in the price of oil leads to a 5 per cent real appreciation of the exchange rate of a typical oil exporting economy. There are two mechanisms that can bring this about, either domestic inflation or nominal currency appreciation. The CIS have chosen a middle path with some of each. In order to limit capital inflows which would put additional upward pressure on inflation and the exchange rate, Russia has maintained negative real interest rates although nominal rates rose throughout 2006. The appreciated rouble has weakened the competitiveness of its traded goods sectors but strong domestic demand has limited the damage to these sectors.

Russia and Kazakhstan continue to allocate a significant proportion of their energy export receipts into oil stabilization funds both as a way to reduce macroeconomic volatility from the oil price cycle as well as a way to provide some inter-generational equity. Russia's official foreign exchange reserves (excluding gold) have growth from only $8 billion at the end of 1999 to $357 billion by April 2007. These reserves, which are now the third largest in the world, essentially, although not de jure, provide collateral for private capital inflows and are an important factor which has contributed to the rapid increase in private sector external borrowing especially in light of the shortcomings of domestic banking. Consistent with this large increase in official reserves has been Russia's large current account balance which was approximately 9.8 per cent of GDP in 2006 and its significant fiscal balance of 5.0 per cent of GDP. In 2006, only China and Japan exported more capital than Russia. Russia has now completely repaid its foreign debt to the Paris Club countries, and Kyrgyzstan and Tajikistan, which are heavily in debt, are benefiting from debt write-offs under IMF and World Bank programs.

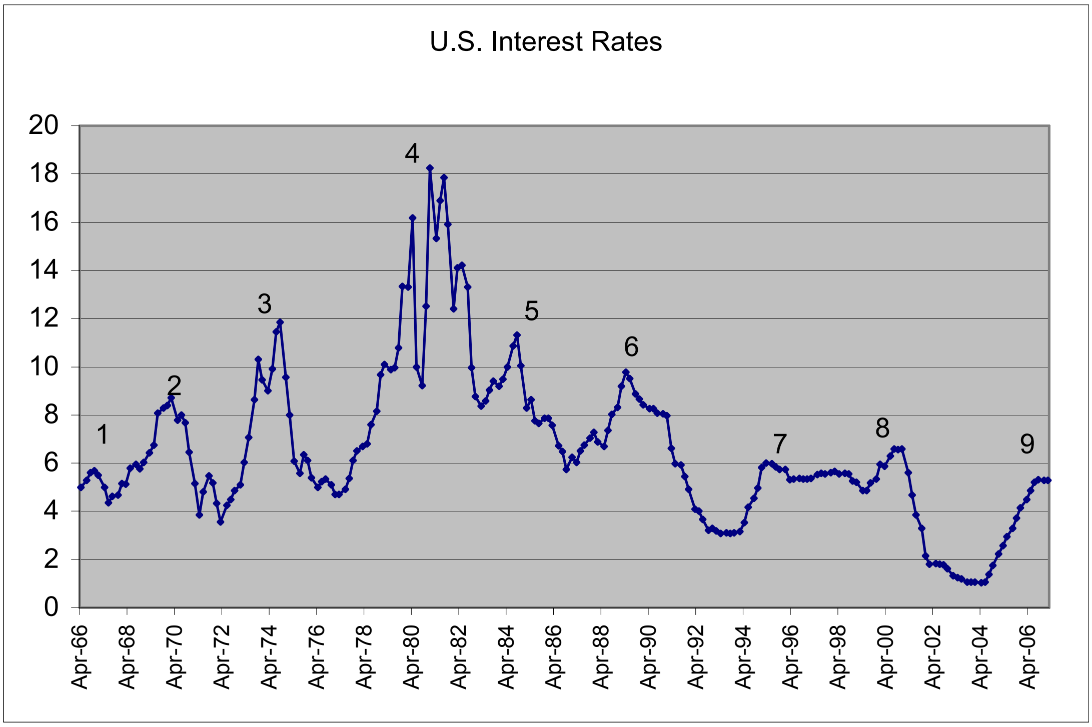
Generally there has been a tendency for the energy-rich CIS to reassert government control or ownership over their natural resources. In Russia, there has been a pullback in foreign investment in the energy sector (such as Royal Dutch Shell ceding some control to Gazprom of the Sakhalin-2 project). However inward FDI, which more than doubled to almost $29 billion in 2006, picked up especially in the consumer goods and financial sectors; overall acquisitions of Russian companies almost doubled to $13.7 billion in 2006. Kazakhstan also attracted significant FDI in its energy and financial services sectors; M&A activity totalled $7.6 billion. Kazakh authorities, as in Russia, raised environmental compliance issues against foreign energy companies, but this issue appears to have been resolved without re-nationalization of the sector although there is proposed legislation which would limit foreign owners rights in the energy sector. In Ukraine acquisitions by foreigners totalled $4.8 billion in 2006 and were concentrated in the financial sector. Renewed political crises in Ukraine may result in a repeat of the weak growth and limited investment that followed the 2004-2005 political crisis. Overall, total investment in the CIS has been about 20 per cent of GDP over the last five years which is similar to that in most other emerging markets. Russia is one of a few of the ECE emerging markets with significant outward FDI, and most of this is in economies outside of the CIS.

Currently only four members of the CIS are members of the WTO (Armenia, Georgia, Kyrgyzstan, and Moldova) while the rest are in various stages of negotiations (except for Turkmenistan); Russia is the largest economy in the world that remains outside of the WTO system. Although Russia achieved a significant milestone in 2006 by finalizing with the U.S. its last important bilateral agreement, a definitive date for Russian membership has yet to be set. Ukraine's WTO accession, which is dependent on implementation of domestic legislation, appears to be tied up in its current political dispute while accession for the remaining CIS is not imminent.

Interestingly, the four CIS economies that are members of the WTO all have significant current account deficits; the deficit in 2006 was 5.6 per cent of GDP for Armenia, 10.0 per cent of GDP for Georgia, 12.8 per cent of GDP for Kyrgyzstan, 11.9 per cent of GDP for Moldova. This situation is suggestive of the poor bargaining strength of outsiders in getting accepted into the WTO. All of the other CIS economies (except Tajikistan and Belarus) had current account surpluses. An alternative way to view the current account situation of the region is that all the resource rich economies have surpluses and all the resource poor have deficits. These deficits are due partially to the rise in the price of energy which has occurred over the last two years. Remittances continue to provide the CIS economies, especially the poorer ones, with much needed foreign exchange. For instance they are valued at over 30 per cent of GDP for Moldova and Tajikistan.

Poverty remains a significant problem in the Central Asian CIS where approximately 90 per cent of the population lives on less than $4.30 (PPP) per day, 50 per cent less than $2.15 (PPP) and 10 per cent on less than $1.08 (PPP) per day. In the Caucasus about two-thirds lives on less than $4.30 (PPP), a third less than $2.15 (PPP) per day and five per cent on less than $1.08 (PPP) per day. Even in Russia, approximately 40 per cent of the population lives on less than $4.30 (PPP) per day. Inequality (as measured by the Gini coefficient) increased rapidly after the breakup of the Soviet Union and peaked in the mid to late 1990s and has slowly declined since that time. Nevertheless inequality is significantly greater in the CIS than in the other transition economies as well as Western Europe; however inequality is not as high in the CIS as in some developing countries especially those in Latin America.

FIGURE 1



1.Gold exchange standard ends, 2.Bretton Woods ends, 3.Smithsonian Agreement fails, 4.Latin American debt crises, 5. South African, Chile, Mexico, Singapore financial crises, 6.U.S. savings and loan financial crisis, 7.Tequila crisis, 8.High-tech stock market bust, 9.Possible housing market collapse.

TABLE 1

Annual Changes in Real GDP in the ECE, 2002-2007

(Percentage change over the previous year)

	2002	2003	2004	2005	2006	2007est.
Austria	0.9	1.1	2.4	2.0	3.2	3.2
Belgium	1.4	1.0	2.7	1.5	3.0	2.5
Finland	1.6	1.8	3.7	2.9	5.5	3.0
France	1.1	1.1	2.0	1.2	2.1	2.2
Germany	0.0	-0.2	1.2	.9	3.0	2.9
Greece	3.9	4.9	4.7	3.7	4.2	3.9
Ireland	6.0	4.3	4.3	5.5	6.0	5.5
Italy	0.3	0.0	1.2	0.1	1.9	2.0
Luxembourg	3.8	1.3	3.6	4.0	6.2	4.8
Netherlands	0.1	0.3	2.0	1.5	2.9	2.9
Portugal	0.8	-0.7	1.3	0.5	1.3	1.8
Spain	2.7	3.0	3.2	3.5	3.9	3.6
Slovenia	3.5	2.7	4.4	4.0	5.2	4.5
Euro area 13	1.0	0.8	2.0	1.4	2.8	2.7
Denmark	0.5	0.4	2.1	3.1	3.3	2.5
Sweden	2.0	1.7	4.1	2.9	4.7	4.3
United Kingdom	2.1	2.7	3.3	1.9	2.8	2.7
Europe - 16	1.4	1.2	2.3	2.0	3.1	2.8
Bulgaria	4.9	4.4	5.7	5.6	6.2	5.9
Cyprus	2.0	1.8	4.2	3.9	3.8	3.9
Czech Republic	1.9	3.6	4.2	6.1	6.1	5.5
Estonia	8.0	7.1	8.1	10.5	11.4	9.9
Hungary	4.3	4.1	4.9	4.2	3.9	2.5
Latvia	6.5	7.2	8.7	10.2	11.9	10.5
Lithuania	6.9	10.3	7.3	7.6	7.5	7.0
Malta	1.9	-2.3	0.8	2.2	2.5	2.3
Poland	1.4	3.8	5.3	3.5	6.1	6.7
Romania	5.1	5.2	8.4	4.1	7.7	6.5
Slovakia	4.1	4.2	5.4	6.0	8.3	8.7
New EU members-11	3.1	4.3	5.7	4.7	6.4	6.1
EU-27	1.3	1.5	2.6	1.9	3.3	3.1
Iceland	-0.3	2.7	7.7	7.5	2.9	0.8
Israel	-0.9	1.5	4.8	5.2	5.1	4.8
Norway	1.5	1.0	3.9	2.7	2.9	3.1
Switzerland	0.3	-0.2	2.3	1.9	2.7	2.1
Europe -31	1.3	1.4	2.6	2.0	3.3	3.1
Albania	2.9	5.7	5.9	5.5	5.0	6.0
Bosnia and Herzegovina	5.0	4.1	5.8	5.0	6.0	6.0
Croatia	5.6	5.3	3.8	4.3	4.6	4.7
Macedonia, fYR of	0.9	2.8	4.1	3.8	4.0	4.5
Montenegro				4.3	6.5	6.5
Serbia [a]	4.2	2.5	8.4	6.2	5.4	5.0
Turkey	7.9	5.8	8.9	7.4	6.1	5.7
South-east Europe (non EU)	7.1	5.4	8.2	6.9	5.9	5.6
Armenia	13.2	14.0	10.5	14.0	13.4	9.0
Azerbaijan	8.1	10.4	10.2	24.3	31.0	29.2
Belarus	5.0	7.0	11.4	9.3	9.9	5.5
Georgia	5.5	11.1	6.0	9.6	9.0	7.5
Kazakhstan	9.8	9.3	9.6	9.7	10.6	9.0
Kyrgyzstan	0.0	7.0	7.0	-0.2	2.7	6.5
Republic of Moldova	7.8	6.6	7.4	7.5	4.0	4.5
Russian Federation	4.7	7.3	7.2	6.4	6.7	6.5
Tajikistan	9.8	10.0	10.1	7.3	6.8	7.2
Turkmenistan	15.8	17.1	14.7	9.0	9.0	10.0
Ukraine	5.2	9.6	12.1	2.7	7.1	5.0
Uzbekistan	4.0	4.2	7.7	7.0	7.2	7.7
CIS	5.3	7.9	8.4	6.5	7.6	7.0
Canada	2.9	1.8	3.3	2.9	2.7	2.5
United States	1.6	2.5	3.9	3.2	3.3	2.1
North America	1.7	2.5	3.9	3.2	3.3	2.1
UNECE - 52	1.9	2.4	3.7	3.0	3.7	3.1
Memorandum Items						
CIS (without Russia)	6.6	9.2	11.0	6.7	9.5	8.0
EU-15	1.2	1.2	2.2	1.6	2.9	2.8
EU NMS – 10 + 2	3.1	4.3	5.6	4.7	6.3	6.1

Source: IMF, national central banks, ECE estimates

[a] Includes Montenegro in 2002-2004