1. Outlook: Dealing with Shocks

After holding up well in early 2008, growth slowed markedly in Europe, mainly owing to the ongoing impact of external shocks. Inflation rose to levels not seen in a decade, but with commodity prices stabilizing and the prospect of very weak activity, inflationary pressures are expected to recede. Advanced economies have been hit by extraordinary financial stress whose alleviation has become the overriding policy concern. For most emerging economies, where resource pressures continue even though growth is moderating, the principal challenges are to bring inflation under control and address external imbalances. Meanwhile, contingency plans need to be prepared to deal with possible financial instability.

Advanced Economies

Commodity Price Shocks Helped Trigger Sharp Slowdown and Caused High Inflation

Mostly external factors have dampened economic activity in the advanced economies of Europe.[1] The commodity price shocks intensified in the first half of 2008, causing a spike in headline inflation and sapping real disposable income and consumer demand (Figure 1). Financial turmoil, which was expected to dissipate, instead worsened again, first in June–July 2008, when large financial institutions came under renewed pressure, and more recently in September with the failure of some large U.S. financial institutions. Europe was affected directly, through bank losses and an associated tightening of financial conditions for borrowers, and indirectly, through a weakening of demand from the United States, where the turmoil originated. Moreover, insufficient progress in resolving global current account imbalances caused the euro to appreciate disproportionately—beyond its medium-term equilibrium value (Box 1)—exerting a drag on growth.

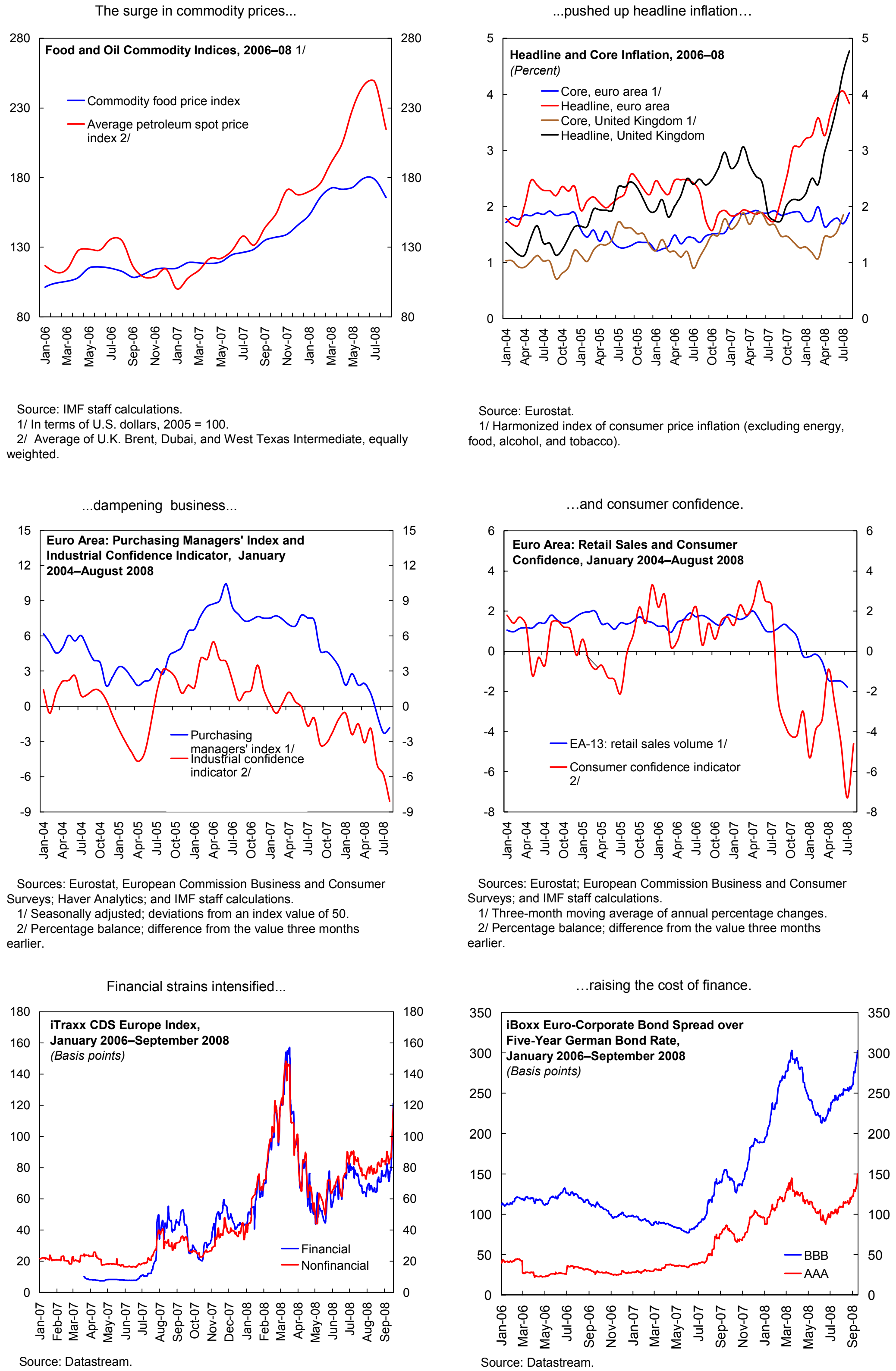
Commodity price shocks have played an important role in the slowdown in activity in Europe, but tightening financial conditions have now taken over. Commodity price shocks adversely affected consumption in a few advanced economies already in the second half of 2007. This process came to a head in the second quarter of 2008, when the price level in the euro area jumped by nearly 2 percent above the first quarter, triggering a significant decline in consumption. Investment, which had held up well, also fell as confidence plummeted and evidence surfaced of the worsening consequences for Europe of the global financial turmoil. While the euro area initially resisted the adverse shocks somewhat better than the United States, it has subsequently slowed faster, as dollar depreciation and more expansionary macroeconomic policies have helped support growth in the United States.

Meanwhile, headline inflation in Europe rose to a level not seen in a decade, though there are some tentative signs that it may have peaked in June–July 2008 (Figure 1). For the euro area, headline inflation, after being pushed up repeatedly by a sequence of commodity price shocks, stabilized at 4 percent in July 2008, before easing to 3.8 percent in August 2008 as the result of falling energy prices. Inflation, excluding energy, food, alcohol, and tobacco, has been relatively stable throughout, remaining below 2 percent. Observations on other advanced economies are similar, but the upward momentum in headline inflation has yet to turn in Norway, Sweden, and the United Kingdom. Inflation expectations edged up following the latest spike in energy prices but have subsequently receded, especially in the euro area. Moreover, when adjusted for inflation risk premiums, break-even

Note: The main authors of this chapter are Thomas Harjes and Athanasios Vamvakidis.

[1] For the purpose of this document, Europe is divided into advanced and emerging economies. The latter comprise Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, the Slovak Republic, Turkey, and Ukraine. All other European economies are included in the group of advanced economies.

Figure 1. Key Short-Term Indicators



Source: IMF staff calculations.
1/ In terms of U.S. dollars, 2005 = 100.
2/ Average of U.K. Brent, Dubai, and West Texas Intermediate, equally weighted.

Source: Eurostat.
1/ Harmonized index of consumer price inflation (excluding energy, food, alcohol, and tobacco).

Sources: Eurostat, European Commission Business and Consumer Surveys; Haver Analytics; and IMF staff calculations.
1/ Seasonally adjusted; deviations from an index value of 50.
2/ Percentage balance; difference from the value three months earlier.

Sources: Eurostat; European Commission Business and Consumer Surveys; and IMF staff calculations.
1/ Three-month moving average of annual percentage changes.
2/ Percentage balance; difference from the value three months earlier.

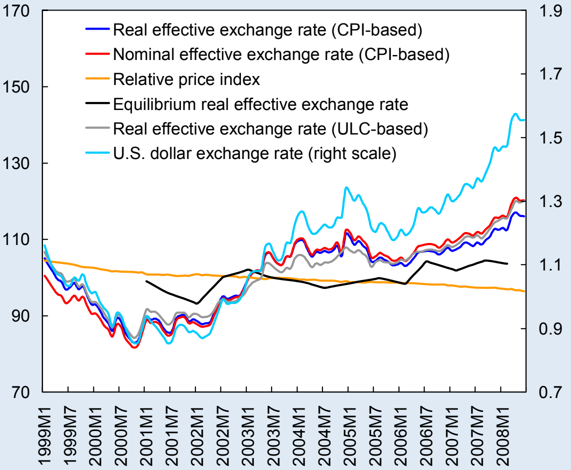
Source: Datastream.

Source: Datastream.

Box 1. How Strong Is the Euro?

Euro Exchange Rate, January 1999–June 2008

(Average, 1999 to 2007 = 100, unless otherwise indicated)



Source: IMF staff calculations.

On the eve of its 10-year anniversary, the euro remains close to the strongest it has ever been, though the trend appreciation that began at the end of 2005 may have ended in August 2008. At its current level, the euro is assessed to have appreciated beyond its fundamental equilibrium level, but by considerably less than what the bilateral euro–U.S. dollar exchange rate may suggest. The recent appreciation of the euro has contributed to slower growth and provoked concerns about competitiveness for some euro area members.

The euro has appreciated considerably with respect to the U.S. dollar in recent years but significantly less in real effective terms (first figure). Its value has risen by 31 percent since the end of 2005 relative to the U.S. dollar, but in nominal effective terms it has appreciated by only half as much. In real terms, the euro has appreciated by 12 percent when measured based on consumer prices and by 15 percent when measured based on relative unit labor costs. The euro area's prices have been on a declining trend relative to the prices of the area's trading partners, falling by 7½ percent since the introduction of the euro and by 2 percent since the end of 2005.[1]

With these developments, the euro was on the strong side relative to fundamentals up to the middle of 2008. IMF estimates of the equilibrium real effective exchange rate (REER) of the euro suggest that it was above its medium-run fundamentals by somewhat more than 10 percent.[2] The euro area's medium-run current account deficit is projected at about ¾ percent of GDP, compared with an equilibrium surplus of 0.2 percent of GDP based on real exchange rate models.[3]

Price level–disaggregated data also confirm that the euro is on the strong side (second figure). Cross-country comparisons of purchasing power parity (PPP) prices relative to per capita GDP show that almost all euro

. . . continued

[1] The weights of the countries in the REER calculation that had higher inflation rates than the euro area in the period 2005–07 add to 68.9 percent, compared with 31.3 percent for countries that had lower inflation rates. Moreover, inflation in the first group was higher than in the euro area by 2.3 percent, while inflation in the second group was lower than in the euro area by only 0.8 percent.

[2] Equilibrium estimates are based on the IMF's CGER approach. CGER stands for the Consultative Group on Exchange Rate Issues, which was established by the IMF in 1995 to strengthen its capacity to assess current account positions and exchange rate levels. The CGER assessments are based on three complementary approaches: the macroeconomic balance approach, the reduced-form equilibrium real exchange rate approach, and the external sustainability approach. For more details, see Lee and others (2008).

[3] For more details, see IMF (2008d, Box 2).

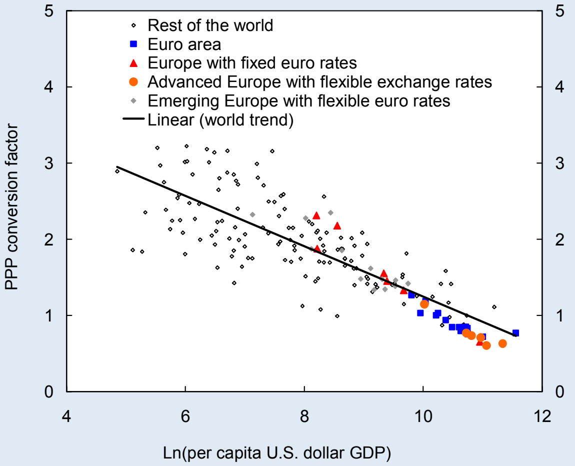
Box 1 *(concluded)*

area countries are somewhat "expensive" relative to their income levels (they are below the world trend line).[4] However, they do not seem to be more so than advanced European economies with flexible exchange rates.

Most countries in the euro area or with fixed euro exchange rates have increased their export market shares in recent years despite the appreciation of the euro, though there are a few exceptions (third figure). The trade patterns of countries in the euro area and countries with fixed euro exchange rates have not shifted inward (fourth figure), as would have been expected in response to deteriorating competitiveness. If anything, euro area and fixed euro exchange rate economies seem to have increased their trade with countries with flexible exchange rates with respect to the euro.

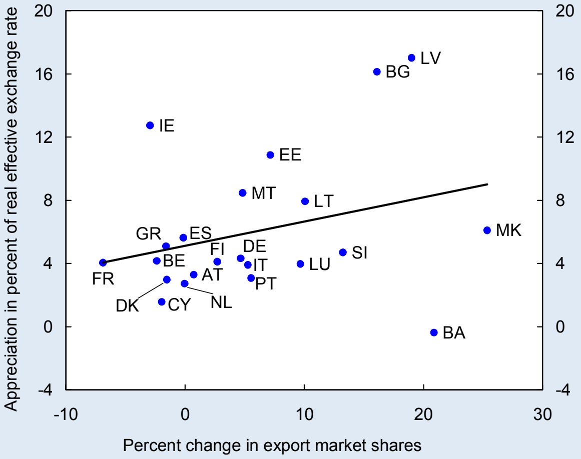
Simulations of a cross-country econometric model estimated in Fabrizio, Igan, and Mody (2007) suggest that improvements in the quality of exported European products may have partly offset the negative impact of the euro appreciation on exports. The model explains movements in export market shares based on changes in REERs and a number of indicators related to changes in product quality and technology of exports. Based on these simulations, the euro appreciation during January 2006 to May 2008 should reduce export market shares (normalized by the country's GDP share in world GDP) by 3½ percentage points in the euro area and by 6 percentage points in

Per Capita GDP and PPP Prices, 2007



Sources: IMF, *World Economic Outlook;* and IMF staff calculations.

Change in Export Market Shares in the World Economy and Appreciation of Real Effective Exchange Rate in Countries of the Euro Area or with Exchange Rates Pegged to the Euro, 2006–07

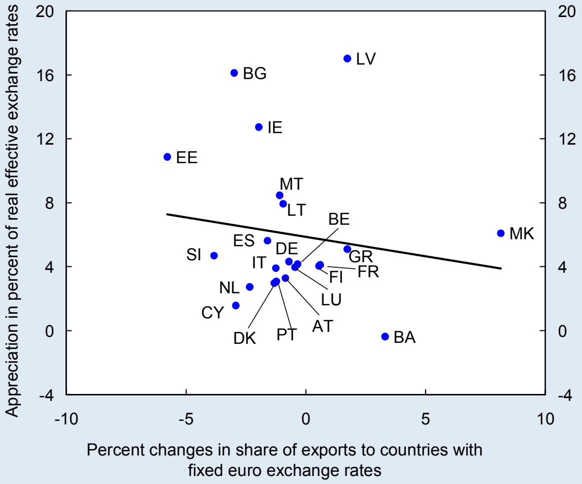


Source: IMF staff calculations.
Note: Country names are abbreviated according to the ISO standard codes.

[4] PPP prices are used to adjust GDP to take into account the fact that prices of nontradable goods are usually cheaper in less developed countries and, therefore, the purchasing power of consumers in these countries is higher than dollar GDP numbers would imply. Accordingly, the higher a country's per capita GDP, the lower its PPP conversion factor (the conversion factor is less than one in developed economies). Therefore, countries with conversion factors lower than those in other countries with similar income levels have a higher level of prices, which suggests that real exchange rates in the former countries may be overvalued.

European countries with fixed exchange rates to the euro, keeping everything else constant. The fact that export market shares in these economies have not deteriorated suggests that other factors in the model, such as quality improvements, may have played an offsetting role.

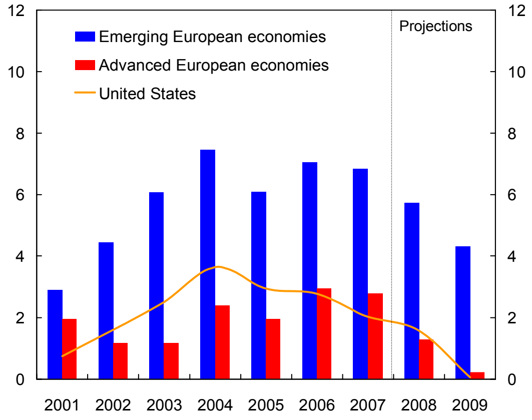
Appreciation in Real Effective Exchange Rate and Change in Trade Patterns in Selected Countries, 2006–07



Source: IMF staff calculations.
Note: Country names are abbreviated according to the ISO standard codes.

inflation rates derived from bond yields suggest that inflation expectations have remained well behaved in the euro area (Bank for International Settlements, 2008).

Figure 2. Europe and the United States: Real GDP Growth, 2001–09
(*Percent*)



Source: IMF, *World Economic Outlook*.

Activity Expected to Stagnate While Inflation Recedes

Activity in the advanced economies is expected to be very weak during the second half of 2008 and first half of 2009, as the adverse consequences of the financial turmoil dampen growth, despite some relief from stabilizing commodity prices (Figure 2). Euro area growth will average 1.3 percent in 2008 and 0.2 percent in 2009, before returning to 1.4 percent in 2010 (Table 1). For many economies, the profile is likely to be one of stagnation into the first half of 2009, with several countries experiencing even a slight, temporary decline in activity.[2] Indeed, the continuing deterioration in business and consumer confidence and in other coincident and leading indicators does not bode well for the immediate future. Countries experiencing declining house prices after previous booms (e.g., Denmark, Ireland, Spain, and the United Kingdom) are expected to see the sharper downturns (Hilbers and others, 2008).

Given the nature of the shocks hitting the European economy, a slowdown in growth is unavoidable. With Europe a net energy importer, the energy price shock is acting as a tax on household income paid abroad. Because the shock is generally perceived as permanent, households are not expected to dip into their savings, especially in the context of falling equity values and slower

[2] See the IMF's October *World Economic Outlook* (2008a) for detailed assumptions underlying these projections and the global context.

Table 1. European Countries: Real GDP Growth and CPI Inflation, 2006–09
(Percent)

	Real GDP Growth				CPI Inflation			
	2006	2007	2008	2009	2006	2007	2008	2009
Europe 1/ 2/	**4.1**	**3.9**	**2.6**	**1.4**	**3.6**	**3.6**	**5.8**	**4.2**
Advanced European economies 1/	3.0	2.8	1.3	0.2	2.2	2.1	3.5	2.2
Emerging European economies 1/ 2/	7.0	6.8	5.7	4.3	7.5	7.5	11.5	9.2
European Union 1/	3.3	3.1	1.7	0.6	2.3	2.4	3.9	2.4
Euro area	2.8	2.6	1.3	0.2	2.2	2.1	3.5	1.9
Austria	3.4	3.1	2.0	0.8	1.7	2.2	3.5	2.3
Belgium	2.9	2.8	1.4	0.2	2.3	1.8	4.6	2.8
Cyprus	4.0	4.4	3.4	2.8	2.2	2.2	4.6	3.5
Finland	4.9	4.5	2.5	1.6	1.3	1.6	3.9	2.5
France	2.2	2.2	0.8	0.2	1.9	1.6	3.4	1.6
Germany	3.0	2.5	1.8	0.0	1.8	2.3	2.9	1.4
Greece	4.2	4.0	3.2	2.0	3.3	3.0	4.4	3.1
Ireland	5.7	6.0	-1.8	-0.6	2.7	2.9	3.5	2.4
Italy	1.8	1.5	-0.1	-0.2	2.2	2.0	3.4	1.9
Luxembourg	6.1	4.5	2.3	1.8	2.7	2.3	3.7	1.8
Malta	3.1	3.7	2.8	2.3	2.6	0.7	3.7	2.2
Netherlands	3.4	3.5	2.3	1.0	1.7	1.6	2.9	2.6
Portugal	1.4	1.9	0.6	0.1	3.0	2.4	3.2	2.0
Slovenia	5.7	6.1	4.3	3.7	2.5	3.6	5.9	3.3
Spain	3.9	3.7	1.4	-0.2	3.6	2.8	4.5	2.6
Other EU advanced economies								
Denmark	3.9	1.7	1.0	0.5	1.9	1.7	3.4	2.8
Sweden	4.1	2.7	1.2	1.4	1.5	1.7	3.4	2.8
United Kingdom	2.8	3.0	1.0	-0.1	2.3	2.3	3.8	2.9
New EU countries 1/	6.6	6.3	5.0	3.5	3.3	4.1	6.4	4.4
Bulgaria	6.3	6.2	6.3	4.2	7.4	7.6	12.2	7.0
Czech Republic	6.8	6.6	4.0	3.4	2.5	2.8	6.7	3.4
Hungary	3.9	1.3	1.9	2.3	3.9	7.9	6.3	4.1
Poland	6.2	6.6	5.2	3.8	1.0	2.5	4.0	3.3
Romania	7.9	6.0	8.6	4.8	6.6	4.8	8.2	6.6
Slovak Republic	8.5	10.4	7.4	5.6	4.3	1.9	3.9	3.6
Estonia	10.4	6.3	-1.5	0.5	4.4	6.6	10.2	5.1
Latvia	12.2	10.3	-0.9	-2.2	6.5	10.1	15.9	10.6
Lithuania	7.9	8.9	3.9	0.7	3.8	5.8	11.3	6.2
Non-EU advanced economies								
Iceland	4.4	4.9	0.3	-3.1	6.8	5.0	12.1	11.2
Israel	5.2	5.4	4.3	2.8	2.1	0.5	4.8	3.3
Norway	2.5	3.7	2.5	1.2	2.3	0.8	3.2	2.7
Switzerland	3.4	3.3	1.7	0.7	1.0	0.7	2.6	1.5
Other emerging economies								
Albania	5.4	6.0	6.1	6.3	2.4	2.9	4.0	3.0
Belarus	10.0	8.2	9.2	8.0	7.0	8.4	15.3	9.6
Bosnia and Herzegovina	6.9	6.8	5.5	5.0	6.1	1.5	8.5	5.2
Croatia	4.8	5.6	3.8	3.7	3.2	2.9	7.0	4.9
Macedonia, FYR	4.0	5.0	5.5	5.0	3.2	2.3	8.5	3.0
Moldova	4.8	4.0	6.5	6.5	12.7	12.4	13.7	9.7
Montenegro	8.6	9.7	7.5	5.0	2.1	3.5	9.2	5.2
Russia	7.4	8.1	7.0	5.5	9.7	9.0	14.0	12.0
Serbia	5.6	7.1	6.0	6.0	12.7	6.8	10.7	7.5
Turkey	6.9	4.6	3.5	3.0	9.6	8.8	10.5	8.4
Ukraine	7.3	7.6	6.4	2.5	9.1	12.8	25.3	18.8

Source: IMF, *World Economic Outlook*.
1/ Average weighted by PPP GDP.
2/ Montenegro is excluded from the aggregate calculations.

increases or declines in house prices. Exports to commodity producers may pick up somewhat, but will not meaningfully compensate for the reduction in domestic demand. Moreover, higher energy prices are likely to have adverse consequences for potential output as energy-intensive capacity has to be phased out, which could be aggravated by real wage rigidities. The food price shock is different from this perspective, because it acts mostly to redistribute income among countries within Europe; however, it poses problems within each country because of its disproportionate effect on low-income households. While the stabilization of commodity prices might help real disposable income growth, resolving the banking crisis that is now affecting Europe will be an arduous and protracted process. Banks' deleveraging will weigh on economic growth well into 2009.

In the baseline forecast, inflation is projected to recede steadily from mid-2008 onward, falling to below 2 percent by end-2009 in most advanced economies. This projection assumes that commodity prices stabilize, that there are no significant second-round effects through a wage-price spiral, and that monetary policy credibility is preserved. While uncertainty is high, risks to the outlook for commodity prices appear balanced. The empirical analysis reported in Chapter 2 together with the projected weakness in activity give ground for optimism about the validity of other baseline assumptions. Energy price shocks are not found to have fed into core inflation in advanced economies, while the effect of food price increases on core inflation has been small. Though vestiges of indexation remain, labor market flexibility in Europe has increased compared with earlier episodes of commodity price shocks, and monetary policy credibility seems well established. Moreover, the projected weakening of activity should put considerable downward pressure on wages and prices.

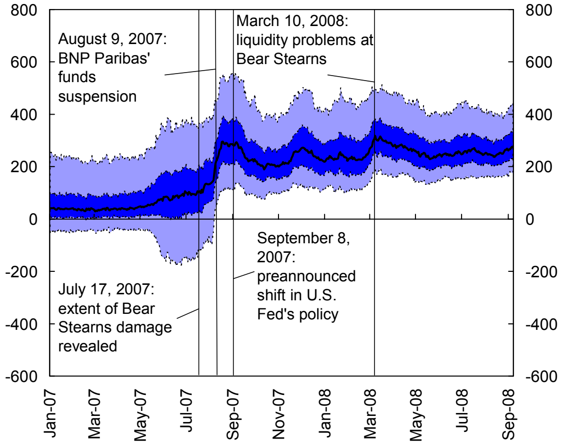
The extent of the slowdown and the shape of the recovery are highly uncertain. Commodity prices and the value of the euro could move favorably compared with the baseline. Although the recent easing of the pressures on these fronts may seem helpful, it seems to reflect an underlying demand slowdown and a reassessment of the relative growth prospects of Europe and the United States, to the detriment of the former. External demand could falter more broadly, especially if an adverse feedback loop develops between advanced and emerging economies, based on trade linkages and the increased degree of production sharing. Domestic demand could, however, be stronger than expected as households in the majority of countries and nonfinancial enterprises have maintained sound balance sheets. For continental Europe, second-round effects on inflation from real wage settlements in excess of productivity constitute a further albeit small risk, in particular as (partial) indexation is still practiced in some countries (European Central Bank, 2008a, p. 51). Finally, against the background of unrelenting tensions in financial markets, the possibility of a mutually reinforcing deterioration of financial and economic conditions persists as the key risk.

Financial Turmoil Continues . . .

Highly volatile financial markets continue to display significant stresses and high perceptions of risk (Figures 1 and 3). While global financial conditions improved following the rescue of U.S. investment bank Bear Stearns in March, tensions flared up again in July, when a large U.S. mortgage lender failed, and the U.S. Treasury and the Federal Reserve decided to extend wide-ranging and explicit guarantees to the government-sponsored enterprises (GSEs).[3] In September, financial strains intensified further, causing the failure of systemically important U.S. financial institutions and requiring extraordinary public intervention to prevent a meltdown of the U.S. financial system. The banking crisis also reached Europe, where several financial institutions had to be rescued or resolved. Financial stock prices have

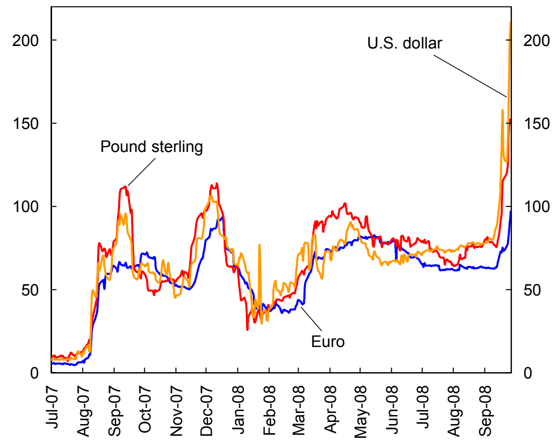
[3] Federal Home Loan Mortgage Corporation and Federal National Mortgage Association.

Figure 3. Estimating Shifts in the Global Price of Risk, 2007–08 1/
(Basis points)



Sources: Bloomberg L.P.; and IMF staff calculations.
1/ Selected percentiles of the estimated probability distribution for the expected unit price of risk that is common across assets. There is a 50 percent chance that the global price of risk will be inside the blue-shaded range and 90 percent chance that the outturn will be inside either the blue- or the purple-shaded area. The central thick black line denotes the estimated median price of risk. See Lombardi and Sgherri (forthcoming) for analytical underpinnings.

Figure 4. Spreads of Three-Month Interbank Rates over Expected Policy Rates, 2007–08
(Basis points)



Source: Bloomberg L.P.

fallen substantially, reflecting investor uncertainty about the viability of some banks.

Markets are concerned about losses related to subprime assets, exposures to unviable financial institutions, and the impact of the economic slowdown on general asset quality. One year after the onset of the financial turmoil, U.S. subprime-related write-downs and recorded credit losses at European banks amounted to about $200 billion, not much less than those incurred by North American banks. Swiss banks' losses reached a staggering $50 billion. As recorded losses are now shifting from trading to loan books and from large global banking groups to regional banks with large mortgage portfolios, the share of U.S. housing market–related losses borne by European banks should diminish. But recent failures of banks and insurance companies are adding further losses. Moreover, the economic slowdown in Europe is contributing to a broader deterioration of loan quality, especially in regions where housing markets are in decline.

Financial institutions are under severe pressure to reduce their high leverage.[4] Markets are paying increasing attention to pure rather than risk-weighted leverage, an indicator on which European financial institutions score less favorably than their U.S. equivalents. Moreover, while recapitalization initially went well, with European banks raising $155 billion between the onset of the turmoil and mid-2008, it is now likely to slow. The appetite of sovereign wealth funds and institutional investors has diminished, while volatile financial markets, together with legal requirements that protect existing shareholders from dilution of ownership, weigh on the cost of raising capital. Instead, public intervention, asset sales, and bank consolidation have begun to play a more prominent role in attempts to strengthen capital positions.

Borrowing costs and credit default spreads have risen, and term spreads in money markets have remained at elevated levels (Figures 1 and 4). Segmentation in money markets has increased as well and term funding is virtually unavailable. These problems have moved to commercial paper, and, together with rising risk aversion, have pushed corporate bond yields of all ratings close to their highest levels of this decade. Generally, availability of credit has become severely impaired.

Financial stability continues to be at risk, though not likely in a systemic manner. As noted

[4] See the IMF's *Global Financial Stability Report* (2008b) for more details.

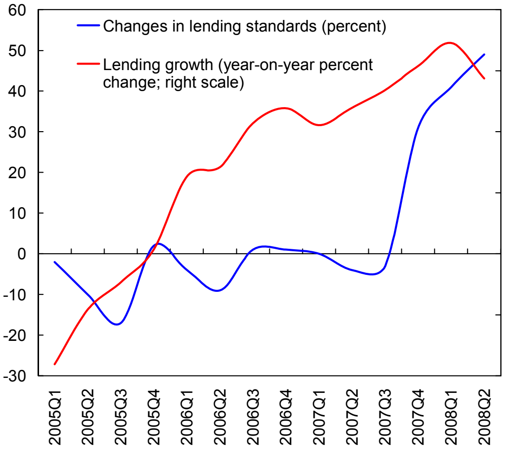
by the European Central Bank (ECB) in June, risks to the euro area's financial stability had on balance increased since the beginning of the year (European Central Bank, 2008b), in line with similar observations by the central banks of the United Kingdom and Sweden (Bank of England, 2008; and Riksbank, 2008). The disruptions in the U.S. financial system in September have heightened the risk of a systemic financial crisis in Europe further, though a full-blown crisis remains improbable and recent actions by the authorities should help in this respect. Nonetheless, additional banks may fail, as implied by their very high risk spreads and market doubts about the viability of their business models.

. . . with Adverse Effects on Real Activity

Household credit is slowing significantly, and mortgage credit has slumped in several regional housing markets. Features of mortgage markets, in particular the role of collateral, are a key factor in determining the boom-bust dynamics of asset prices and their real effects (see Chapter 3 for details). In Ireland, house prices have now declined for over a year, and in the United Kingdom, they have dropped sharply over the past few months; meanwhile, in Spain they have started falling recently. Consequently, in these countries, construction activity has been contracting noticeably. The reliance on wholesale funding by Spanish banks entails a risk that the credit squeeze will stretch to other sectors, especially if funding costs rise further and the maturity profile of debt liabilities continues to shorten. Also, in the United Kingdom, there is an acute risk that adverse feedback loops between housing and credit sectors will have a sizable negative effect on real activity.

Tighter financing conditions are expected to temper the issuance of debt securities by European corporates. Debt issuance is expected to grind to a halt after a period of robust growth. Corporate bank lending is beginning to show signs of moderation, in line with the typically lagged response of such lending to the tightening of financing conditions over the credit cycle (Figure 5). These tighter conditions should increasingly affect European businesses that are highly dependent on bank lending and highly leveraged, with adverse consequences on business activity. Default rates are expected to rise from their recent historically low levels, with highly leveraged corporations and real estate–related businesses being particularly vulnerable.

Figure 5. Changes in Credit Standards for Loans and Lending to Enterprises, 2005–08 1/



Sources: Haver Analytics; and European Central Bank.
1/ Net percentage of banks reporting tightening of credit standards.

Policies Need to Limit the Damage from Financial Turmoil

The immediate priority for central banks in advanced economies is to restore calm to financial markets through provision of liquidity as needed. With these economies set to slow, commodity prices stabilizing, and risks tilted to the downside from the financial turmoil, scope for monetary easing has emerged. In the euro area, the ECB signaled its determination to anchor inflation expectations and meet its inflation objective with an increase in the policy rate in early July 2008. Since then it has remained on hold as upside risks to inflation are diminishing and downside risks to output are rising. With the slowdown in activity clearly under way and inflation expectations well behaved, a more accommodative policy stance is now feasible. Meanwhile, to keep inflation expectations anchored, the Bank of England has kept rates unchanged since August 2008, but the sharp deterioration of the economic outlook for the United Kingdom is bringing forward the prospect of an easing of the policy stance. In other cases, such as Norway and Sweden, where activity has remained stronger, central banks have recently tightened further, but the tightening cycle is likely to have run its course.

Financial sector policies should aim at resolving the stresses in the financial system. Actions on a scale similar to the U.S. intervention are unlikely to be required, but coordinated and concerted action is also needed in Europe. Proactive liquidity management has been appropriate, and helpful adjustments to liquidity management frameworks have been implemented in several countries and properly coordinated across borders. However, these frameworks should also feature incentives that support the improvement of credit quality of collateral deposited with central banks after the financial stress has dissipated. In this regard, the recent tightening of the ECB's collateral policy will be helpful. But the banking crisis has now also required solvency support for major financial institutions, including some cross-border banks, while leading to the adoption of different guarantees by national governments. To restore confidence, European leaders will need to make a decisive commitment to concerted and coordinated action to alleviate financial stresses and avoid the serious risk of backtracking on European financial integration. Addressing the concerns raised by cross-border spillovers of actions taken by national authorities will require movement toward more joint responsibility and accountability for financial stability in Europe.

Looking further ahead, to dampen the propensity of the financial sector to amplify business cycle fluctuations and the impact of monetary policy and asset price developments on real activity, banking regulation may have to play a role in mitigating the cyclical swings in credit conditions (see Chapter 3 for detailed analysis).

Fiscal policies can help cushion the downturn, but medium-term fiscal sustainability needs to be safeguarded. In the current context, automatic stabilizers can be allowed to play fully around the required consolidation path, except in those countries where this would breach their fiscal rules. The Stability and Growth Pact (SGP) has improved fiscal discipline, but many European countries still face persistent challenges in meeting their medium-term objectives; in some countries, fiscal deficits risk exceeding the Maastricht deficit limit in the near term (Table 2). Similarly, the United Kingdom needs to set policy consistent with meeting its fiscal rules. In the current circumstances, discretionary loosening is unlikely to be effective and countries should set fiscal policy so as to reach their medium-term objectives in line with commitments under the revised SGP and consistent with medium-term fiscal rules. Discretionary use of fiscal resources should primarily be focused on measures to directly alleviate stress in financial markets, if and when needed.

In reaction to higher commodity prices, the fiscal policy response should be limited to temporary, well-targeted income support to vulnerable households, while structural policies should promote supply and free trade. General fiscal support or a reduction in taxes on items most affected by the commodity price shocks would be counterproductive: both would boost demand, further aggravating wage and price pressures, and likely benefit the wealthy more. Instead, removing remaining supply-limiting distortions in the agricultural sector, including through a reform of the Common Agricultural Policy, and breaking the deadlock on the Doha Round of trade talks would provide clear benefits.

Table 2. European Countries: External and Fiscal Balances, 2006–09

(Percent)

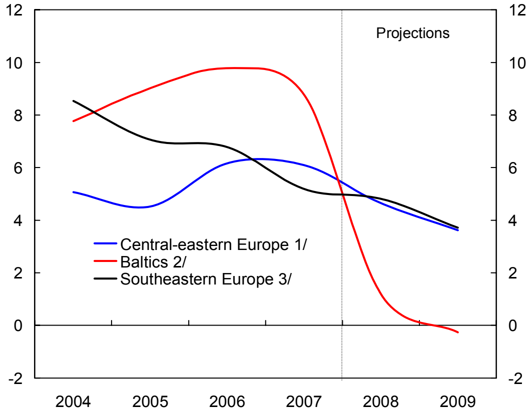
	Current Account Balance to GDP				General Government Balance to GDP			
	2006	2007	2008	2009	2006	2007	2008	2009
Europe 1/	**0.6**	**0.2**	**-0.4**	**-0.6**	**-0.1**	**0.1**	**-0.4**	**-1.1**
Advanced European economies 1/	0.8	0.6	0.0	0.1	-0.9	-0.3	-1.2	-1.7
Emerging European economies 1/ 2/	0.0	-1.8	-1.8	-3.0	1.9	1.4	1.5	0.4
European Union 1/	-0.4	-0.7	-1.2	-1.2	-1.5	-0.9	-1.7	-2.2
Euro area	0.3	0.2	-0.5	-0.4	-1.3	-0.6	-1.5	-2.0
Austria	2.4	3.2	2.8	2.4	-1.6	-0.7	-0.7	-1.1
Belgium	2.7	2.1	0.0	-1.1	0.4	-0.1	-0.4	-1.3
Cyprus	-5.9	-9.7	-9.7	-7.8	-1.2	3.3	0.6	-0.3
Finland	4.6	4.6	3.4	2.9	4.0	5.2	4.9	3.7
France	-0.7	-1.2	-2.8	-2.7	-2.4	-2.7	-3.3	-3.9
Germany	6.1	7.6	7.3	6.8	-1.5	-0.2	-0.3	-0.8
Greece	-11.1	-14.1	-14.0	-14.1	-2.6	-2.8	-2.8	-2.3
Ireland	-3.6	-5.4	-5.0	-4.4	2.9	0.3	-4.0	-4.7
Italy	-2.6	-2.5	-2.8	-2.4	-3.4	-1.6	-2.6	-2.9
Luxembourg	10.5	9.9	8.6	8.2	1.3	3.0	1.7	1.0
Malta	-8.2	-5.4	-7.7	-6.4	-2.5	-1.8	-1.7	-1.0
Netherlands	8.2	6.8	5.6	5.1	0.6	0.6	1.1	1.7
Portugal	-10.1	-9.8	-12.0	-12.7	-3.9	-2.6	-2.2	-2.3
Slovenia	-2.8	-4.9	-4.7	-4.7	-0.8	-0.1	0.1	-0.3
Spain	-8.9	-10.1	-10.1	-7.7	2.0	2.2	-1.6	-2.5
Other EU advanced economies								
Denmark	2.9	1.1	1.3	1.8	4.9	4.8	3.2	3.0
Sweden	8.5	8.5	6.4	5.8	2.2	3.4	2.5	1.0
United Kingdom	-3.4	-3.8	-3.6	-3.4	-2.6	-2.7	-3.5	-4.4
New EU countries 1/	-5.9	-7.1	-7.3	-7.3	-3.1	-1.7	-1.9	-2.1
Bulgaria	-15.6	-21.4	-24.4	-21.5	3.5	3.5	4.2	2.7
Czech Republic	-2.6	-1.8	-2.2	-2.5	-2.7	-1.6	-1.9	-2.1
Hungary	-6.1	-5.0	-5.5	-6.1	-9.2	-5.5	-3.8	-3.3
Poland	-2.7	-3.8	-4.7	-5.7	-3.9	-1.5	-2.0	-2.3
Romania	-10.4	-14.0	-13.8	-13.3	-0.6	-2.3	-2.3	-2.8
Slovak Republic	-7.1	-5.4	-5.1	-4.7	-3.7	-2.2	-2.2	-1.7
Estonia	-16.7	-18.1	-10.8	-8.7	3.3	3.0	-1.3	-1.4
Latvia	-22.7	-22.9	-15.1	-8.3	-0.4	0.7	-1.4	-2.0
Lithuania	-10.7	-14.6	-14.9	-8.7	-1.5	-1.9	-1.6	-0.7
Non-EU advanced economies								
Iceland	-25.4	-14.6	-18.2	-13.7	6.3	5.5	2.0	-3.3
Israel	5.9	3.2	0.4	0.5	-1.4	-0.8	-1.9	-2.0
Norway	17.3	15.4	19.1	18.0	18.5	17.4	20.4	19.7
Switzerland	14.7	16.6	9.3	8.7	2.3	2.5	1.5	1.4
Other emerging economies								
Albania	-5.6	-9.2	-10.5	-7.1	-3.2	-3.8	-5.2	-3.0
Belarus	-3.9	-6.8	-5.9	-8.0	1.4	0.4	2.1	0.0
Bosnia and Herzegovina	-8.4	-12.7	-15.8	-13.5	2.2	-0.1	-1.9	-2.6
Croatia	-7.9	-8.6	-10.1	-10.2	-3.0	-2.3	-2.4	-1.5
Macedonia, FYR	-0.9	-3.0	-14.0	-13.8	-0.5	0.6	-1.5	-3.0
Moldova	-11.8	-17.0	-19.9	-19.1	0.2	-0.2	-0.5	-1.0
Montenegro	-24.7	-39.6	-39.6	-36.8	2.2	4.5	3.4	0.5
Russia	9.5	5.9	6.5	3.4	8.3	6.8	6.3	3.8
Serbia	-10.0	-15.9	-18.6	-19.3	-1.6	-1.9	-2.0	-4.9
Turkey	-6.0	-5.7	-6.5	-6.7	-1.6	-2.9	-2.0	-1.8
Ukraine	-1.5	-3.7	-7.2	-9.2	-1.4	-2.0	-0.9	-1.3

Source: IMF, *World Economic Outlook*.

1/ Weighted average. Government balance weighted by PPP GDP; external account balance, by U.S. dollar-weighted GDP.

2/ Montenegro is excluded from the aggregate calculations.

Figure 6. Growth in Emerging Europe, 2004–09
(Percent)



Source: IMF, *World Economic Outlook.*
1/ The Czech Republic, Hungary, Poland, and the Slovak Republic.
2/ Estonia, Latvia, and Lithuania.
3/ Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania, Serbia, and Turkey.

Emerging Economies

Growth Is Slowing Significantly

Following a prolonged expansion, activity and domestic demand have started to moderate in emerging Europe, in most cases lowering growth rates toward more sustainable levels and beginning to reduce external imbalances (Figure 6 and Tables 1 and 2). In most countries, a slowdown was necessary to ease overheating pressures and bring growth rates in line with what could be justified by fundamentals (IMF, 2008c). The region has been relatively resilient to the global financial turmoil, but it is now increasingly facing tighter financial conditions and more discerning investors. Credit growth and capital inflows remain strong on average, but inflows have slowed noticeably and become more sensitive to individual countries' imbalances, the soundness of policy frameworks, and progress in structural reforms. For some countries, for example the Baltics, the pace of credit growth has come down markedly from earlier peaks. Slower growth in advanced economies has weighed on exports, while price shocks have dampened consumption. Risks to the growth outlook are tilted to the downside, stemming primarily from external demand and external financial conditions, while in some cases domestic asset price declines could have a significant impact on the balance sheets of households, enterprises, and financial institutions, further undermining growth.

The extent of the slowdown varies considerably across the region, depending on the speed of the earlier expansion, the resulting external imbalances, and the stance of macroeconomic policies. Growth in central-eastern Europe[5] is easing to rates just below trend. The moderation is more pronounced in southeastern Europe, though this region is expected to continue to grow at rates above or close to potential. Moreover, Romania, Moldova, FYR Macedonia, Bulgaria, and Albania have yet to show significant signs of slowing. The Baltic economies are experiencing a more abrupt adjustment, with recessions in Estonia and Latvia, correcting an unsustainable economic boom (Box 2). Turkey is also slowing, while Russia's oil-driven boom has started easing. Financial risks have risen appreciably, constituting a key downside risk to the outlook for most emerging economies.

Inflation Is Still a Concern . . .

Recent price shocks have affected emerging Europe substantially more than the rest of Europe, mainly due to the larger share of food and fuel in these countries' consumption baskets (see Chapter 2). Global energy and food price increases have had a significant impact on domestic prices of these items. However, domestic factors—such as weather conditions, convergence-related price pressures, and trade integration—have played a dominant role in determining food prices in recent years. Inflation in the region is projected to average about 11 percent in 2008–09 (Table 1). Half of the countries in the region have already hit double-digit inflation in 2008, with the highest rates observed in Ukraine, followed by Latvia, Belarus, and Russia.

[5] The Czech Republic, Hungary, Poland, and the Slovak Republic.

Box 2. The Baltics: Harder Times Ahead

Against a backdrop of wide economic imbalances, the Baltic economies are slowing sharply in response to a tightening of external financing conditions (figure). For years, domestic demand had grown too fast, driven by optimistic expectations about convergence, foreign-financed credit, and sharply rising real estate prices, amplified in some cases by procyclical fiscal policies. The resulting external and internal imbalances and financial risks eventually led the mainly Nordic-owned banks to tighten lending standards and slow credit growth, a move that has been reinforced by the global financial turbulence of the past year. As a result, growth has fallen. In Estonia, year-on-year growth fell close to zero in the first quarter of 2008; Latvia has experienced its slowest growth rate in a decade; and there has been some deceleration in Lithuania, albeit from a less elevated level.

While a correction of economic imbalances was needed, adjustment will not be easy. As demand continues to unwind, labor market pressures should dissipate and current account deficits narrow. But the resumption of balanced growth will involve reallocating resources from nontradables to tradables, and wage growth will need to move back into line with productivity growth. Even though the Baltic economies are relatively flexible, this could take some time, with competitiveness deteriorating in the interim. In the financial sector, slowing GDP growth will lead to a decline in credit quality, which will put pressure on bank capital; however, overall financial sector resilience will be supported by large foreign-owned banks with a long-term commitment to the region. The slowdown will also erode government revenue, pushing budgets into deficit, although low public indebtedness should mitigate concerns about fiscal solvency. The adjustment could be painful, but delaying would entail a longer and deeper growth slowdown.

While the burden of adjustment will fall primarily on the private sector—as described above—consistent and well-articulated policies will be needed to encourage smooth adjustment and maintain investor confidence:

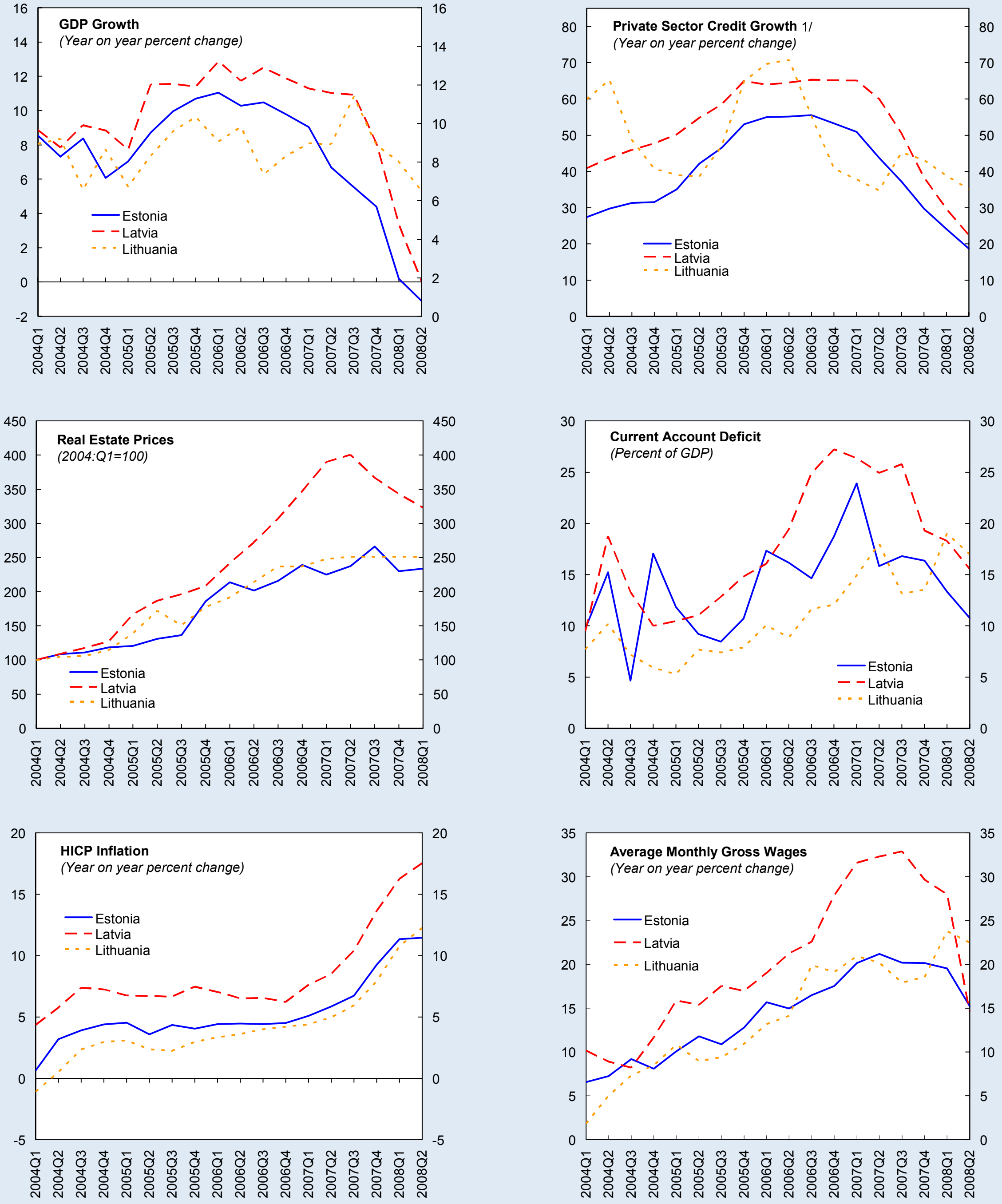
- Public communications should guide private sector expectations about a realistic adjustment path and emphasize the need for wage restraint.
- Adjustment can be facilitated by structural reforms to improve the flexibility of goods and factors markets.
- In the financial sector, the authorities should ensure that banks maintain adequate capital and liquidity, that high prudential standards are maintained, and that financial safety nets be upgraded where necessary.
- Automatic fiscal stabilizers should be allowed to operate, and discretionary easing of fiscal policy avoided.

. . . continued

Note: The main author of this box is Gavin Gray.

Box 2 *(concluded)*

Estonia, Latvia, and Lithuania: Economic Indicators



Sources: Haver Analytics; Emerging Markets Economic Data; Eesti Pank; Latvian authorities; and IMF staff estimates and calculations.

1/ For Estonia and Latvia, both banks and leasing companies' activities are included in the definition of private sector credit. For Lithuania, only bank lending is included.

Rising core inflation suggests that commodity price shocks have exacerbated existing overheating pressures (Figures 7 and 8 and Chapter 2). Continued strong demand (primarily in Bulgaria and Romania) and, in some cases, wages rising faster than productivity (primarily in central-eastern Europe) have been key factors. Core inflation so far in 2008 has increased the most in Russia and Bulgaria. It has fallen only in Hungary and Moldova.

In contrast to advanced economies, several emerging economies in Europe have responded to the recent commodity price shocks with administrative measures to limit their impact on inflation and increase food supplies. Measures have included lower import tariffs and other trade barriers on selected food items (FYR Macedonia, Moldova, and Russia); selective food export taxes (Croatia and Russia); food export quotas (Ukraine); temporary export bans for wheat (Serbia); lower consumption taxes for food (Lithuania), public transportation (FYR Macedonia), and petroleum (Croatia); use of state commodity reserves to replenish domestic food supply (FYR Macedonia, Moldova, Montenegro, and Ukraine); subsidies and other support to agriculture (Belarus, Croatia, and Moldova); and a tax relief to oil refineries (Belarus). Attempts to limit food price inflation have also been undertaken through direct caps on price margins (Belarus) or by moral suasion (FYR Macedonia and Montenegro). These measures have not, on balance, substantially altered prevailing inflationary pressures.

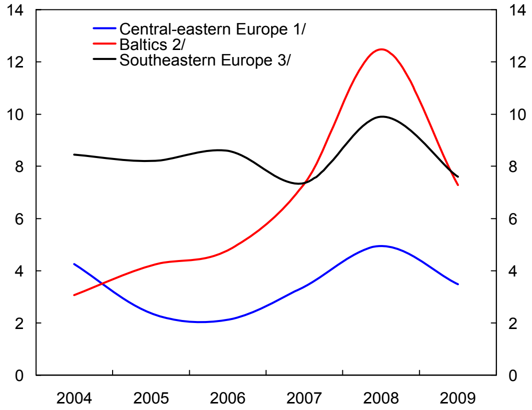
. . . but External Imbalances Present the Major Risks

Risks of a hard landing remain elevated in parts of the region. Although external imbalances are expected to narrow as growth rates fall in most countries (Table 2), they remain high by historical standards and compared with other emerging economies. Moreover, about half of the countries in the region still have double-digit current account deficits as a share of GDP. Large external imbalances and a high dependence on foreign financing are exposing a number of countries in the region to external shocks and changes in international credit conditions and investors' sentiment. Decisions by foreign banks to limit their exposure to the region, following the recent increase in risk aversion and financial market volatility, could affect financial conditions more than domestic policies.

Indeed, market confidence has eroded recently. Risk premiums and borrowing costs have increased throughout the region since mid-2007,

Figure 7. Inflation in Emerging Europe, 2004–09

(Percent)



Source: IMF, *World Economic Outlook.*

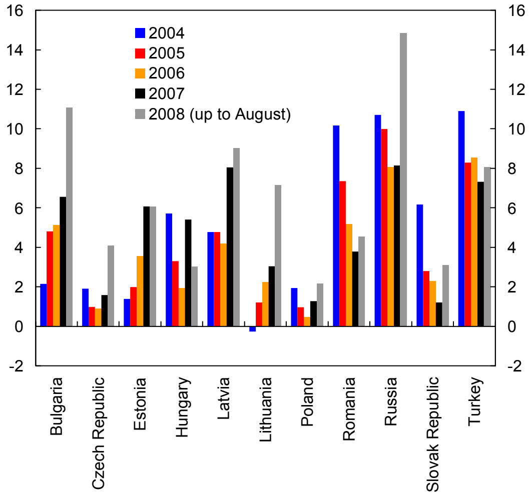
1/ The Czech Republic, Hungary, Poland, and the Slovak Republic.

2/ Estonia, Latvia, and Lithuania.

3/ Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania, Serbia, and Turkey.

Figure 8. Emerging Europe: Annual Inflation Excluding Energy, Food, Alcohol, and Tobacco 1/

(Percent)

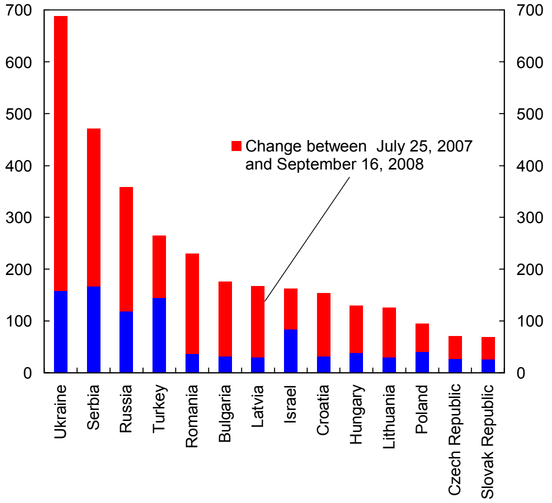


Sources: Eurostat; and Haver Analytics.

1/ Excluding food and gasoline for Russia.

Figure 9. Sovereign Spreads, July 25, 2007–September 16, 2008

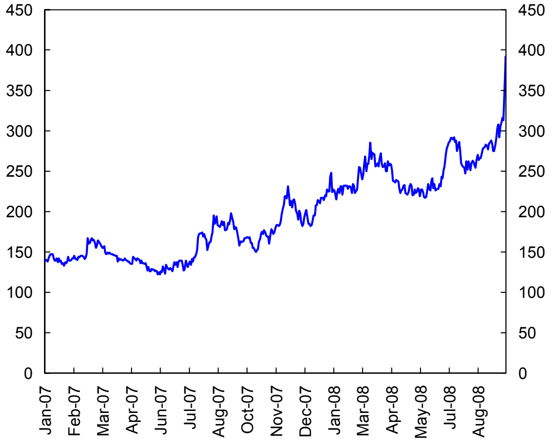
(Basis points)



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

Figure 10. Emerging Europe EMBI+, January 2007–September 2008 1/

(Basis points)



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

1/ EMBI+ is the JPMorgan Emerging Markets Bond Index Plus.

although from historically low levels (Figures 9 and 10). Stock market indices have also dropped markedly in most countries so far in 2008; in the case of Russia triggering a temporary suspension of trading. Against the background of the seizure of U.S. financial markets in September, some emerging economies experienced capital outflows and/or a very sharp widening of spreads. Banks operating in emerging Europe are being affected by the widening turmoil in western Europe.

Policies Need to Engineer a Soft Landing

For nearly all of emerging Europe, tightening macroeconomic policies to reduce external imbalances and contain inflation, and putting in place contingency plans to deal with potential financial instability remain a priority. Where possible, monetary policy has been tightened (the Czech Republic, Poland, Romania, Russia, Serbia, and Turkey), and exchange rates have been allowed to appreciate to ease inflation pressures (particularly in central-eastern Europe). For central-eastern Europe, risks to inflation and growth now appear balanced, justifying keeping monetary policy on hold. Elsewhere, however, further tightening seems required to address concerns about second-round effects from recent price shocks and help reduce external imbalances. In south-eastern Europe, mindful of the more volatile external environment, reining in domestic demand, in particular by containing growth in public expenditure, is essential. Fiscal balances are projected to improve in one-third of the countries in 2008, and delivering on this intention will be essential (Table 2). In addition, with output still above potential in several countries and rising fiscal deficits in most, the pace of fiscal consolidation in the region needs to be stepped up. The challenge for Russia is to address the concerns about the stability of its financial system, while alleviating the impact of the commodity boom on domestic demand through a combination of monetary tightening, greater exchange rate flexibility, and a prudent fiscal stance (Box 3).

While fiscal consolidation remains key, some targeted and temporary income support for vulnerable households is needed and preferable to the use of administrative measures to attempt to curb inflationary pressures. Income support policies will need to be carefully designed to avoid adding to overall demand pressure. Administrative measures, which usually introduce further market distortions, preventing supply and demand from

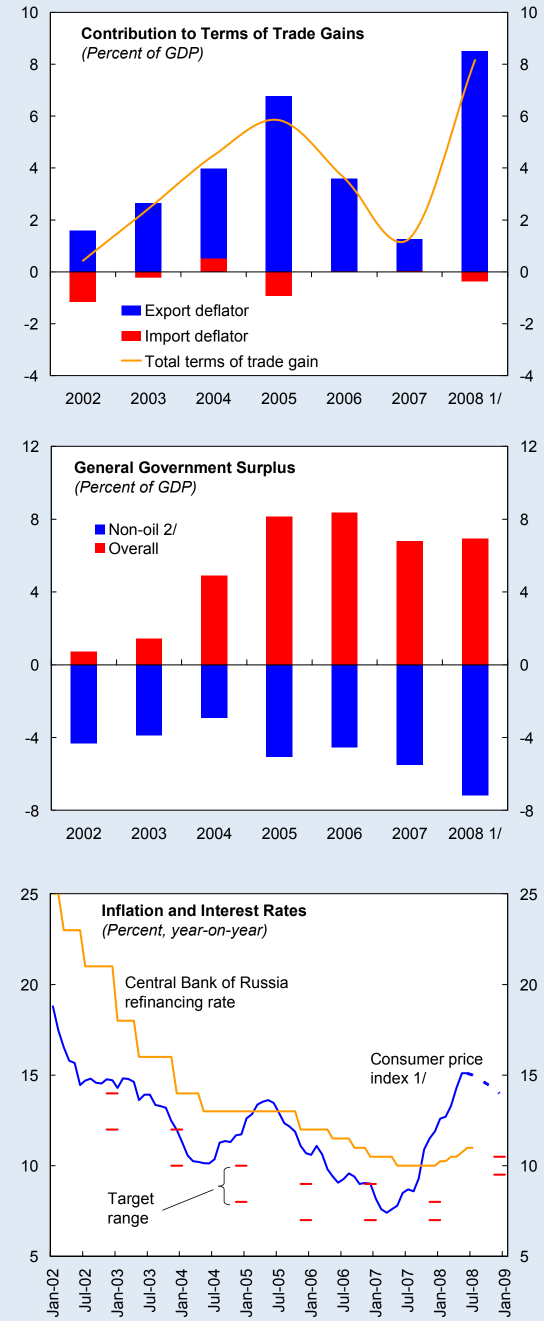
Box 3. Russia: Dealing with Surging Commodity Exports

The worldwide surge in commodity prices is fueling Russia's already-booming economy. Like elsewhere, rising food and commodity prices have directly boosted domestic inflation, especially with food items representing over 40 percent of Russia's consumption basket. However, in contrast to most other European economies, Russian firms are benefiting from the commodity price boom. Oil and gas account for around 20 percent of GDP, and about 60 percent of export earnings (with coal, metals, and precious stones accounting for another 20 percent). Russia's terms of trade have increased by over 110 percent during 2000–08, representing a cumulative gain of about 25 percent of GDP. Almost one-third of this gain has accrued in 2008 alone.

The effect on the domestic economy has been muted by the operation of Russia's Oil Stabilization Fund. Established in 2004, this fund has set aside 85 percent of all marginal windfall oil revenues in excess of $27 a barrel, and has been key in sterilizing the domestic impact of surging export revenues (figure).

Nonetheless, there has been significant leakage into domestic demand. With rising export prices adding to strong growth prospects, domestic demand has recently risen at a rate of about 15 percent a year, more than double most estimates of potential growth. As a result, inflation has moved up sharply, well beyond what can be justified by increases in food and energy prices. Temporary measures to calm select food prices in 2007, through export tariffs and strategic grain sales, were widely held to be ineffective, and have largely been allowed to lapse.

A gradual widening of the non-oil fiscal deficit has contributed to demand. This, in turn, stems from intense political pressure to spend more of Russia's windfall gains on the economy's critical social and infrastructure needs. Additionally, efforts to increase public savings through the stabilization fund have been offset by substantial private dissaving.



Sources: National authorities; and IMF staff calculations.
1/ Projections from July 2008.
2/ Excluding Yukos auction proceeds.

. . . *continued*

Note: The main author of this box is Andrew Tiffin.

Box 3 *(concluded)*

In this context, monetary policy has been largely accommodating, notwithstanding recent incremental increases in policy rates and reserve requirements. Concerned about Russia's external competitiveness, the central bank has been reluctant to allow nominal appreciation, and thus has heavily intervened in the foreign exchange market. With limited scope to sterilize these interventions, the result has been rapid money and credit growth and, ultimately, inflation. Deteriorating investor sentiment has recently added substantial volatility, with liquidity conditions tightening sharply and the exchange rate depreciating.

Against the background of this challenging environment, the IMF has advocated a different policy mix. Monetary policy will need to be refocused on inflation reduction in the context of more exchange rate flexibility. Moreover, fiscal policy will need to avoid any further stimulus until demand pressures ease. However, the recent disruption in domestic financial markets has complicated the policy response, requiring liquidity support and possibly use of fiscal resources to shore up the financial system.

adjusting to the new price signals, should be avoided. Instead, the current price shocks should be seized as an opportunity to remove existing distortions and unclog bottlenecks in domestic commodity markets, including by liberalizing commodity trade and eliminating production subsidies. Competition in the food and energy sectors could be enhanced to increase supply and ease price pressures. Land reform (for example, in Ukraine and Croatia) and public investment in energy efficiency would also pay off in the medium term.

In countries where the adjustment has been more abrupt—primarily in the Baltics—policies have to strike a balance among the needs to support the economy, control inflationary pressures, and sustain market confidence. The adjustment should be allowed to take its course, cushioned by the free operation of automatic fiscal stabilizers. Meanwhile, a strengthening of the financial system and its supervision, including the cross-border dimension, is paramount.

A reinvigorated commitment to structural reforms, including in the financial sector, could smooth the adjustment and improve the long-term prospects of the region. As previous IMF work has shown, parts of emerging Europe (primarily southeastern Europe, parts of central-eastern Europe, and the Commonwealth of Independent States countries) lag well behind progress achieved in the rest of Europe in liberalizing product and labor markets, creating a business-friendly environment, and tackling inefficient bureaucracies and corruption (IMF, 2008c). Continuing strengthening of financial sector supervision and progress in institutional reforms should ensure that financial development proceed without adding volatility, thus contributing to the region's convergence with the rest of Europe.