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Economic integration in the ECE region: developments and new challenges in light of the economic crisis

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Note by the secretariat

I. Mandate

1. At its thirty-ninth meeting on 16 December 2010, the Executive Committee of the Economic Commission for Europe (ECE) endorsed the provisional agenda of the sixty-fourth session of the ECE. The rules of procedure of the Commission require basic documents to be prepared in relation to the agenda items, as appropriate. This document is being submitted to support the discussion under item 2 on “Economic integration in the ECE region: developments and new challenges in light of the economic crisis” under the High-level segment.

II. The global context

2. The world economy is now recovering from the most severe financial shock since the Great Depression of the 1930s and the deepest economic downturn since the Second World War. During 2009 world Gross Domestic Product (GDP) declined for the first time in over 50 years. Despite the severity of the financial shock, the aggressive use of monetary and fiscal policy, a relatively high level of economic cooperation amongst the world’s governments, and assistance from international and regional financial institutions allowed the crisis to be contained. Without these unprecedented and quite extraordinary policy responses, in all likelihood, the world would have experienced another depression similar to the 1930s.

3. Although world GDP declined by 0.6 per cent in 2009, significant parts of the world (especially in Asia) largely avoided the worst of the crisis and were able to maintain reasonable although lowered economic growth. The advanced economies (North America, Western Europe and Japan) were particularly negatively affected, but the European

emerging economies (EEE) and the European Union (EU) new member States (NMS) were the most negatively impacted regions in the world.

4. Trade flows declined dramatically throughout the world between the autumn of 2008 and the spring of 2009 due to the decline in national incomes and to the absence of trade finance. World trade in volume terms declined by 12.2 per cent in 2009; this was the largest annual decline in over 70 years. Given that there were also significant price declines, especially for petroleum and minerals, the decline in dollar terms was approximately 23 per cent. The decline in trade flows either globally or nationally were therefore much larger than the corresponding declines in GDPs. Trade flows began to recover in the second half of 2009 and continued to do so in 2010 when trade expanded (in volume terms) by approximately 13 per cent. Trade protectionism, which characterized the 1930s crisis, was largely avoided due to the global governance of trade, primarily through the disciplines of the World Trade Organization (WTO), but also due to an appreciation of how protectionism had proven to be self-defeating in the 1930s. Trade flows were a major channel that transmitted the crisis to economies (outside North American and Western Europe) that did not own significant amounts of the financial assets whose collapsing value was at the heart of the crisis.

5. World GDP growth returned to close to its pre-crisis trend in 2010 and growth is forecast to remain at about that level for 2011 although it may decline slightly. As was the case before the crisis, growth in the developing/emerging economies is considerably higher than in the advanced economies. Given the predominance of advanced economies in the ECE region, this region will continue to experience growth rates in the coming years considerably below the world average.

6. Despite the ongoing recovery, this crisis will have significant long-term implications for living standards in much of the world and in the design and operation of both domestic and international institutions. Generally the crisis has reduced the influence of the ECE economies in global governance; for example, the G-20 has effectively replaced the G-7 as the main global body for promoting macroeconomic coordination and International Monetary Fund (IMF) board seats and quotas allocated to European countries have been slightly reduced.

7. During the height of the economic crisis in 2008-2009 international coordination of economic policy was simplified by the fact that economic stimulus was required everywhere and the need for coordination was primarily to avoid “free riders” since it can be costly for those countries implementing stimulus (i.e., higher debt levels) while the benefits would accrue to all. As a result there was a high level of global economic cooperation. However the recovery has proceeded at vastly different speeds in different countries and as a result the desired policy responses vary considerably based upon these different economic circumstances. Not only do the desired national policies now vary, but what one country views as needed from its own perspective may actually be counter-productive for countries at a different stage of their recoveries. As a result the global coordination of economic policies has become much more difficult.

8. Global imbalances are considered to be one of the root causes of the economic crisis. Although the uneven recovery (faster growth in the trade surplus economies and lower growth in the deficit economies) has temporarily reduced the size of global imbalances, once a global recovery is fully achieved it is likely that imbalances, and the vulnerabilities they create, will return to undesirable and unsustainable levels if not properly addressed with exchange rate adjustments.

III. The ECE region in global perspective

9. The ECE region has accounted for over one-half of world economic output (on a purchasing power parity basis) for over a century. However, its share of world GDP has recently fallen below 50 per cent due to the more rapid growth in the developing economies. As recently as 2000, the EU and North America each accounted for over a quarter of world output and the EEE of east and south Europe, the Caucasus, and Central Asia accounted for another 5 per cent. The world share of the EU and North America has now declined to just over a fifth each while that of the EEE has increased to 6 per cent. The share of the ECE region in world output is expected to continue to decline in the coming decade as its growth in population and per capita income are below world averages.

10. 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 and there was therefore some convergence in the per capita incomes of these regions with the United States. 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 the United States or one-half of Western Europe. However, since 1970 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 over the last 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.

11. The ECE region, composed of 56 member States, remains quite diverse. Although it contains most of the world's advanced economies, 26 (or almost one-half) of its member States have a per capita income below twice the world average, while 12 of these are below the world average and five of these are below one-half of the world average. Nine of its economies are considered as United Nations landlocked developing countries.

12. The ECE economies imported \$9.7 trillion and exported \$8.9 trillion dollars in 2008; these economies account for 60.6 per cent of world imports and 56.0 per cent of world exports (using 2008 data as 2009 data is distorted by the significant trade declines associated with the global economic crisis). The world shares by major ECE geographical subregion are: North America accounts for 16.1 per cent of imports and 11.1 per cent of exports, Europe (including Turkey and Israel) accounts for 41.6 per cent of imports and 40.4 per cent of exports, and the Commonwealth of Independent States (CIS) (plus Georgia) accounts for 2.9 per cent of imports and 4.5 per cent of exports.

13. Over the last three decades, growth in the advanced ECE economies has been relatively slow compared to other world regions and to their own post-World War II historical experience. In many of these economies, income and wealth inequality has increased; in particular, the income of the very rich has grown significantly above the average. Thus the economic models of these economies have been unable to produce strong economic growth while maintaining or increasing the degree of equity. Nevertheless, the levels of income and equity are among the highest in the world.

14. An important consideration in evaluating national economic policy is the degree to which the country's national income is successfully used to promote the economic welfare of its population. Economic welfare remains a normative concept but there are numerous ongoing attempts to formalize its measurement. The most important factor in determining its level is generally believed to be that of per capita national income. Additional considerations include a high degree of income, gender and ethnic equality, and high levels of education, leisure and health care (including life expectancy). Numerous attempts have been made to quantify economic welfare including that of the United Nations Development

Programme (UNDP) Human Development Index. Generally, these studies have concluded that the high-income advanced economies of the ECE region, especially the Nordic economies, have achieved the highest levels of economic welfare. After controlling for the level of per capita income, the NMS and the EEE are generally found to have high levels of economic welfare. However, somewhat paradoxically, surveys asking residents to rate their own happiness find that the European emerging economies do poorly after controlling for their level of per capita income.

15. The advanced ECE economies are the main global sources of outward foreign direct investment (FDI). The ECE economies accounted for almost \$1.5 trillion in FDI outflows or over 76 per cent of the world's total FDI outflows in 2008. In 2009, total ECE FDI outflows declined by almost half to \$780 billion. Of the world's top 20 sources of FDI, 15 are ECE economies. The United States is the largest source of FDI in the world, followed by France. In addition, Russia is a major source of outward FDI; in terms of both recent annual flows and in the level of FDI stocks, Russian outward FDI is similar in size to that of China. The ECE economies were the destination for almost \$1.1 trillion of FDI inflows in 2008; this represented over 61 per cent of world FDI inflows. The United States is the largest recipient of FDI inflows in the world; Russia is the second largest emerging economy recipient after China. Overall, the ECE region is a net investor (i.e., outflows minus inflows) of FDI for the rest of the world and in 2008 supplied approximately \$400 billion of net FDI to the rest of the world. The European emerging economies are also a net recipient of FDI with their inward FDI stock almost twice the level of their outward stock.

16. Although significant progress has been made towards achieving the Millennium Development Goals at the global level, the economic crisis has set back progress in some countries for some of the targets. As a result the developing countries remain especially dependent on official development assistance (ODA) from the advanced economies to get back on track. The ECE economies account for 89.4 per cent of total Development Assistance Committee (DAC) net official development assistance and it is therefore their ability to maintain or increase assistance over the next several years that will be critical. The ODA/GNI (Gross National Income) target for 2010 of .34 committed to at Gleneagles G8 meeting and at the United Nations Millennium +5 Summit was not achieved due to a number of reasons including most likely the economic crisis. Particularly important in the failure to achieve this target was the failure by the EU to achieve its target of .59 as it provided only .48. Despite missing this target however, the EU still provides a higher percentage contribution than the non-EU members (except Norway).

IV. The economic and financial crisis in the ECE region

17. Of the five United Nations regions as defined by the regional commissions, the ECE region was the most negatively impacted by the financial crisis. Real growth for the region declined from 3.2 per cent in 2007 to 0.9 per cent in 2008 to minus 3.7 per cent in 2009 and recovered to 2.5 per cent in 2010. However 10 or slightly less than a fifth of the region's economies continued to experienced negative growth in 2010. The current forecast is for growth of 2.3 per cent in 2011 rising to 2.8 per cent in 2012.

18. Of the three subregions of the ECE (Western and Central Europe, North America and the European emerging economies-EEE), the decline in GDP growth was the largest in the European emerging economies both in terms of its actual level in 2009 which was -6.2 per cent and in terms of the decline relative to recent historical experience; the growth rate in 2009 was 13.8 percentage points less than the five-year average of 2003 to 2007. Western and Central Europe (which includes the NMS) had a growth rate of -4.0 per cent in 2009 which represented a change of -6.6 percentage points from 2003–2007. North America was the least impacted ECE subregion with growth of -2.6 per cent in 2009 which

represented a decline of 5.4 percentage points from the 2003–2007 average. Despite the fact that the emerging economies were the most severely affected subregion, eight of these economies had positive growth in 2009; Poland and Israel were the only remaining ECE economies in the other two subregions to have positive growth in 2009.

19. The ECE region's moderate recovery in 2010 is forecast to continue into 2011 and no widespread double-dip recession is expected. This pattern of growth is consistent with the Organization for Economic Cooperation and Development (OECD) composite leading indicators that point to continued expansion. Nevertheless, many of the region's economies will not return to their pre-crisis income level peaks (generally in 2008) until mid-2011 or 2012. The economic recovery for the region will be moderate due to the effects unemployment will have on constraining consumer expenditures, the need for governments to withdraw fiscal stimuli prematurely because of rapidly increasing debt levels, and due to the fact that the financial systems in these economies remain partially impaired as they recapitalize and de-leverage. Growth for the EEE is likely to be stronger than in the ECE advanced economies but they are bouncing back from steeper declines; the outlook for these economies is especially sensitive to global economic developments.

20. Although the NMS and the EEE experienced a very serious crisis in 2009 with some large GDP declines, this crisis was not even close to the severity of the economic decline experienced in the 1990s during the transition from planned to market economies. All but a few of these economies will have higher real GDP by mid-2011 than prior to the crisis in 2008 while many of these economies needed over 15 years to get back to their 1989 pre-liberalization levels during the transition crisis. However, Russia and many of the CIS economies were more negatively impacted by the recent crisis than by the 1998 Russian currency crisis and sovereign default.

21. The severity of the crisis in the NMS and the EEE was due to a number of significant vulnerabilities that had developed in many of them. These included extremely large current account deficits, large amounts of short-term external debt (i.e., bank loans), rapid credit growth which was especially problematic given that banks had quite limited credit histories for many of their borrowers, a high share of foreign-currency denominated loans, fixed exchange rates in some, and housing and asset bubbles. The one fundamental vulnerability often associated with a crisis which these economies did not have was either a large fiscal deficit or a high level of sovereign debt. In order to promote future financial stability, current economic policy should ensure that these vulnerabilities do not reappear as the recovery proceeds.

22. During the crisis, unemployment rose in most of the ECE economies throughout 2009 but stabilized in the early part of 2010; in the United States and the EU the rate peaked at slightly over 10 per cent while it was close to, but slightly below, that in the largest emerging economies. However, unemployment exceeded 15 per cent in Estonia, Georgia, Latvia, Serbia, and Spain and 30 per cent in Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia. The forecast is that unemployment rates in most of the ECE will remain significantly above trend for another three to four years. The human costs of these high levels of unemployment will further increase as unemployment insurance is exhausted and as households deplete their savings. Given the declines in GDP that did occur, the declines in employment were greater than what would be expected in the United States and smaller than expected in Western Europe. Thus, although the decline in GDP was lower in the United States than in the eurozone, unemployment increased more in the former. This was due largely to the differences in labour market flexibility between the subregions. However, some European countries such as Germany, Italy and the Netherlands implemented a number of emergency or short-term labour market policies whose intent was to minimize job losses and a number of these proved to be quite successful. For instance, Germany experienced little change in unemployment as the rate in the spring of 2010 was

similar to the rate two years earlier. The increase in unemployment in Russia was also quite small given the large decline in GDP.

23. Inflation in the ECE advanced economies and many of the NMS generally remains below central bank targets of around 2 per cent due to economic weakness. However, consumer prices in the eurozone have recently been increasing with prices at the end of 2010 being 2.2 per cent higher than a year earlier (and thus above the European Central Bank (ECB) target). Concerns about the potential for future inflation have been accumulating due to the rapid growth of central bank liquidity and rising global commodity prices. Inflation rates in the EEE are generally in the higher single digits; these rates are more typical for these economies and represent their current and expected faster economic growth. In addition, the higher global commodity prices are likely to have a greater impact on inflation in these economies since food prices represent a much higher percentage of their consumption expenditures.

24. Real trade (in volume terms) declined throughout the ECE region in 2009 compared to 2008 levels due to the economic crisis. North American exports declined by 15 per cent while imports declined by 17 per cent; European exports and imports both declined by 15 per cent; CIS exports declined by 5 per cent while imports declined by 26 per cent. Although the real decline in CIS exports was relatively small, the nominal decline was quite large due to the collapse in oil prices. Thus for example, Russian exports declined by 39 per cent in dollar terms in 2009. During 2010 trade rebounded but for many of the ECE economies had yet to get back to pre-crisis levels by the end of the third quarter of 2010; extra-EU exports have grown much faster than intra-EU exports due to the economic weakness in that region.

25. The fiscal budget and debt situation of the region's advanced economies has deteriorated considerably and in some cases has become problematic due to the discretionary stimulus measures implemented but more importantly to the automatic stabilizers which resulted in declining tax revenues and increases in mandated income support measures. In some cases governments felt obliged to assume the debts of their private financial sectors in order to stabilize their financial markets. Sovereign debt levels have become particularly worrisome since the crisis related debt has been added on to the already projected long-term fiscal deterioration anticipated due to demographic developments unless there are significant changes in pension and tax policies. Significant market uncertainty exists as to whether the sovereign debt levels in some of the most severely impacted eurozone economies represent just a liquidity problem or a more serious solvency problem.

26. A number of ECE economies benefited enormously from external assistance provided by numerous multilateral organizations including the IMF, the European Bank for Reconstruction and Development (EBRD), and the European Union. As is generally the case, this assistance was contingent on the countries agreeing to implement certain policies or achieving certain targets. The IMF having received considerable criticism for the severity of its conditionality for the Asian economies during the 1998 crisis relaxed considerably its conditionality. Nevertheless its policies generally required some tightening of the existing macroeconomic policy of the recipient country. Many of these programmes, especially those for the NMS were done jointly with the European Union. Generally it seems that the EU pushed for stronger conditionality than the IMF in these joint programmes. During the crisis, 16 of the region's economies were forced to turn to the IMF for some form of assistance; this included several countries from each of the subregions including three advanced economies, four of the NMS, seven in the CIS and two in South-East Europe.

27. There was significant concern during the 2008–2009 crisis about the fact that the banking systems in many of the NMS and South-East Europe had a high level of foreign

ownership. There was the potential that the parents could have drained liquidity out of these economies to store up their parent operations. However that did not happen and it has now been concluded that foreign ownership generally proved to be a stabilizing influence. To some degree this was due to the assistance these financial systems received from the IMF, EBRD, World Bank, and the European Investment Bank under the Vienna Initiative. Nevertheless foreign ownership does pose a possible systemic risk as has happened again in South-East Europe with the Greek debt crisis (as Greek banks have a market share of about 20 per cent in South-East Europe); thus how to obtain the maximum benefit from international financial integration while minimizing risks remains a challenge for policy makers.

28. Despite the severe economic downturn during this crisis, political and social stability were generally maintained throughout the region, although there were some disturbances in some of the most impacted economies. Therefore the situation was considerably different from what developed in the 1930s. This was due importantly to the well-developed social safety nets that have been created in these economies and the fact that governments were able to contain the economic declines by aggressively using macroeconomic counter-cyclical policies.

29. Although there are a variety of underlying causes of the recent financial and economic crisis, a central factor was that the financial authorities in the ECE advanced economies failed to properly regulate their financial industries. In the aftermath of the crisis, extensive regulatory changes have been implemented that should reduce the likelihood of a similar crisis in the future. However, in many cases the strongest or most extensive proposals were often times not implemented over concerns about how they might impact the competitiveness of a country's financial sector. A higher degree of regulatory harmonization achieved through better international cooperation could have reduced these concerns and produced a more stable financial sector.

30. The financial crisis highlighted several deficiencies in the institutional design of the EU and in particular in the design of the eurozone. At the most general level economic coordination amongst its members proved inadequate for crisis management. A centralized fiscal authority plays a central role in maintaining internal equilibrium in a currency union but that does not exist in the eurozone. Having a central bank that can act as lender of last resort can be a stabilizing influence during crisis periods; however, the ECB is not authorized to carry out this function. The underlying logic in the design of the eurozone was that internal imbalances would primarily result from mismanaged public accounts but the crisis has demonstrated that the private sector can often create large imbalances even when government finances are prudent. Also, the eurozone has no mechanism for correcting internal current account imbalances other than deflation in deficit economies; this is a process that can lead to long periods of high unemployment and can therefore be quite costly. Additional issues, such as how to achieve financial market integration while financial market regulation remained essentially national raised some fundamental issues about how the EU was or should be designed.

31. A significant vulnerability for many of the non-resource rich EEE prior to the crisis were large current account deficits due to these economies dependence on foreign savings to finance their development. These current account deficits narrowed quite significantly and rapidly once the crisis hit. The average for the NMS moved from approximately 12 per cent of GDP in 2007 to roughly balance in 2009. The adjustment in the current account deficits of the Baltic economies has been exceptionally large. The NMS and South-East Europe (SEE) current account deficits are forecast to remain reasonably low and would therefore appear to be sustainable. This is due to the expectation that capital inflows to these regions will be considerably smaller in the future than they were before the crisis. This will require a structural change in their underlying growth models from an emphasis

on externally financed consumption and investment to domestically financed export production.

32. For those economies whose growth in the future will need to be more export-led, policy initiatives are needed that can facilitate that adjustment. These include further trade liberalization (along with WTO accession for non-members), improvements in infrastructure, education and skill levels, promotion of domestic innovation, streamlining border crossing procedures, the computerization, simplification and harmonization of custom documents and procedures, and improvements in the investment climate (including strengthening intellectual property rights) that can attract foreign investment that can bring in managerial and technological expertise. In some of these economies unit labour costs rose too fast during the boom period prior to the crisis and adjustments are now needed; this can occur through currency depreciation where possible, deflation or increased productivity growth.

33. For the CIS-resource rich economies which had large current account surpluses which averaged 15 per cent of GDP in 2008, these surpluses declined to only 3 per cent in 2009. As world growth has picked up the surpluses have began to increase again and the IMF forecast that by 2013 they may average about 10 per cent of GDP which was their level in 2006. To continue to develop these economies need to diversify their export baskets into high value-added and employment-generating activities.

34. For a number of the EEE remittances are a very significant component of gross national income. In 2009 remittances were officially reported greater than 10 per cent of GDP for Albania (10.9 per cent of GDP), Bosnia and Herzegovina (12.7 per cent), Republic of Moldova (23.1 per cent) and Tajikistan (35.1 per cent); other estimates for years prior to the crisis have generally found that remittances were above 10 per cent of GDP in a number of other ECE economies including Armenia, Georgia, Kyrgyzstan, and Uzbekistan. In fact for some of these economies remittances represent a larger financial inflow than either private capital flows or foreign assistance. In the CIS 31 million people have emigrated to work in another country. Remittances, especially from Russia fell by over 30 per cent (or 39 per cent from trend) during the peak of the crisis and were a major channel by which the crisis spread to some of these economies. In 2009 remittances shrank by 36 per cent in the Republic of Moldova, 28 per cent in Kyrgyzstan and 31 per cent in Tajikistan. Remittances modestly rebounded in 2010 but remained well below 2008 levels. Remittances are far less important, but still significant for many of the NMS.

V. Economic integration and competitiveness in the ECE region

35. The ECE economies have extensively pursued economic integration both globally and regionally; as a result their trade to GDP ratios have been increasing consistently over the previous two decades. Although this has produced significant growth in GDP, it has also resulted in the loss of national autonomy in a number of economic areas to the more general forces of “globalization”. Global integration has occurred primarily under the trade liberalization rounds under the auspices of the WTO; completion of the currently stalled Doha negotiations remains a key stated objective of most of the ECE economies. Generally periods of economic stress with high levels of unemployment are not considered conducive for further trade liberalization.

36. Currently the WTO has 153 members which account for 96 per cent of world trade. However, seven of the CIS economies (Azerbaijan, Belarus, Kazakhstan, Russia, Tajikistan, Turkmenistan, and Uzbekistan) and three of those in South-Eastern Europe (Bosnia and Herzegovina, Montenegro, and Serbia) have yet to gain accession to the WTO.

Russia is the largest ECE emerging economy and the only G-20 country not in the WTO. This has been a significant factor that has limited the integration of these former transition economies into the world economy. Russia has concluded agreements that address most of the substantive economic issues for membership and if some remaining largely political issues can be resolved its accession would appear to be imminent.

37. Within the ECE, regional integration has occurred significantly due to the creation of preferential trade agreements; all of the ECE economies are partners in at least one preferential trade agreement. These include in Western Europe the European Union and the European Free Trade Area (EFTA), in North America the North American Free Trade Agreement (NAFTA), in South-East Europe the Central European Free Trade Agreement (CEFTA), and in the CIS there are several institutional frameworks including the CIS, the Eurasian Economic Community (EurAsEC) and the Economic Cooperation Organization. Within the EEE almost one-half of trade is between preferential trade agreement (PTA) partners (compared to a world average of one-third) but in some cases these agreements are poorly implemented. In some cases there is some preferential arrangement between these different regional trade blocs such as between the EU and CEFTA, but generally these different preferential areas are integrated primarily on a multilateral non-discriminatory basis under the WTO. For example there is no preferential arrangement between the United States and the EU.

38. All the (former) transition economies were integrated under the CMEA (Council of Mutual Economic Assistance) which was preferential by its nature. However, since 1989 the three regions of the NMS, SEE and the CIS have developed along separate paths and pursued integration within each region but integration between the regions has been minimal. This is especially true between the SEE and CIS, although the Republic of Moldova is an exception. SEE and the CIS have significantly different economic fundamentals and different political and economic objectives regarding trade. In South-East Europe the chief objective has been to re-integrate into the European region and prepare for EU accession; in the CIS a chief objective has been to re-establish the extensive trade links that existed under the Soviet Union as a way to promote economic industrialization especially into high-value-added manufactures. As a result there are large differences in the nature and structure of the regional trade initiatives that have developed in these two regions.

39. The economies in the ECE trade extensively with the other ECE economies. Over 78 per cent or almost four-fifths of exports from ECE economies go to another ECE country. This percentage was stable between 2002 and 2008, although it declined slightly to 76 per cent in 2009 due to the unusual trade developments associated with the financial crisis. During 2008, 82 per cent of the exports of the EU-17 (the EU-15 plus Malta and Cyprus) went to another ECE economy; the percentage of exports to the ECE economies for the other subregions were: 94 per cent for the NMS-10, 57 per cent for North America, 94 per cent for South-East Europe, 84 per cent for the CIS, and 79 per cent for the remaining ECE economies.

40. As a result of this pattern of preferential trade agreements and the importance of geographical distance in determining trade, trade within the ECE's subregions dominates trade between subregions. For example in 2009, 72 per cent of European exports went to other European partners, and 48 per cent of North American (including NAFTA member Mexico) exports stayed in North America; the CIS is somewhat of an exception as only 19 per cent of its exports stay in the CIS. Only 7 per cent of Europe's exports go to North America while 18 per cent of North America's exports go to Europe. Nevertheless, the EU and the United States are each other's largest export market. Trade between North America and the CIS is quite limited; only 5 per cent of CIS exports go to North America while less than 1 per cent of North American exports go to the CIS. With United States-Russian

bilateral trade, neither economy is a top ten destination for the other's exports. Only 3 per cent of Europe's exports go to the CIS although 53 per cent of CIS exports are destined for Europe; the EU is Russia's largest import source and export destination. Also intra-regional trade within the CIS has been declining in importance; for example Russian imports from the other CIS has declined from 25.6 per cent of its imports in 2000 to only 13.7 per cent in 2008.

41. Unilateral preference programmes established by the advanced economies for the developing/transition economies are termed a Generalized System of Preference (GSP). Within the ECE, the United States, EU, Canada, Norway, Switzerland, Russia and Turkey have such programmes. Except for the Russian and Norway programmes, most of the EEE are GSP beneficiaries (or eligible for even better programmes as with the EU and its Stabilization and Association Agreements with South-Eastern Europe or its Autonomous Trade Preferences with the Republic of Moldova). Preferences are provided for only a limited set of goods, perhaps only a third to an half of products are usually covered. Although these programmes do not require reciprocity (i.e., tariff concessions by the developing/transition countries) they often do have some criteria that must be satisfied. For example currently Belarus, Tajikistan and Turkmenistan are not eligible for the United States GSP due to concerns over intellectual property or labour standards. The EU withdrew GSP eligibility for Belarus over labour standards.

42. The eurozone increased to 17 members by adding Estonia on January 1, 2011. All the remaining NMS are obliged to join sooner or later; whereas at present none of the remaining NMS meet the entry requirements. Some of them have pegged their currencies to the euro for a number of years and would likely benefit from accession as it would likely further reduce interest rates and increase FDI levels. The NMS with flexible exchange rates (Czech Republic, Hungary, Poland and Romania) benefited from their ability to depreciate as a useful substitute for wage flexibility during the global economic downturn. Longer term, these countries are likely to join the European Economic and Monetary Union (EMU) after they achieve higher productivity levels and nominal price convergence. The United Kingdom of Great Britain and Northern Ireland, also outside of the eurozone, also benefited considerably from its ability to depreciate its currency versus the euro.

43. There are currently 5 EU candidate countries, one of which (Iceland) decided to apply for membership in the wake of a massive financial destabilization hitting its relatively small economy in 2008–2009. The remaining candidate countries (Croatia, Montenegro, The former Yugoslav Republic of Macedonia and Turkey) started their accession process earlier. Croatia may well become the twenty-eighth EU member in 2011. The remaining SEE countries (Albania, Bosnia and Herzegovina, and Serbia) continue to pursue EU membership; currently Albania has a Stabilization and Association Agreement (which generally includes duty-free and quota-free trade for most industrial and agricultural products) while Bosnia and Herzegovina and Serbia have more limited Interim Trade Agreements while they wait for the Stabilization and Association Agreement (SAA) process to be completed.

44. The EU and Turkey have a customs union but it does not cover some sectors such as agriculture, services or public procurement although negotiations are underway to expand the coverage into these areas. The EU-Turkey Customs Union agreement specified that Turkey would harmonize its industrial standards with the technical norms established by the EU law (*acquis communautaire*). The Customs Union has resulted in a rapid growth of mutual trade and accelerated the modernization of Turkish industry, improving its external competitiveness and export performance. Turkey has also signed free trade agreements with four of the members of CEFTA (Albania, Bosnia and Herzegovina, Croatia, and The former Yugoslav Republic of Macedonia), EFTA (Iceland, Liechtenstein, Norway, and Switzerland), Egypt, Georgia, Israel, Morocco, Syria, Tunisia, and the Palestinian

Authority. Turkey is in negotiations with the other Mediterranean countries to create a Euro-Mediterranean Free Trade Area. The EU has granted the Republic of Moldova essentially duty free access for non-agricultural products referred to as Autonomous Trade Preferences (ATPs) as part of its European Neighbourhood Policy (ENP)

45. CEFTA eliminated or reduced significantly tariffs on the goods of the participating countries but does not abolish customs controls at common borders; it has largely eliminated a complex web of bilateral agreements that were confusing and difficult to implement. The Agreement has been signed by Albania, Bosnia and Herzegovina, Croatia, Republic of Moldova, Montenegro, Serbia, The former Yugoslav Republic of Macedonia and the United Nations Interim Administration Mission in Kosovo. CEFTA aims to expand trade in goods and services, foster FDI, protect intellectual property rights in accordance with international standards and harmonize competition rules and state aid. It also includes well developed procedures for dispute settlement. The Agreement conforms to the rules and procedures of WTO and EU regulations and provides a framework for the contracting Parties to prepare for EU accession (the founding CEFTA members are now all in the EU).

46. Following a number of unsuccessful attempts to establish a customs union on the territory of the CIS, three CIS countries (Belarus, Kazakhstan and Russian Federation) finally implemented one by establishing a common customs code in July 2010 and have further committed to remove all customs borders within their territories in July 2011. A key challenge will be to ensure that the Customs Union Commission of the three countries becomes an effective dispute settlement mechanism without which no customs union can succeed. In addition to the customs union, the governments of the Russian Federation, Kazakhstan and Belarus have declared their intent to deepen mutual economic integration by establishing the common economic space in 2012. These countries have also agreed in principle to harmonize a number of technical, sanitary and phytosanitary standards which will be similar to those of the EU as Russia has already harmonized these standards with the EU.

47. Historically, the successful creation and maintenance of preferential trade agreements has depended significantly on the underlying nature of the partner's trade flows. That being the degree to which trade is in manufactured products versus commodities, the degree to which trade is balanced overall or by sector (i.e., the level intra-industry trade), the similarity in the quality of goods, the geographical distribution of trade prior to an agreement, the type of currency arrangements amongst the partners, and the nature of their political relationships, etc. Generally trade flows in the CIS do not have the characteristics that trade had in Western Europe before the creation of the European Community and thus there are numerous reasons why the EU's experience may not provide a particularly relevant example for the CIS countries to try to emulate. More specifically, trade within the EU was at its creation and currently is primarily in manufactured goods while trade within the CIS is primarily in commodities. In addition in the EU a significant amount of a country's exports and imports are of roughly the same product (i.e., a high level of intra-industry trade) while that is not the case for trade within the CIS. These differences in the structure of trade have important implications for the suitability and design of a regional trading agreement.

48. Economic integration amongst Central Asian countries remains limited due to a number of institutional and economic factors. Although there are a number of broad regional initiatives, including those administered by the CIS, the Eurasian Economic Community, and the Economic Cooperation Organization, trade agreements in the region are generally bilateral, differentiated, and overlapping. This has created a "spaghetti bowl" effect where the entangled trade policy rules are often very complicated, conflicting and confusing which makes them hard to implement. These regional agreements attempt to link together a varied trade landscape with different levels of liberalization which varies from

the very liberal in Kyrgyzstan to fairly liberal in Azerbaijan, Kazakhstan, and Tajikistan, to quite restrictive in Uzbekistan. Trading opportunities are further limited by inadequate trade finance capacities. In addition, the physical infrastructure developed prior to 1990 was centralized in a hub and spoke structure with most of the SPECA countries being spokes with connections to the hub but not among one another. Projects are gradually being put in place to create connections between these former “spokes” but there is still much work to be done and the lack of adequate physical infrastructure is an additional barrier to intra-regional trade.

49. As a result of the above factors, intra-regional trade remains limited, representing less than 10 per cent of Central Asian countries’ total trade. Moreover, state-owned companies continue to generate the bulk of this trade, often under intergovernmental agreements that involve a select range of capital goods and energy resources. This has rendered a situation whereby products that rank high on the United Nations Special Programme for the Economies of Central Asia (SPECA) countries’ exports to the rest of the world, such as fruits, vegetables and vehicles, are largely excluded from intra-regional trade flows. At the same time, exports remain geographically concentrated in a narrow range of countries, namely China, France, Germany, Italy, the Russian Federation, and the United States which together, account for 62 per cent of SPECA countries total exports of goods.

50. To reverse these trends, the SPECA countries adopted a common framework for fostering intra-regional trade at the end of their Ministerial Conference, Aid-for-Trade Road Map for SPECA Ministerial Conference, held in Baku on 1–2 December 2010. The framework, as set out in the Ministerial Declaration, seeks to create dynamic synergies between national and regional trade policies, in addition to also achieving greater inclusion of SPECA countries in the global economy and the WTO-led Aid-for-Trade (Aft) initiative. Other than Afghanistan, the other SPECA countries (all ECE members) have up this point been largely excluded from the Aft initiative. To provide for proper follow-up monitoring and support of trade development initiatives, the conference launched a SPECA Regional Aid-for-Trade Implementation and Monitoring Council (SPECA Aft Council). The Council, working closely with the SPECA Project Working Group on Trade, will bring together beneficiary countries, multilateral and bilateral donors and United Nations agencies working on trade issues, to ensure that all regional trade development priorities identified by SPECA countries are adequately supported by projects and funding.

51. Although trade integration has benefited from preferential trade agreements, it depends critically on the extent and quality of physical infrastructure, including especially the transport infrastructure. For instance, the European Commission supports infrastructure development in the NMS with the aid of targeted transfers from the EU budget and low-cost credits provided by the European Investment Bank. The Commission also coordinates the development of principal transport corridors in the trans-European region. ECE has complemented the EU coordination of transport corridors by extending them to the CIS and adjacent countries with the aim of developing efficient Euro-Asian transport linkages. These linkages include a number of strategic road and rail routes as well as key terminals.

52. Transport costs are especially high in CIS countries because they are disadvantaged geographically, being either landlocked, outside the main trade routes, or having a low density of economic activity (as in Central Asia). In addition, they lack modern infrastructure and have fragmented transport markets that prevent economies of scale. Generally there appears to be a “virtual border” between central Europe and the CIS with transport times and costs per kilometre continuing to rise as one goes further eastward. The average speed of rail transport (which accounts for 90 per cent of CIS freight transport) is 60km/hour in the EU versus 45km/hour in the CIS, while the differential is even greater for truck transport (70km/hour in the EU and only 37.5km/hour in the CIS). The current institutional structure of the transport network in Central Asia is an important source for

these higher transport costs. The relatively low levels of railway labour productivity indicate that there is a considerable scope for improvement in a number of ECE emerging economies. This includes the ownership structure as well as their pricing policies. To the degree that this aspect of the problem is man-made, it may be more amenable to policy action.

53. Good infrastructure is necessary but not sufficient for reaping the benefits of trade. Trade and transport facilitation within regional entities and at their external borders are equally important. The WTO plays a key role in the facilitation of international trade in goods and services and the ECE complements this by administering 57 United Nations legal instruments for the facilitation of international transport and the reduction of trade barriers. A proper implementation of a number of these instruments would help reduce the currently high trade costs in the CIS.

54. Trade in many of the CIS is hampered by burdensome administrative costs; this includes the large number of documents required for exporting and importing. Most of the Western European countries require about three to five documents to import or export a standardized cargo of goods. However Azerbaijan requires 14 documents for importing, while Kazakhstan requires 10 for exporting. The World Bank's Doing Business report ranks countries in terms of the ease of trading based upon the time and difficulty (i.e., number of documents, etc) in obtaining customs clearances. In its 2009 report four (Azerbaijan, Kazakhstan, Tajikistan, and Uzbekistan) of the 10 most difficult countries in obtaining customs clearance are in the CIS. Differences in technical standards also act as technical barriers to trade; the creation of common standards or acceptance of the principle of mutual recognition of the others' standards would contribute to improving export opportunities and lowering the costs of imports. The failure to make more progress is often blamed on special interest groups, poor governance, corruption, or simply the failure of national governments to focus attention on these issues. Nevertheless in recent years a number of governments in Europe and Central Asia were able to reduce significantly the time and cost of trading across borders with the aid of reforms that improved customs procedures. Such countries include a number of EU member States (Latvia, Lithuania, Portugal, Slovakia, Spain), SEE countries (Albania, Bosnia and Herzegovina, Croatia, Montenegro, The former Yugoslav Republic of Macedonia) and CIS countries (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Ukraine).

55. Economic integration for the landlocked ECE economies has benefited from progress in reducing border crossing and transport costs associated with moving goods through neighbouring or transit countries to reach other destinations. One of the key agreements that facilitate this is the International Road Transport Convention (TIR) which the ECE administers. The TIR Convention is global in its scope and all of the ECE economies are contracting parties except Iceland (although the Convention is not applied in North America). Essentially this allows a container to be sealed in the exporting country and remain unopened until it arrives at the importing destination.

VI. Additional gender and competitiveness considerations

56. Maximizing economic output and increasing competitiveness in global markets require that all labour resources be fully and efficiently used. Macroeconomic policies to ensure full employment are essential as are policies that target the elimination of any form of ethnic and gender-based obstacles and market distortions such as job discrimination and occupational segregation. Across the ECE region, women tend to have lower economic activity rates than men, are concentrated in fewer occupations, work fewer hours in paid employment (due to higher prevalence of part-time working) and have more career interruptions, largely due to care responsibilities. These differences not only result in lower

economic output but also raise equity issues as they contribute to lower earnings (gender pay gap) and slower career progressions which accumulate over a lifetime to lower pensions in old age.

57. National income and living standards in the ECE region could be increased if women's participation in formal employment were increased and if women's employment was not concentrated in a small number of often low-paid occupations. The adult employment-to-population ratio (aged 25 and above) in 2008 in the ECE was 51 per cent for women and 69 per cent for men. Half of all working women in the EU are concentrated in either education and health (34 per cent) or wholesale and trade industry (17 per cent) while half of all working men are concentrated in manufacturing (22 per cent), wholesale and retail (14 per cent) and construction (13 per cent). This gender segregation of women and men in the labour market reflects gender stereotypes in education and the prevailing gender roles in society. Educational choices are strongly gender-biased: women represent the large majority (three-quarters) of tertiary students in health and welfare related subjects but are a minority (one-quarter) in engineering, manufacturing and construction. One area for which gender parity has been largely achieved in the ECE region is women's completion of schooling; in fact, women have started to outnumber men in tertiary education.

58. Technological advancement will be the key factor in determining the degree to which living standards in the ECE will increase in the coming decades. There are numerous policies that can be implemented to create and apply new technologies in order to create more dynamic and competitive economies. Foremost is improving the educational levels of the population; education has a significant public goods component and thus requires significant public funding. Public funding for research and development (R&D) is also often required due to its public goods nature or the externalities involved; taxes and subsidies can be used to increase private sector R&D. Given the extensive changes in industrial structure that will be required to deal with climate change in the coming decades, policies to enhance innovation need to be framed within a technological framework that recognizes these climate and energy related considerations. The European Union's Europe 2020 Strategy for Jobs and Growth appears to address these issues and provides a framework for other economies to consider; however, implementation will be a key since the objectives in its previous Lisbon Strategy were largely not achieved.
