Part I

Outlook: Through Financial Turbulence to Sustained Growth

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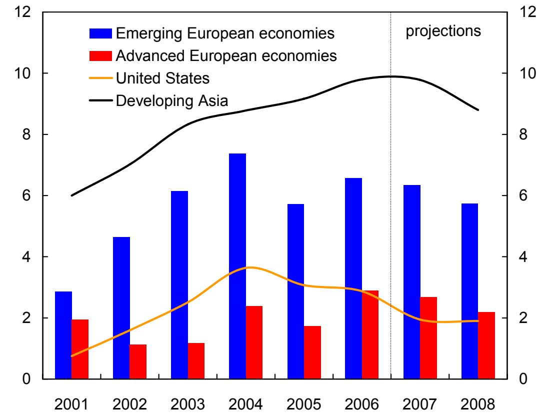
Strong underlying fundamentals should allow the European economy to weather the current financial market turbulence relatively well. If the turbulence recedes, the impact on growth should be manageable. Emerging Europe has so far remained largely unscathed by the financial market turbulence. Nonetheless, growth is set to ease in 2008 in nearly all of Europe. In addition, uncertainty and downside risks have increased, and protracted credit market tightening could push growth below the baseline. The immediate challenge for policymakers is to restore confidence in key financial markets, support real activity, and keep inflation low. More fundamentally, however, there is a continuing need to address vulnerabilities and sustain growth over the medium term, which requires further progress in fiscal consolidation, economic integration, and structural reforms.

Strong Fundamentals Should Help Overcome Financial Turbulence

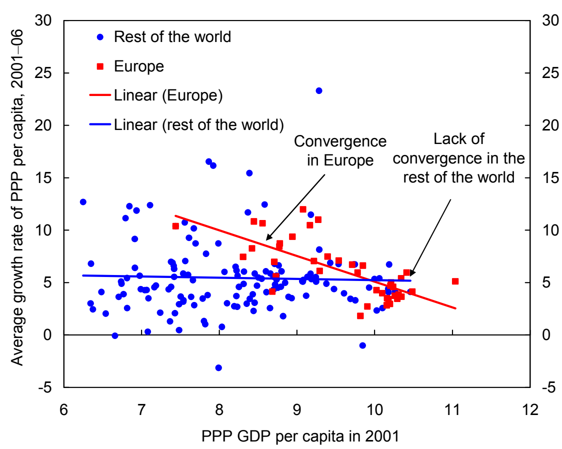
Economic activity has remained strong in 2007, with the euro area expected to outpace the United States and the top-performing European emerging economies posting growth rates second only to developing Asia (Table 1 and Figure 1).[1] Europe stands apart from the rest of the world in that convergence within the continent in recent years has been much faster (Figure 2). Growth has been

Figure 1. Europe and the Rest of the World: Real GDP Growth, 2001–08
(*Percent*)



Source: IMF, *World Economic Outlook*.

Figure 2. Convergence in Europe and in the Rest of the World, 2001–06



Source: IMF, *World Economic Outlook.*
Note: PPP is purchasing power parity.

Note: The main author of this chapter is Athanasios Vamvakidis.

[1] In what follows, the group of emerging European economies comprises Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, FYR, Malta, Moldova, Montenegro, Poland, Romania, Russia, Serbia, the Slovak Republic, Slovenia, Turkey, and Ukraine. All other European economies are included in the group of advanced economies.

Table 1. European Countries: Real GDP Growth and CPI Inflation, 2006–08

	Real GDP Growth			CPI Inflation		
	2006	2007	2008	2006	2007	2008
Europe 1/	**3.8**	**3.7**	**3.2**	**3.5**	**3.3**	**3.1**
Advanced European economies 1/	2.9	2.7	2.2	2.2	2.0	2.0
Emerging European economies 1/, 2/	6.6	6.3	5.7	7.2	6.8	6.0
European Union 1/	3.2	3.0	2.5	2.3	2.3	2.3
Euro area	2.8	2.5	2.1	2.2	2.0	2.0
Austria	3.3	3.3	2.5	1.7	1.9	1.9
Belgium	3.0	2.6	1.9	2.3	1.8	1.8
Finland	5.0	4.3	3.0	1.3	1.5	1.8
France	2.0	1.9	2.0	1.9	1.6	1.8
Germany	2.9	2.4	2.0	1.8	2.1	1.8
Greece	4.3	3.9	3.6	3.3	3.0	3.2
Ireland	5.7	4.6	3.0	2.7	2.5	2.1
Italy	1.9	1.7	1.3	2.2	1.9	1.9
Luxembourg	6.2	5.4	4.2	2.7	2.2	2.2
Netherlands	3.0	2.6	2.5	1.7	2.0	2.2
Portugal	1.3	1.8	1.8	3.0	2.5	2.4
Slovenia	5.7	5.4	3.8	2.5	3.2	3.1
Spain	3.9	3.7	2.7	3.6	2.5	2.8
Other EU advanced economies						
Denmark	3.5	1.9	1.5	1.9	1.9	2.0
Sweden	4.2	3.6	2.8	1.5	1.9	2.0
United Kingdom	2.8	3.1	2.3	2.3	2.4	2.0
New EU countries 1/	6.4	6.1	5.2	3.2	3.9	4.0
Bulgaria	6.1	6.0	5.9	7.3	8.2	7.9
Cyprus	3.8	3.8	3.7	2.5	2.0	2.4
Czech Republic	6.4	5.6	4.6	2.5	2.9	4.4
Hungary	3.9	2.1	2.7	3.9	7.6	4.5
Malta	3.3	3.2	2.6	2.6	0.6	2.0
Poland	6.1	6.6	5.3	1.0	2.2	2.7
Romania	7.7	6.3	6.0	6.6	4.3	4.8
Slovak Republic	8.3	8.8	7.3	4.4	2.4	2.0
Estonia	11.2	8.0	6.0	4.4	6.0	7.0
Latvia	11.9	10.5	6.2	6.5	9.0	8.9
Lithuania	7.5	8.0	6.5	3.8	5.2	4.6
Non-EU advanced economies						
Iceland	2.6	2.1	-0.1	6.8	4.8	3.3
Israel	5.2	5.1	3.8	2.1	0.5	2.5
Norway	2.8	3.5	3.8	2.3	0.8	2.5
Switzerland	3.2	2.4	1.6	1.0	1.0	1.0
Other emerging economies						
Albania	5.0	6.0	6.0	2.4	2.5	3.3
Belarus	9.9	7.8	6.4	7.0	8.1	10.0
Bosnia and Herzegovina	6.0	5.8	6.5	7.5	2.5	1.9
Croatia	4.8	5.6	4.7	3.2	2.3	2.8
Macedonia, FYR	3.0	5.0	5.0	3.2	2.0	3.0
Moldova	4.0	5.0	5.0	12.7	11.2	8.9
Russia	6.7	7.0	6.5	9.7	8.1	7.5
Serbia	5.7	6.0	5.0	12.7	6.4	8.8
Turkey	6.1	5.0	5.3	9.6	8.2	4.6
Ukraine	7.1	6.7	5.4	9.0	11.5	10.8

Source: IMF, *World Economic Outlook* .
1/ Average weighted by purchasing power parity GDP.
2/ Montenegro has not yet been included in the World Economic Outlook database.

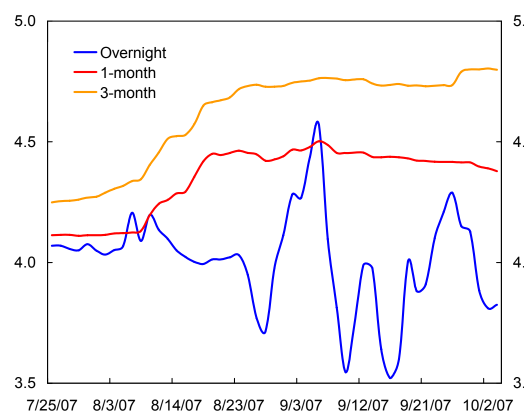
especially buoyant in the Baltic countries, several European Union (EU) member states in Central Europe, and the oil producers, notably Russia and Norway. Strong domestic demand—particularly investment, including buoyant construction activity—has combined with a favorable external environment to drive Europe's growth in recent years. Wage moderation and labor market reforms in the European Union's advanced economies have supported job creation, lowered unemployment, and increased participation. Inflation remains under control in the advanced economies, and is projected to average close to the 2 percent target of both the European Central Bank (ECB) and the Bank of England, but energy and food prices contributed to an uptick in September (Table 1). However, inflation remains well above this level in most emerging economies, especially those with pegged exchange rate regimes; in some cases, this reflects overheating.

Recent financial turbulence has dampened the near-term outlook. While growth was set to ease somewhat, most countries are now expected to see a more pronounced slowing in 2008, as discussed in the October 2007 WEO. The projected lower growth for the United States and the fallout from financial turbulence are expected to reduce growth temporarily in advanced European economies. The direct impact on emerging Europe is projected to be quite muted, but the slowdown is expected to foster the beginning of a gradual correction of the external imbalances and easing of the overheating pressures apparent in a number of these economies. The baseline forecast assumes a gradual resumption of normal financial market functioning and liquidity conditions over the coming months.

Direct exposure to the U.S. subprime mortgage market and the interconnection of money markets caused the financial turbulence to spread quickly to the advanced economies of Europe (Box 1). Several European banks were exposed to the shock either directly, through their holdings, or indirectly, through off-balance-sheet special investment vehicles (SIVs or conduits). These vehicles often had contingent credit lines with the banks and were receiving short-term financing by issuing commercial paper. When the subprime crisis hit, lack of information on related exposures and difficulties in valuing collateral triggered a general reluctance to trade in money markets. Reflecting the liquidity freeze, volatility in interbank money rates rose sharply (Figure 3). Liquidity problems were further aggravated by investors' general retrenchment from asset-backed commercial paper (ABCP), which required banks to fund the underlying assets directly.

Money and credit markets in advanced economies are still returning to normal operating conditions, but the fallout for individual financial institutions has so far been contained. Stock prices

Figure 3. Euro Area: Average Interbank Offer Rates, July 25, 2007–October 3, 2007
(Percent)



Source: Datastream.

Box 1. Why Was Europe Affected by the Collapse of the U.S. Subprime Mortgage Market?

The recent financial market turbulence is unprecedented in a number of ways. In contrast with other regional or global economic crises in recent decades, it originated in advanced economies and has affected their financial markets—particularly in Europe—much more than others, including emerging economies that are usually considered to be more vulnerable. It was the first test of structured finance and related credit derivatives and instruments traded globally. The shock drained liquidity in the usually highly liquid interbank money markets of several countries.

The origin of the shock was a reassessment of subprime mortgage risk in the United States and its implications for complex derivatives pricing worldwide.[1] Several European banks exposed to the U.S. subprime mortgage market started reporting substantial increases in provisions for bad loans during the first half of 2007. Concerns about credit quality in the U.S. subprime real estate market in July and early August translated into concerns about asset-backed commercial paper (ABCP), which was used to fund collateralized debt obligations. As a result, financial institutions began a retrenchment of their holdings of related assets.

Several large European banks found themselves exposed to the shock, either directly as holders of ABCP or indirectly through conduits and structured investment vehicles with similar holdings that had ensured open credit lines with banks.[2] The ABCP market came to a sudden stop and forced exposed banks to step in with funding, causing a liquidity squeeze in the global money market through the interbank market. Concerns that conduits would have to draw further on banks with which they had open credit lines and, in some cases, be forced to sell assets in a declining market followed. Sections of the money and swap markets effectively shut down as transactions were refused owing to price uncertainty.

Uncertainty about the size and scope of the losses has magnified the impact of the shock. Many conduits that were investing in subprime mortgage securities had deferred the risk assessment of the underlying long-term assets to the rating agencies while receiving short-term funding using ABCP. As risk-averse investors in ABCP, most of which were money market funds, became wary about their uncertain exposures to the subprime mortgage fallout, the market for ABCP dried up. With banks committed to providing liquidity to their conduits and suspect about the exposure of their competitors to ABCP conduits, confidence plunged, and liquidity in the interbank money market and the financial system tightened. Furthermore, banks that are exposed to further future rollover failures of ABCP have started building precautionary cash reserves, reducing market liquidity further. Retained liquidity and a "wait–and-see" and "flight-to-quality" approach by investors and banks have affected other asset classes, such as leveraged buyouts, which also depend on banks for funding.

The problem was exacerbated in Europe by the reliance of many European conduits on U.S. dollar funding. Because U.S. banks were reluctant to provide liquidity to European borrowers with uncertain exposures, the shortage of U.S. dollar funding spilled over to the European money market. The problem was compounded by the reliance of many financial firms on the foreign exchange swaps market, which is intermediated in U.S. dollars.

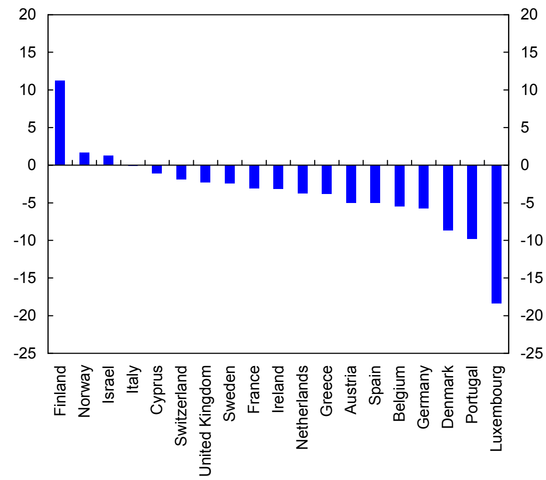
[1] The October 2007 *Global Financial Stability Report* (IMF, 2007a) contains an extensive discussion of the evolution of the financial turmoil and its policy implications.

[2] ABCP vehicles (or conduits) are usually backed up by lines of credit from banks. About 90 percent of them have access to bank credit lines for 100 percent of their assets.

of the banking sector in advanced economies suggest continuing uncertainty (Figure 4). Two German banks with direct exposure to subprime losses had to be bailed out, while the United Kingdom's fifth-largest mortgage lender, which relied substantially on money market liquidity, faced a run on deposits that prompted an intervention by the authorities. Some banks and mortgage lenders in other European countries also felt the shock. But banks with large retail networks and diversified portfolios have not been greatly affected so far. A few large European banks have had to book losses, but the amounts, while sizable in absolute terms, have up to now been small relative to the banks' balance sheets.

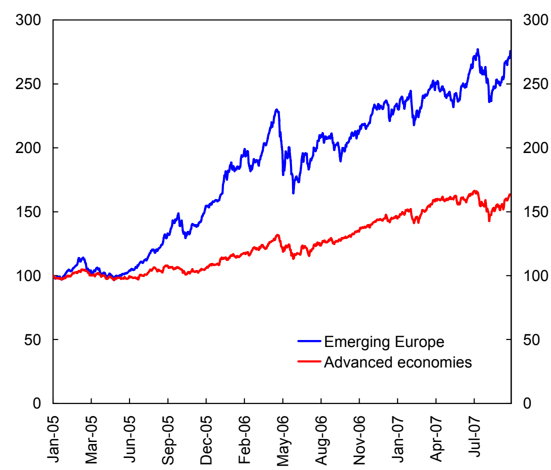
Remarkably, emerging Europe has so far weathered the turbulence well, despite vulnerabilities linked to fast credit growth and, in some cases, high external debt. In addition to prospects for continued rapid growth, other factors seem to have provided shelter from financial turbulence to date. With strong demand for prime loans in recent years limiting the need to seek profits in riskier assets, direct exposure to ABCP has been virtually nonexistent. Exposure to complex financial products has been substantially smaller than in advanced economies, interbank markets have been relatively thin, and, for some countries, the exchange rate has been playing a larger role in the transmission mechanism of monetary policy. Money market conditions initially tightened appreciably in a few countries, and floating currencies came under pressure, especially in Turkey, Hungary, and Romania. However, these tensions eased quickly, except in Russia, where difficulties of some medium-sized banks in obtaining liquidity lingered for some time, and Romania, where exchange rate pressures continued. Exchange rate peggers have so far been less affected than floaters. Stock markets initially fell sharply in several other countries, most notably Turkey and Poland, but have recovered since (Figure 5). However, external credit spreads have remained wider in most emerging economies, notably Serbia, Ukraine, and Croatia (Figure 6).

Figure 4. Change in Banking Sector Stock Prices, July 25, 2007–October 3, 2007
(Percent)



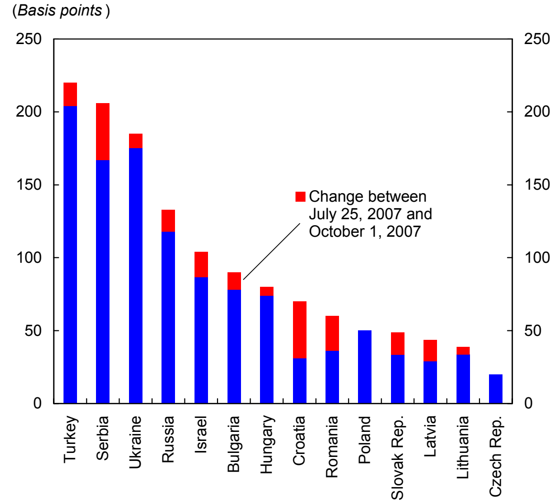
Source: Datastream.

Figure 5. Daily Stock Market Indices, January 2005–October 2007



Source: Datastream.

Figure 6. Sovereign Spreads, July 25, 2007–October 1, 2007
(Basis points)



Sources: Bloomberg L.P.; and IMF staff calculations.

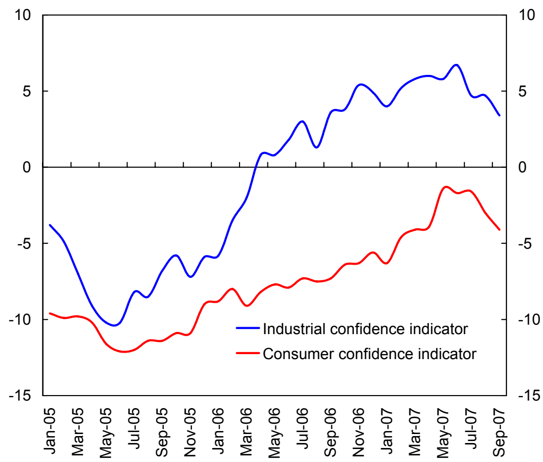
Protracted Credit Market Tightening Would Add Downside Risk

The turbulence in financial markets has heightened downside risks. Besides risks that have been around for some time, including a disorderly unwinding of global imbalances, developments in energy and commodity prices, and political uncertainty in some parts of emerging Europe, a sustained deterioration in financial conditions may push the European economy below the baseline projections. Financial turbulence has also amplified the risk of a disruptive unwinding of global imbalances.

Advanced economies appear to be vulnerable to confidence effects and credit tightness in particular. A sharper slowdown of the U.S. economy would dampen exports, but the effect would likely be relatively contained unless it were associated with a disorderly unwinding of global imbalances and a further sharp appreciation of the euro. More important, a lasting deterioration of business and consumer sentiment, which has been considerably dented by the financial turbulence (Figure 7), would weaken domestic demand. As regards credit tightness, corporate borrowing for investment and construction activity in the housing sector would be affected the most. In the latter case, countries that experienced rapid house price increases (notably Belgium, France, Ireland, the Netherlands, Spain, and the United Kingdom) would be most exposed. Together with reduced profitability, the drying up of demand for securitized assets could induce an expansion of bank balance sheets and strain capital positions. Such a scenario could lead to a sustained tightening of credit conditions, with a dampening impact on domestic demand.

Emerging Europe could be affected through two channels: an overall increase in risk aversion and a slowing of foreign demand. A prolonged deterioration in financial conditions in mature markets could lead to a cutback in lending to emerging markets, especially if parent banks reassess their exposures to subsidiaries in emerging Europe. Mortgage and housing markets would be the first to

Figure 7. EU-27 Confidence Indicators, January 2005–September 2007



Source: European Commission.

feel the impact of tight credit conditions, as several emerging economies in Europe have experienced housing booms in recent years, sometimes fueled by substantial foreign borrowing. Even so, a broader rise in risk premiums would need to be substantial to significantly increase the debt-service burden in most emerging European economies: according to IMF staff estimates, a 100-basis-point increase in interest rates (well in excess of that experienced so far) would raise external debt service on average by 0.4 percent of GDP. However, countries with high levels of private sector debt (most of which is at variable interest rates), such as Bulgaria, Croatia, Estonia, Hungary, and Latvia, would be more affected. As to the second channel, a growth slowdown in the advanced European economies would hit exports in emerging Europe, hurting short-term growth prospects. In combination, the operation of both channels could pose particular adjustment problems for countries that have been running large current account deficits (including the Baltics and several economies in Southeastern Europe).

On the positive side, financial turbulence may well herald a healthy correction from past exuberance, thus strengthening the foundations for future growth. Asset markets tend to overreact, especially when opacity of information is a key factor, as is the case now. While some markets remain under stress, others have continued to

function well, suggesting that the impact on the real economy could be transitory. The market turbulence may set in motion a process that brings risk spreads and asset prices closer to fundamentals, improves credit discipline, and gradually diminishes external imbalances in emerging economies.

Policymakers Are Facing Unexpected Uncertainty

Financial turbulence has complicated policymakers' task of steering their economies to maintain growth without overheating, especially in advanced European economies. Monetary policy faces a delicate balancing act of responding to liquidity disruptions, while guarding against the buildup of inflationary pressures. In addition, lessons will need to be drawn from the current episode of turbulence for financial sector policies. Meanwhile, in several emerging economies in Europe, dealing with inflationary pressures and external vulnerabilities remains the dominant policy concern.

Central bank action seems to have been effective so far in calming market sentiment, but some money markets remain tight. While overnight money market rates were reduced following the central bank interventions, one- to three-month funding rates are taking longer to normalize (Figure 3). Most major European central banks have responded to the financial turbulence by providing liquidity support to the money market and by lending against riskier collateral, including mortgages. The ECB has injected large amounts of liquidity in the interbank money market a number of times since early August. The Bank of England offered resources beyond one-month maturity after the run on deposits of a mortgage bank in late September, though no bids were received for these funds. The Bank of Russia provided liquidity during the shock to support a return to smooth functioning of the money market.

The European central banks are also reappraising their monetary policy stance in view of the likely impact of tightened credit conditions on growth and inflation. The ECB kept its policy rate constant in early September, although it had earlier signaled its intention to hike rates. The Central Bank of Turkey brought forward a cut in its policy rate to September, noting that the turbulence would lessen external and domestic demand. In Hungary, domestic factors induced the central bank to lower interest rates. However, the central banks of Norway, Sweden, and Switzerland increased interest rates in response to continued strong domestic demand and emerging capacity constraints. Similarly, concerns about inflationary pressures prompted the central banks of Poland and the Czech Republic to raise interest rates at the end of August.

In dealing with the current uncertainty, central banks will need to continue to stand ready to provide liquidity support to money markets as needed, while keeping interest rate policy focused on inflation and the real economy. Liquidity support should be designed to ensure a smooth functioning of money markets, while problems at individual institutions need to be resolved in ways that minimize the risk of moral hazard. In the euro area, monetary policy has been appropriately kept on hold in view of the downside risks associated with the financial turmoil. Looking further forward, the baseline forecast presumes these risks to dissipate gradually, and a further tightening may then be required. Such a stance would of course need to be reconsidered if the risks materialized and the slowdown became protracted. In the United Kingdom and other advanced European economies, similar considerations will need to guide monetary authorities.

In terms of financial sector policies, recent events indicate that private and public prudential frameworks have not kept up with developments in financial innovation—they will need to do better going forward. As argued in the analytical part of this REO, financial innovation is an important source of strengthened performance over the medium term, and as such must be allowed—and indeed encouraged—to flourish. But new financial products often exploit gaps in existing prudential arrangements that can prove problematic. As discussed in the October 2007 *Global Financial*

Stability Report, a balanced review of these arrangements is therefore necessary, focused on improving transparency and strengthening the effectiveness of financial regulation. In addition, the recent market turmoil has drawn attention to the need to secure effective financial safety nets and swift crisis resolution mechanisms.

In the Baltics and Southeastern Europe, meanwhile, policymakers will need to focus on steering the economy toward a soft landing. Countries with floating exchange rates could further raise interest rates as needed to stem inflationary pressures. Fiscal restraint will have to contribute, too, and will be crucial for countries with fixed exchange rates (e.g., the Baltics and Bulgaria) or tightly managed floats (e.g., Croatia). Throughout emerging Europe, strong bank supervision will be critical to manage rapidly expanding balance sheets.

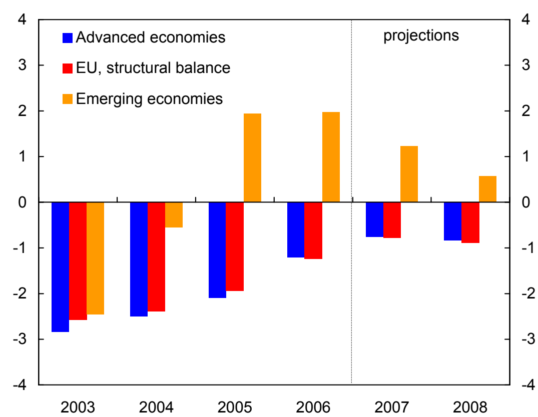
Reforms Are Key to Sustaining Growth

To reduce vulnerabilities and raise medium-term growth prospects, Europe needs to continue fiscal adjustment and pursue structural reforms proactively. Recent fiscal consolidation has made inroads, but deficits remain too large in many advanced and emerging economies to deal comfortably with shocks and secure sustainability, in light of expenditure pressures from population aging. Structural reforms have paid off but, on average, Europe's advanced economies are still failing to make notable progress in closing the transatlantic divide in per capita GDP. Yet Europe's most successful performers have demonstrated that comprehensive reforms pay clear dividends. Emerging Europe has made great strides compared with the advanced economies, but viewed over a decade it is not doing as well as better-performing peers, notably in Asia, and its vulnerabilities are higher. For Europe's emerging economies, it will be essential to deliver the higher growth potential that investors are anticipating.

Fiscal Policy Needs to Return to the Consolidation Track

Fiscal consolidation, which had proceeded at a reasonable pace in 2004–06, is expected to stall during 2007–08 (Figure 8 and Table 2). In spite of the favorable outlook, fiscal policies are set to loosen in half of the European countries, and the pace of fiscal consolidation to slow in most of the rest. For the most part, these developments reflect policies that have used cyclically driven and, therefore, temporary revenues to slacken the pace of adjustment or raise spending. As a result, fiscal balances already deteriorated in 2006 in several cases (Serbia, Hungary, Romania, and the Slovak Republic). In the euro area, fiscal consolidation has continued in 2007 but is projected to stop in most countries in 2008. France and Italy, for example, are moving ahead with tax cuts and postponing further consolidation. Norway and Russia are unwinding large, oil-driven surpluses, reversing part of the earlier consolidation. At the other end of the spectrum, Hungary, which has had Europe's largest deficit, is expected to deliver significant fiscal adjustment.

Figure 8. European Regions: General Government Balance, 2003–08
(*Percent of GDP*)



Source: IMF, *World Economic Outlook*.

Table 2. European Countries: External and Fiscal Balances, 2006–08

	Current Account Balance to GDP			General Government Balance to GDP		
	2006	2007	2008	2006	2007	2008
Europe 1/	**0.4**	**-0.2**	**-0.5**	**-0.4**	**-0.2**	**-0.5**
Advanced European economies 1/	0.5	0.2	0.0	-1.2	-0.8	-0.8
Emerging European economies 1/, 2/	0.1	-1.9	-2.9	2.0	1.2	0.6
European Union 1/	-0.7	-1.0	-1.2	-1.8	-1.2	-1.2
Euro area	0.0	-0.2	-0.4	-1.6	-0.9	-1.1
Austria	3.2	3.7	3.7	-1.2	-0.8	-0.6
Belgium	2.0	2.5	2.5	0.1	-0.2	-0.2
Finland	5.2	5.0	5.0	3.7	4.3	3.8
France	-1.2	-1.6	-1.8	-2.5	-2.5	-2.7
Germany	5.0	5.4	5.1	-1.6	-0.2	-0.5
Greece	-9.6	-9.7	-9.6	-2.1	-2.1	-1.9
Ireland	-4.2	-4.4	-3.3	2.9	0.8	0.2
Italy	-2.4	-2.3	-2.2	-4.4	-2.1	-2.3
Luxembourg	10.6	10.5	10.3	0.1	0.4	0.4
Netherlands	8.6	7.4	6.7	0.7	-0.6	0.5
Portugal	-9.4	-9.2	-9.2	-3.9	-3.3	-2.4
Slovenia	-2.5	-3.4	-3.1	-0.8	-0.9	-1.1
Spain	-8.6	-9.8	-10.2	1.8	1.4	0.8
Other EU advanced economies						
Denmark	2.4	1.3	1.3	4.7	3.9	3.8
Sweden	7.2	6.0	5.7	2.1	2.3	2.2
United Kingdom	-3.2	-3.5	-3.6	-2.7	-2.5	-2.3
New EU countries 1/	-6.0	-7.2	-7.7	-3.4	-2.8	-2.4
Bulgaria	-15.8	-20.3	-19.0	3.5	3.0	2.5
Cyprus	-5.9	-5.5	-5.6	-1.4	-1.0	-0.6
Czech Republic	-3.1	-3.4	-3.5	-3.4	-3.8	-3.2
Hungary	-6.5	-5.6	-5.1	-9.1	-6.2	-4.2
Malta	-6.1	-9.4	-8.2	-2.4	-2.0	-1.9
Poland	-2.3	-3.7	-5.1	-3.9	-2.7	-2.9
Romania	-10.3	-13.8	-13.2	-1.7	-2.8	-2.1
Slovak Republic	-8.3	-5.3	-4.5	-3.4	-2.7	-2.3
Estonia	-15.5	-16.9	-15.9	3.3	3.0	2.0
Latvia	-21.1	-25.3	-27.3	-0.4	0.8	0.6
Lithuania	-10.9	-14.0	-12.6	-1.2	-1.9	-1.0
Non-EU advanced economies						
Iceland	-27.3	-11.6	-6.0	5.3	3.2	-1.3
Israel	5.6	3.7	3.2	-1.8	-3.4	-2.8
Norway	16.4	14.6	15.1	18.0	15.2	15.9
Switzerland	15.1	15.8	15.0	0.8	0.6	-0.3
Other emerging economies						
Albania	-5.9	-7.4	-6.5	-3.2	-3.9	-3.9
Belarus	-4.1	-7.9	-8.1	0.5	0.5	0.5
Bosnia and Herzegovina	-11.5	-15.3	-15.0	3.0	-0.5	-0.9
Croatia	-7.8	-8.4	-8.8	-3.0	-2.6	-2.3
Macedonia, FYR	-0.4	-2.8	-5.9	-0.5	-1.0	-1.5
Moldova	-12.0	-8.0	-7.3	0.3	-0.5	-0.5
Russia	9.7	5.9	3.3	8.4	6.4	4.4
Serbia	-11.5	-14.7	-15.0	-1.4	-2.3	-2.1
Turkey	-7.9	-7.5	-7.0	0.2	-0.8	-0.5
Ukraine	-1.5	-3.5	-6.2	-1.4	-1.8	-2.5

Source: IMF, *World Economic Outlook* .
1/ Weighted average. Government balance weighted by purchasing power parity GDP; external account balance, by dollar-weighted GDP.
2/ Montenegro has not yet been included in the World Economic Outlook database.

There are compelling reasons to pursue fiscal consolidation:

- More fiscal room would become available to manage possible significant downturns, which is especially relevant in several advanced economies. In the euro area, the commitment to reach specific medium-term objectives by 2010 is welcome, but countries that are significantly short of these objectives need to step up the pace of adjustment beyond current intentions.

- Convergence-related demand pressures in emerging Europe would be mitigated. Despite efforts to tighten monetary conditions, they have been loose in a number of emerging economies because monetary policy has been overwhelmed by large capital inflows in many countries, particularly those where its use is restricted by pegged exchange rate regimes (Figure 9). As a result, monetary tightening has been providing little help in curbing domestic credit growth (see Figure 10). Fiscal restraint needs to go beyond mere cyclical stabilization to offset exuberant private sector demand. In this context, policymakers should also remove tax-induced distortions that have contributed to the blistering pace of credit growth.

- Insurance would be provided against the risks posed by the external vulnerabilities that the private sector has generated. While Europe's overall external current account is close to balance, this masks an unprecedented dispersion, with large deficits in the Baltics, Greece, Portugal, Spain, and most emerging economies in Southeastern Europe (Figure 11 and Table 2). Foreign bank borrowing has funded a large share of these deficits, boosting external indebtedness in several countries to levels much higher than in emerging economies outside Europe (Figure 12). Given the risk of external shocks, whether unrelated to country fundamentals or otherwise, prudence argues for building up safety margins, with increases in public savings mitigating the increases in private dissaving.

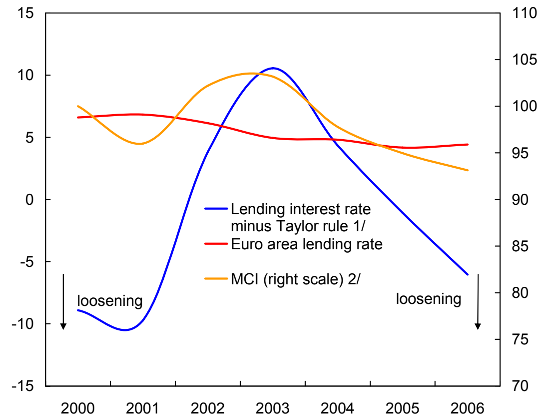
- Fiscal sustainability concerns in some emerging economies (e.g., the Czech Republic, Hungary, and Poland) and spending pressures from aging populations throughout Europe would be addressed. Given the already heavy tax burden in most countries, spending reforms seem to be the only option for consolidation. In many countries, further reforms of social security and health care systems seem necessary to establish the long-term fiscal sustainability of these systems.

With the baseline prospects still favorable for advanced economies and buoyant for emerging Europe, proceeding with fiscal consolidation within a framework that allows full play to the automatic stabilizers is unlikely to dent the short-term outlook and is well worth the strengthened medium-term prospects it would open.

Economic Integration and Structural Reform—Paths to a Strengthened Performance

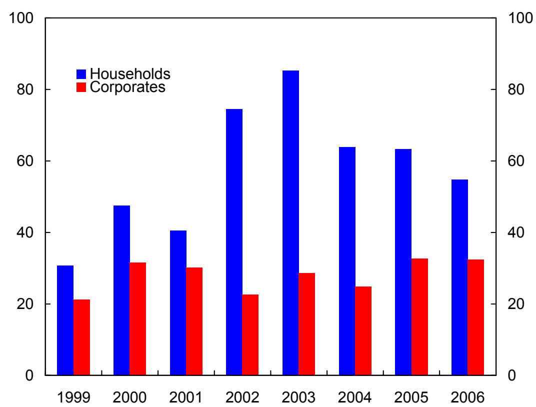
Europe stands to gain considerably from continuing economic integration. Although the recent financial turbulence underscores that financial integration also comes with some perils, there is little doubt that Europe has benefited greatly from the ongoing multifaceted process of economic integration (Box 2). The main channels have been trade integration, a long-standing pedigree of the European Union; financial integration, which has taken off over the past decade; and cross-border labor migration, which is also on the rise. There is strong evidence that economic integration has improved living standards in Europe. Emerging Europe has become Europe's fastest-growing market, contributing on some estimates between 0.2 and 0.4 percent annually to advanced economies' growth in recent years. And financial integration has been key for the income convergence of

Figure 9. Emerging Europe: Monetary Conditions, 2000–06



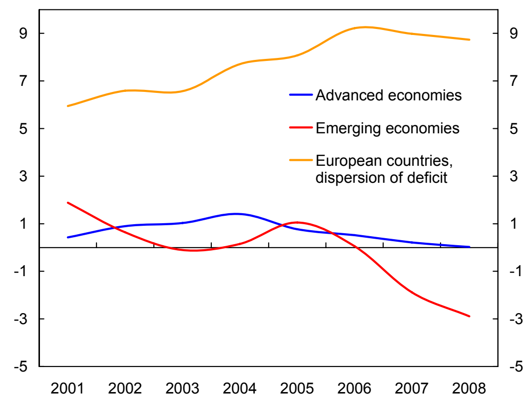
Sources: IMF, *International Financial Statistics*; and IMF staff calculations.
1/ The Taylor rule is defined as the sum of the output gap, the equilibrium interest rate (assumed to be equal to potential growth estimated using the Hodrick-Prescott filter), expected inflation (assumed to be equal to actual inflation in the past three years), and the inflation gap (assumed to be equal to actual inflation minus an inflation target, which is taken to be the 2 percent European Central Bank target plus 1.5 percent from Balassa-Samuelson effects). The figure shows the average for all emerging European economies.
2/ MCI is the monetary conditions index (equal to 100 in 2000) and is the weighted sum of the changes in the real lending interest rates and in the real effective exchange rates. The figure shows the average for all emerging European economies.

Figure 10. Emerging Europe: Credit Growth, 1999–06
(*Percent*)



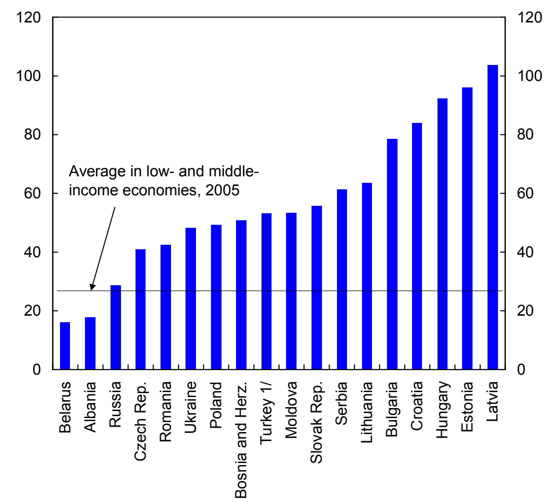
Source: Country central banks.

Figure 11. European Regions: Ratio of Current Account Balance to GDP, 2003–08
(*Percent*)



Source: IMF, *World Economic Outlook.*

Figure 12. External Debt, 2006
(*Percent of GDP*)



Sources: Country central banks; and IMF staff calculations.
1/ Percent of GNP.

emerging Europe (Part II, Chapter 2). With integration far from complete for most emerging economies, substantial economic benefits still lie ahead.

To fully reap the benefits from integration and reduce vulnerabilities to shocks, Europe needs to push ahead with structural reforms, building on recent progress. Europe's structural rigidities remain its Achilles' heel, inhibiting growth and making adjustment to shocks protracted and difficult. Germany's recovery took hold only after five years of slow growth and significant reforms, while Portugal has yet to rekindle its convergence bid, which faltered in the late 1990s.

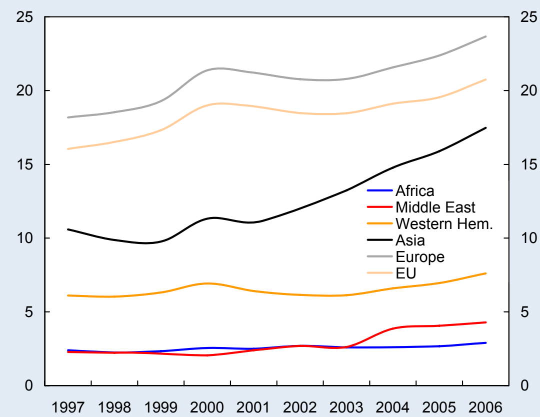
Box 2. Europe's Economic Integration

Although the foundations of Europe's economic integration were put in place by the Treaty of Rome in 1957, the collapse of communism and EU enlargement provided a big push, increasingly encompassing countries that are not (yet) members of the European Union.[1] Already much more advanced than regional integration in the rest of the world, economic integration within Europe has accelerated in recent years, underpinning improved economic performance. As documented below, Europe's economic integration is manifested in three areas: intra-European trade, financial market integration, and labor market integration.

Intra-European Trade

Both in levels and as a share of GDP, European economies trade more with each other than do economies within all other continents. Moreover, trade within Europe has been expanding rapidly since the 2004 EU enlargement, although not as fast as in Asia (first figure).[2] The expansion in European trade has not been at the expense of trade with the rest of the world, as the openness of the European economy has kept increasing: the ratio of exports plus imports to GDP has risen from 48 percent in the early 1990s to 82 percent today.

Intraregional Trade, 1997–06
(Percent of GDP)



Source: IMF, *Direction of Trade Statistics*.

Most intra-European trade is among developed economies, but the share of trade with emerging Europe has been increasing (table). The advanced European economies sent 11 percent of their exports to emerging Europe in 2006, compared with 8 percent in 2000. Moreover, their exports to emerging Europe have been growing by double the rate of their exports to each other in the past two years.

Intra-European Exports, 2000–06
(Percent of total intra-European exports)

	2000	2006
Advanced to emerging economies	8	11
Advanced economies to each other	81	71
Emerging economies to Europe	11	18

Trade integration in Europe has led to faster economic growth. Exports to emerging economies in Europe contributed 0.6 percent to the growth of advanced European economies in 2006, compared with just 0.1 percent at the beginning of the decade. Using an empirical growth model measuring cross-border spillover effects, the acceleration of growth in emerging Europe in the past five years (by 3.8 percentage points) and the increase of the share of imports coming from advanced European economies (by 3 percentage points) have raised annual growth in advanced European economies between 0.2 and 0.4 percent, keeping everything else constant.[3] Estimates from the literature on the links between trade and growth, and

[1] A thorough discussion of the history of Europe's economic integration is provided in Eichengreen (2007).
[2] States within the United States trade more with each other than European countries do, even within the European Union, but this is an improper comparison, because countries tend to trade more within than across borders. Furthermore, free trade is historically much more recent within Europe than within the United States, and trade liberalization outside the European Union has not yet been completed.
[3] The econometric model was estimated in Arora and Vamvakidis (2005).

controlling for other standard growth determinants, suggest that the increase in intra-European trade in the last 10 years is expected to have accelerated Europe's annual GDP growth by 0.3 percent.[4]

Financial Market Integration[5]

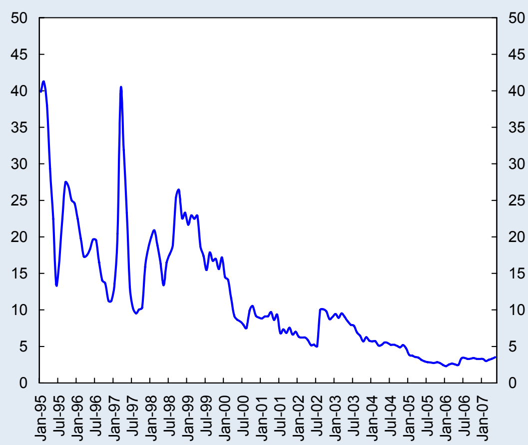
European financial market integration has progressed significantly in recent years with emerging Europe integrating faster than the rest of Europe. In a novel approach, integration is defined here using price-based rather than volume-based measures. An imperfectly integrated region undergoing financial integration is expected to experience convergence of the cost of capital across countries. Empirical analysis indeed finds strong evidence of a declining trend in cross-country dispersion of equity premiums (taken as a proxy for firms' cost of capital) across advanced and emerging economies (second figure). Moreover, this process is faster in emerging Europe than in other countries included in the study, thereby significantly contributing to convergence within the region.[6]

In addition, the analysis suggests that Europe has been experiencing a virtuous circle wherein progress in financial integration and improved real prospects have been mutually reinforcing. Measures of a country's speed of integration (proxied by the distance of a country's cost of capital from the group average) predict subsequent increases in its risk-adjusted growth opportunities (proxied by the ratio of market price-to-earnings ratios to their volatility). Similarly, improvements in risk-adjusted growth opportunities predict future advances in financial integration. Adjusting for risk is especially important when looking at welfare implications. Countries with high, but very uncertain, growth prospects are unlikely to be as well off as countries with a more favorable risk-return trade-off. From this perspective it is reassuring that most emerging countries in the sample are experiencing an improvement, though a few seem to have increased growth at the expense of a proportional increase in risk.

Labor Market Integration

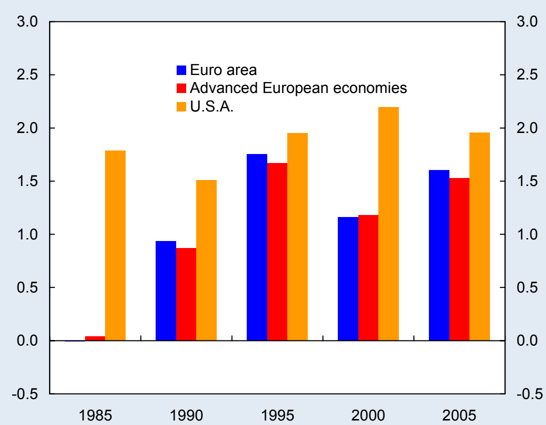
Labor migration within Europe has increased considerably since the early 1990s. As a share of population, net migration to the euro area has risen to 82 percent of that to the United States,

Cross-Country Dispersion of Equity Premiums



Source: De Nicolò (2007).

Net Migration/Population, 1985-2005
(Percent)



Source: World Bank, *World Development Indicators*.

[4] For a discussion of this literature see Baldwin (2003).
[5] Gianni De Nicolò contributed this section, based on De Nicolò (2007).
[6] The countries included are 16 advanced economies (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom) and 13 emerging economies (the Czech Republic, Hungary, Poland, Romania, Russia, Bulgaria, Croatia, Estonia, Latvia, Lithuania, the Slovak Republic, Slovenia, and Ukraine).

Box 2 *(concluded)*

from negligible levels in the 1980s (third figure).[7] Although bilateral flow data are not available, anecdotal evidence suggests that most labor movement within Europe is from emerging to advanced economies. Furthermore, the recent waves in net migration in Europe coincide with the liberalization of the Eastern European economies in the early 1990s and the EU enlargement process in recent years. Indeed, according to Article 18 of the Treaty of Rome, all EU citizens have the right to apply to work in any position in the union (including national civil services, with the exception of sensitive positions), although after a short transition period in some cases for the new members.

The impact of migration on growth is an open empirical question, but seems to be positive in advanced European economies. According to IMF staff calculations, migration explains 8 percent of the increase in the euro area's labor force since the beginning of this decade, which by itself is expected to lead to faster growth. The fact that unemployment has been falling at the same time suggests that imported labor is not replacing domestic labor. Therefore, labor migration may explain part of Europe's fast economic growth in recent years, although more research is needed to determine how much.

The economic impact of migration on emerging Europe, which is a net supplier, is a more complex issue. Both pull and push factors—high demand for cheap labor from receiving economies and a difficult business environment in supplying economies—explain large labor outflows relative to population size in some emerging European economies. Although these countries benefit from significant remittances, human capital drain is a concern for their long-term growth prospects. However, structural reforms that improve the business environment could limit or even partly reverse the outflows.

[7] Labor movements within the United States are much larger than within Europe or even within the European Union. However, the comparisons in this box refer to migration to the United States rather than within labor reallocations.

Structural reforms have progressed during recent years in most European economies, but gaps with the rest of the world remain large for most countries (Table 3). Labor market reforms in advanced economies have increased employment rates, and the recent reinvigoration of the European Union's Lisbon Agenda is encouraging. France's ambitious structural reform plan is also welcome. But further steps are needed to narrow tax wedges and relax excessively strict employment protection regulations, and to increase contestability in the market for services, by implementing the EU Services Directive.[2] Financial integration and further reforms of financial systems (Part II, Chapter 1) will also be essential.

Table 3. Index of Economic Freedom: Ranking Compared with the Rest of the World, 2005

Switzerland	4	Portugal	38
United Kingdom	5	Israel	44
Estonia	8	Spain	44
Ireland	9	Czech Republic	52
Finland	11	France	52
Iceland	11	Italy	52
Luxembourg	11	Bulgaria	56
Denmark	15	Greece	56
Netherlands	15	Poland	56
Austria	18	Moldova	76
Germany	18	Croatia	82
Cyprus	22	Romania	82
Hungary	22	Macedonia	86
Latvia	22	Slovenia	91
Lithuania	22	Turkey	91
Norway	22	Albania	97
Sweden	22	Bosnia and Herzegovina	97
Malta	32	Russia	112
Slovak Republic	32	Ukraine	112
Belgium	38		

Source: Fraser Institute.
Note: The index of economic freedom is the average of five subindices measuring the size of the government, legal system and property rights, sound monetary policy, freedom to trade, and regulation (including labor market regulation and business regulation).

[2] The Services Directive aims at creating a free market for services within the European Union.

With the pace and sustainability of convergence at stake, emerging Europe will need to push ahead with structural reforms. Although progress in recent years has been significant, this was from a low starting point in most cases. The Baltic countries are outliers, with structural reforms progressing well beyond what has been seen even in advanced economies. But these economies, together with others in the region, also feature relatively vulnerable external positions, and structural reforms aimed at strengthening contestability in the domestic economy are a major avenue toward strengthening the tradable goods and services sector and sustainability.

Economic transition in Central Europe has also progressed, improving competition and increasing potential growth, but an element of post-accession reform fatigue, easily available foreign financing, and expectations in some cases that eventual euro adoption will shield the economy from external shocks seem to have weakened the reform drive.[3] The challenge now is to move beyond the minimum standards prescribed by the EU *acquis*,[4] and focus on strengthening productivity and transparency, including by improving the business environment and strengthening financial systems (Part II, Chapters 2 and 3).

The countries in Southeastern Europe and the Commonwealth of Independent States (CIS) have lagged behind and will need to step up the pace.[5] There is still significant room for reforms to reduce the role of the state in the economy, increase labor market flexibility, reduce red tape, progress with judiciary reform, and, in a number of countries, complete land registries.[6] Although preparation to join the European Union in some cases will lead to reforms in these areas, more ambitious steps will be needed for these countries to be able to compete successfully within the European Union.

[3] For recent empirical evidence, see Vamvakidis (2007).

[4] The EU *acquis*, or *acquis communautaire*, refers to the total body of EU law.

[5] Commonwealth of Independent States (CIS) countries covered by the IMF's European Department are Belarus, Moldova, Russia, and Ukraine.

[6] A recent IMF Working Paper has estimated that such reforms could increase potential growth substantially in Croatia (see Moore and Vamvakidis, 2007).

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