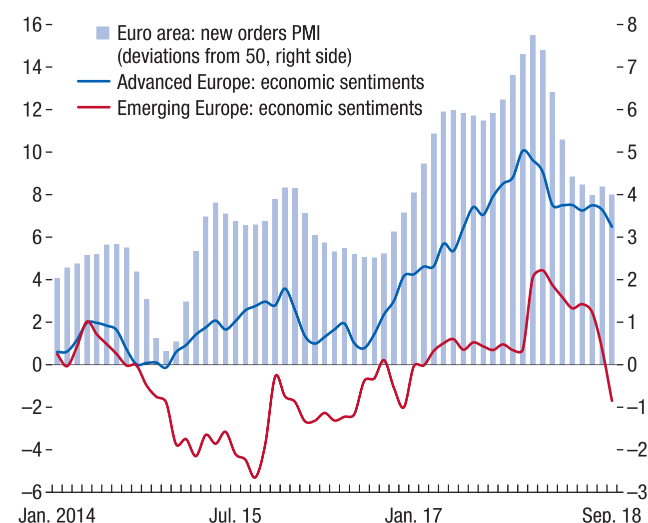
1. Domestic Expansion Running into External Turbulence

Activity continued to expand in the first half of 2018, but at a slower-than-expected pace, mainly in advanced Europe. The external environment has become less supportive, with slowing global demand, escalating trade disputes, and higher fuel prices. Tighter financial conditions in vulnerable emerging market economies and maturing business cycles act as additional headwinds. With weakening forward-looking indicators, growth is now projected to slow from 2.8 percent in 2017 to 2.3 percent in 2018 and 1.9 percent in 2019, down from respective projections of 2.6 percent and 2.2 percent in the May 2018 *Regional Economic Outlook: Europe*. Near-term risks to the outlook have shifted to the downside. As growth is expected to continue to exceed potential, policymakers should continue to focus on structural reforms and rebuilding policy buffers to prepare for the next downturn.

Figure 1.1. Private Sector Consumer Confidence and New Orders

(Deviation from long-term mean; weights are based on purchasing power parity GDP)



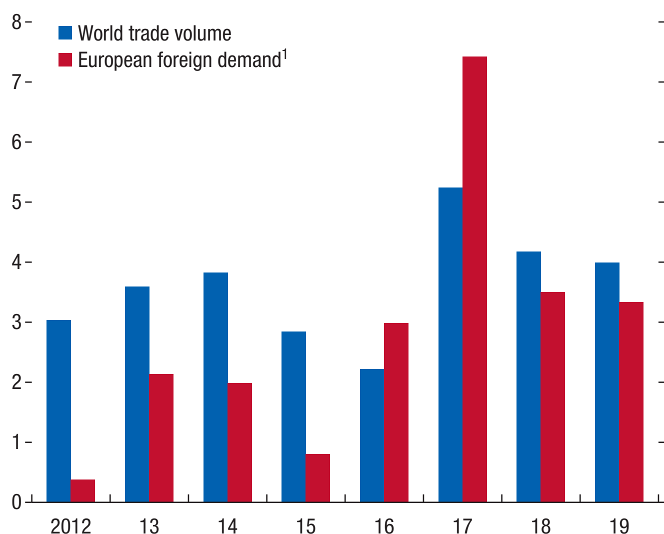
Sources: Haver Analytics; IMF, *World Economic Outlook*; and IMF staff calculations.
Note: PMI = purchasing managers' index.

The Pace of Economic Expansion Has Slowed in Many European Economies

Europe has seen strong growth over the past couple of years, as many downside risks have not materialized. On the back of supportive macroeconomic policies, economic activity continued to expand in the first half of 2018, driven by domestic demand. However, there are signs of softening in Romania, Turkey, and the United Kingdom. Also, in the euro area, GDP growth cooled further to 0.2 percent in the third quarter (quarter-on-quarter, annual rate), from 0.4 percent in each of the first two quarters. The deceleration was mainly due to weaker external demand (especially for goods), special factors (inclement weather, car production), and base effects in the first quarter of 2018. In most Central, Eastern, and Southeastern European (CESEE) countries, the expansion remained robust thanks to a higher absorption of EU funds and strong private consumption growth on the back of increasingly tight labor markets. Nordic and Baltic economies, the Czech Republic, and Switzerland also continued to perform well. With most confidence indicators down to pre-2017 levels (Figure 1.1), forward-looking indicators suggest moderation of growth. Only a few indicators hint at stronger growth in the second half of 2018.

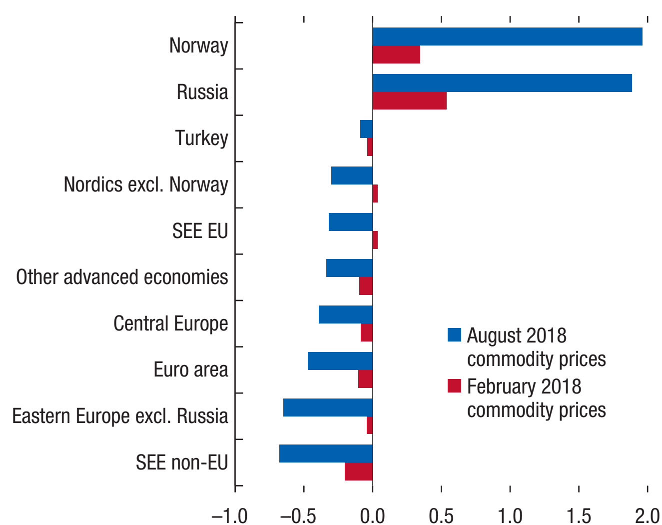
This chapter was prepared by a staff team composed of Vizhdan Boranova, Kamil Dybczak, and Sylwia Nowak, with input from Raju Huidrom and Nemanja Jovanovic. The team was led by Emil Stavrev under the general guidance of Jörg Decressin. Laura Papi provided useful advice and comments. Nomelie Veluz provided administrative support. The chapter reflects data and developments as of October 15, 2018.

Figure 1.2. Global Trade and Foreign Demand
(Year-over-year percent change)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
[1]Measured by volume of global imports of European goods and services.

Figure 1.3. Terms-of-Trade Windfall Gains and Losses, 2018–19[1]
(Average annual gains and losses, percent of GDP)



Source: IMF staff estimates.
Note: SEE EU = Southeastern European EU member states; SEE non-EU = Southeastern European non-EU members states.
[1]The windfall is an estimate of the change in disposable income arising from commodity price changes compared to the previous year. See Figure 1.9 in October 2018 *World Economic Outlook* (WEO) and Gruss (2014).

Several Headwinds Are at Play

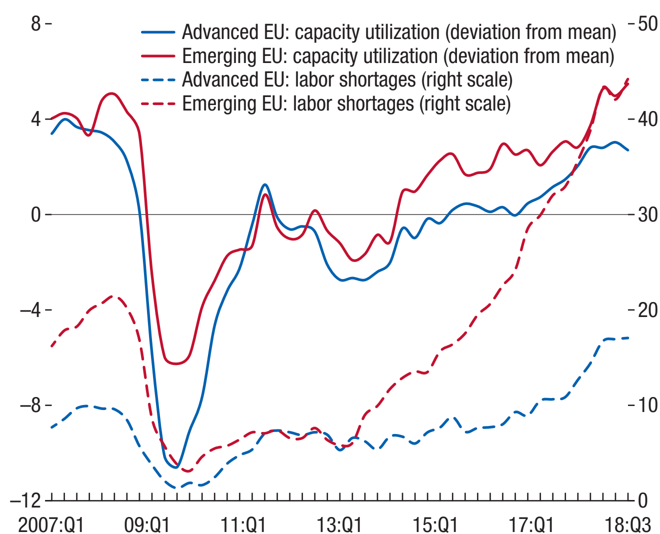
The external environment has become less supportive. European exporters enjoyed exceptionally strong export growth in the fourth quarter of 2017. Global imports of European goods and services grew by 7.5 percent in 2017, up from 3 percent a year earlier. However, foreign demand for European exports moderated in 2018 and is expected to remain soft in 2019 (Figure 1.2). In the *euro area*, the slowdown of exports is driven by intermediate and capital goods, which account for two-thirds of goods exports from the *euro area* to the rest of the world. Also, some of the slowdown in the third quarter reflects lower car production, notably in Germany, as carmakers adapt to comply with new pollution tests. Trade tensions are another factor. Thus far, the direct impact of already-implemented US tariffs on steel and aluminum has been limited, given low exports of these items from Europe to the *United States,* but there are concerns that they could weigh appreciably on growth ahead (see risks below).

Higher energy prices have dampened real incomes in most of Europe. Commodity prices have increased 7 percent since the spring of 2018, as oil prices climbed to $79 a barrel in September, the highest level since 2014. This increase in fuel prices has lifted headline inflation by an average of about ½ percentage point across Europe. For *Norway* and *Russia*, the terms-of-trade windfall gains are estimated at about 1.5 percent of GDP each year (Figure 1.3). In the rest of Europe, higher fuel prices have dampened real disposable incomes by up to 0.7 percentage point of GDP, a worsening of about a third of a percentage point of GDP compared with the April 2018 *World Economic Outlook* estimates. In the *newer EU member states*, the impact of higher energy prices has been offset by the increased absorption of EU funds and strong wage growth. The increase in fuel prices is also expected to further strengthen current account surpluses for oil exporters.

Additional headwinds come from maturing business cycles. Output gaps are estimated to be mostly closed or positive. Production capacity

Figure 1.4. Factors Limiting Production

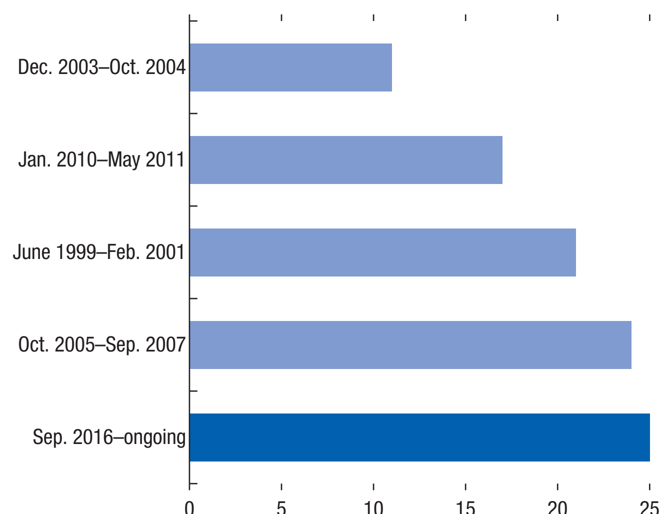
(Labor shortages, percent balance; capacity utilization, percent of full capacity; seasonally adjusted)[1]



Sources: European Commission, *Quarterly Business and Consumer Survey*; Haver Analytics; IMF, *World Economic Outlook*; and IMF staff calculations.
[1]Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease. Capacity utilization is measured as the capacity at which the company is operating at the time of the survey.

Figure 1.5. Euro Area Industrial Activity—The Top Five Longest Expansion Periods since 1997

(Cumulative number of months the PMI stayed above its long-term average)



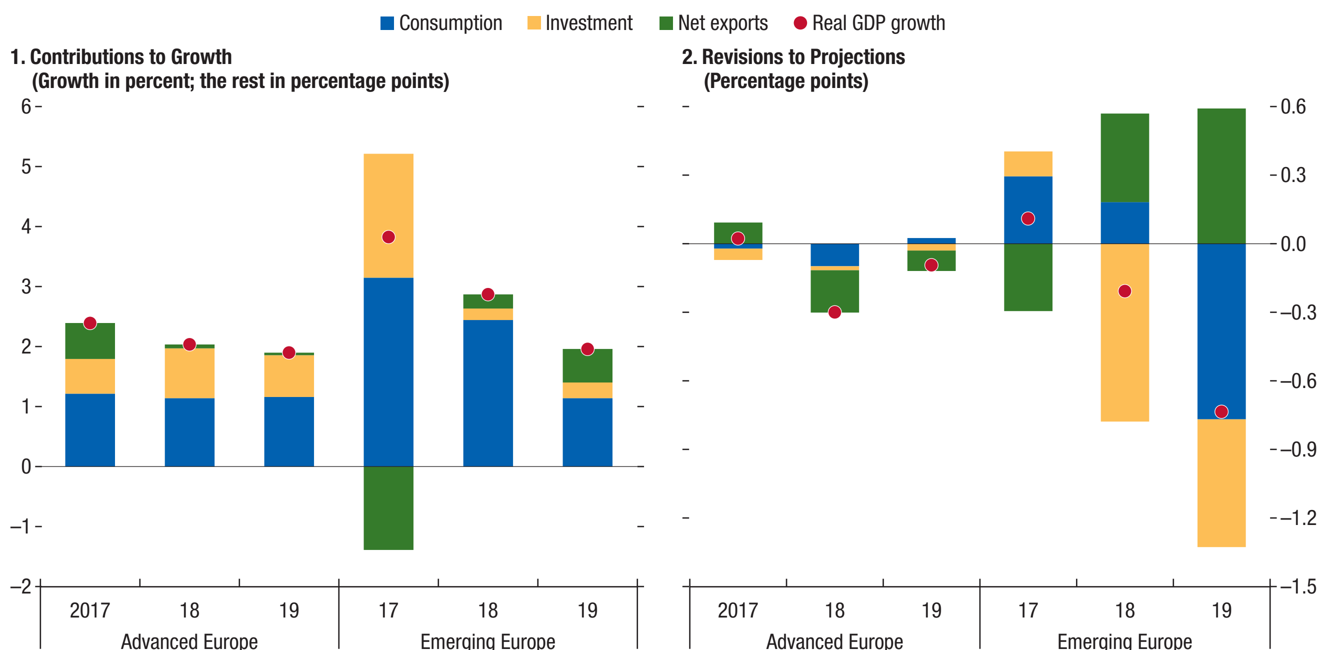
Sources: Haver Analytics; and IMF staff calculations.
Note: PMI = purchasing managers' index.

constraints and labor shortages are becoming more binding, mostly in *emerging Europe*, but also in selected *advanced European economies* (Figure 1.4). Accordingly, in several *CESEE countries*, these tight labor market conditions have translated into continued fast wage growth, exceeding 10 percent annually in the first half of 2018. Wage growth has also moved upward in the *euro area*, but much more slowly than in the *CESEE countries*, consistent with a flatter wage Phillips curve as discussed in the May 2018 *Regional Economic Outlook: Europe*. The current manufacturing expansion is one of the longest in the past two decades (Figure 1.5). Bank credit to the private sector is growing at moderate rates, but there are signs of asset price overvaluations in selected markets, especially in housing markets (for example, the *Czech Republic* and some of the *Nordics;* see Chapter 2).

Policy rates have been adjusted upward in some economies to offset the potential inflationary impact of the exchange rate depreciation (*Turkey*, *Russia*) and high wage growth (*Czech Republic, Romania*). Yet in most countries core inflation has remained low for now, with the notable exception of *Turkey*.

Financial conditions have tightened somewhat, especially in vulnerable countries. Financial conditions remain accommodative in *advanced Europe* and tightened only moderately in most of *emerging Europe* due to higher interest rates in the *United States* and the appreciation of the US dollar. However, in *Turkey,* concerns over economic policy credibility and geopolitical tensions have, alongside a worsening of sentiment toward emerging markets, led to a sharp lira depreciation by about 40 percent since the beginning of the year. In *Italy*, sovereign bond yields jumped to a four-year high due to difficulties in forming a government and policy uncertainties. So far, spillovers to other markets have been fairly contained, but there is appreciable uncertainty, and contagion from future stress could be notable, especially for economies with weaker macroeconomic fundamentals and limited policy buffers.

Figure 1.6. Real GDP Growth: Contributions and Forecast Revisions



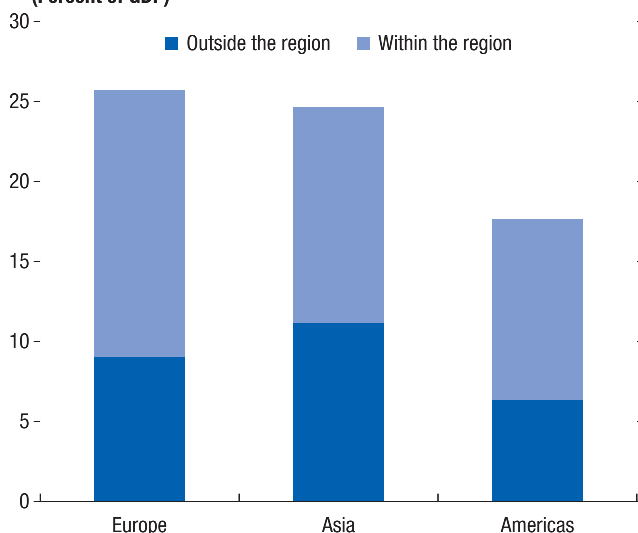
Sources: IMF, *World Economic Outlook*; and staff calculations.

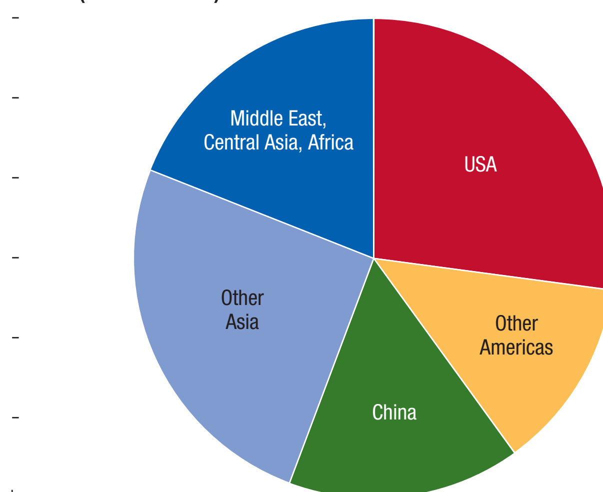
Outlook: Slower but above Potential Growth with Increased Downside Risks

Real GDP growth in Europe is expected to moderate from 2.8 percent in 2017 to 2.3 percent in 2018 and 1.9 percent in 2019 (Figure 1.6, panel 1; Table 1.1), but to remain above potential in most countries in the region. Domestic demand will continue to be the main engine of growth, supported by rising employment and wages. Growth has been revised downward in about half of the countries compared with projections in the May 2018 *Regional Economic Outlook: Europe*. The downward revisions reflect mainly weaker external demand and higher energy prices (Figure 1.6, panel 2). In *advanced Europe,* growth is revised down by 0.3 percentage point in 2018 and 0.1 percentage points in 2019, compared with the previous forecast. The downward revision to *Germany's* growth in 2018 is particularly large at 0.6 percentage point, reflecting disappointing exports and historical revisions. In *emerging European countries excluding Turkey,* growth projections are unchanged in 2018 and are revised up by 0.2 percentage point in both 2019 and 2020. *Macedonia, Romania,* and *Turkey* saw large downgrades of about 1 percentage point each in 2018. In *Turkey*, growth is expected to weaken further from 3.5 percent in 2018 to only 0.4 percent in 2019 before recovering in 2020, as the weaker lira, higher borrowing costs, and elevated uncertainties weigh on investment and demand.

Headline inflation is expected to increase across European countries on the back of higher energy prices and positive output gaps. In *advanced Europe,* inflation has been revised up by 0.1 percentage point in both 2018 and 2019 to 1.8 percent. In *emerging Europe*, the revisions have been much larger, at 0.8 percentage point in 2018 and 2 percentage points in 2019. The new forecast primarily reflects the worsened inflation outlook for *Turkey*, due to sizable pass-through from the lira depreciation, higher energy prices, high wage growth, and unanchored inflation expectations. In 2019, the IMF staff also expects a pickup in inflation in *Russia*, due to the recently passed

Figure 1.7. Global Value Chains





Sources: Eora Multi-Region Input-Output database; and IMF staff calculations.

increase in the main value-added-tax rate and additional debt-financed infrastructure spending.

The balance of risks is tilted to the downside both in the short term and beyond. Escalating trade tensions and the potential shift away from a multilateral, rules-based trading system could disrupt supply chains, with a significant impact on growth, notably if confidence is affected, as illustrated by market jitters over potential US tariffs on car imports. As discussed in Scenario Box 1 in the October 2018 *World Economic Outlook,* escalating trade tensions could impact global economic activity through a combination of higher trade costs, lower business confidence, weaker private sector investment, and tighter financial conditions. Given Europe's trade openness and deep integration into global value chains (Figure 1.7), an intensification of trade tensions could have a significant impact, especially if accompanied by tighter financial conditions.[1] A sharp tightening in global financial conditions would expose existing vulnerabilities, dent confidence, and weigh on investment and growth. Separately, the possibility of a "no-deal" Brexit raises the risk of a disruptive exit and of high trade and nontrade barriers between the *United Kingdom* and the rest of the European Union (IMF 2018). In the medium-term, risks stem from the possibility of shifts in policy agendas and the implementation of politically popular but unsustainable macroeconomic policies, delays of structural reforms, demographic challenges, rising inequality, and declining trust in mainstream policies.

[1]IMF staff estimates suggest that an increase in trade policy uncertainty could appreciably reduce investment in the euro area, with a higher impact on countries more deeply integrated into global value chains (Ebeke and Siminitz, forthcoming).

Policy Priorities

The policy stance should be tailored to the maturing cyclical positions. The procyclical fiscal stance, prevailing in many European countries, should be scaled back. Policymakers should seize the opportunity of above-potential growth and low unemployment to advance growth-friendly policies to reduce high levels of public debt and rebuild fiscal buffers to facilitate coping with future shocks. Countries should prioritize measures that reduce fiscal deficits toward their medium-term targets and lower debt. The urgency is greater in

countries with significant vulnerabilities, such as *Italy* and *Turkey*. In contrast, countries with ample fiscal space and stronger-than-warranted external positions (*Germany, Netherlands*) should use available space to raise potential output through more public investment and promote external rebalancing.

Monetary policy priorities differ across countries. As core inflation has picked up and headline inflation has reached or is approaching targets in *emerging Europe*, central banks should gradually normalize monetary policy in a well-communicated manner to ensure a smooth adjustment. In countries where underlying inflation pressures remain subdued (mostly *advanced Europe*) monetary policy should remain supportive to ensure durable increases in inflation toward targets. In the *euro area*, as asset purchases come to an end, forward guidance on interest rates becomes more important in order to keep policy rates at their current, extraordinarily low levels at least through next summer.

Regarding financial sector policies, targeted macroprudential measures can be particularly useful in addressing specific financial stability risks. As discussed in Chapter 2, borrower-based measures can be effective in containing the share of high-risk loans. Also, further progress is needed in cleaning bank balance sheets, including continued reduction in nonperforming loans. In the *euro area*, the increased debt in corporate balance sheets warrants close monitoring, especially among lower-rated companies.

As capacity constraints are becoming more binding on the back of weaker productivity growth, countries are urged even more than before to implement policies to boost labor force participation and foster higher potential growth.

Structural reform priorities remain unchanged (May 2018 *Regional Economic Outlook: Europe*). In *advanced Europe*, countries should introduce further reforms of labor and product markets to boost competitiveness and improve productivity at the national level. In *emerging Europe*, enhancing institutions (November 2017 *Regional Economic Outlook: Europe*), improving the investment environment and boosting labor participation by women and the elderly remain top policy priorities. In *Russia*, further steps should be taken to continue to improve the investment climate, boost infrastructure investment and human capital, and improve the efficiency of goods markets.

To help increase the *euro area's* resilience to future shocks, architectural reforms should be implemented to further reduce risks and improve risk sharing. Completing the banking union, with common rules and backstops, and advancing the capital markets union would support private cross-border risk diversification. Equally important is the pressing need for fiscal institutional reforms. A central fiscal capacity that supports macroeconomic stabilization, and that embeds strong safeguards against permanent transfers and moral hazard, should be developed in conjunction with a revamping of fiscal rules to make them simpler and easier to enforce. While all likely Brexit outcomes will entail costs, an agreement that minimizes the introduction of new tariff and nontariff barriers would best protect growth and income in the *United Kingdom* and the EU. Separately, the *European Union* and its partners should work together constructively to reduce trade barriers and, whenever possible, to resolve disagreements through the World Trade Organization.

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Annex Table 1.1. GDP Growth
(Year-over-year percent change)

		October 2018 WEO			April 2018 WEO			Difference[1]		
	2017	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**
Europe	2.8	2.3	1.9	1.9	2.6	2.2	2.0	−0.3	−0.3	0.0
Advanced European Economies	2.4	2.0	1.9	1.7	2.3	2.0	1.7	−0.3	−0.1	0.0
Euro Area	2.4	2.0	1.9	1.7	2.4	2.0	1.7	−0.4	−0.1	0.0
Austria	3.0	2.8	2.2	1.6	2.6	2.0	1.5	0.2	0.2	0.0
Belgium	1.7	1.5	1.5	1.5	1.9	1.7	1.5	−0.4	−0.1	0.0
Cyprus	3.9	4.0	4.2	3.3	3.6	3.0	2.6	0.4	1.3	0.7
Estonia	4.9	3.7	3.2	3.0	3.9	3.2	3.0	−0.2	0.0	−0.1
Finland	2.8	2.6	1.8	1.6	2.6	2.0	1.5	0.1	−0.2	0.1
France	2.3	1.6	1.6	1.6	2.1	2.0	1.8	−0.5	−0.4	−0.2
Germany	2.5	1.9	1.9	1.6	2.5	2.0	1.5	−0.6	−0.2	0.1
Greece	1.4	2.0	2.4	2.2	2.0	1.8	1.8	0.0	0.5	0.4
Ireland	7.2	4.7	4.0	3.5	4.5	4.0	3.5	0.2	0.0	−0.1
Italy	1.5	1.2	1.0	0.9	1.5	1.1	0.9	−0.4	−0.1	0.0
Latvia	4.5	3.7	3.3	3.1	4.0	3.5	3.3	−0.3	−0.2	−0.2
Lithuania	3.9	3.5	2.9	2.7	3.2	3.0	2.8	0.4	−0.1	0.0
Luxembourg	2.3	4.0	3.5	3.3	4.3	3.7	3.3	−0.3	−0.2	0.0
Malta	6.7	5.7	4.6	4.0	5.7	4.6	4.0	0.0	0.0	0.0
Netherlands	2.9	2.8	2.6	2.3	3.2	2.4	2.1	−0.4	0.2	0.2
Portugal	2.7	2.3	1.8	1.5	2.4	1.8	1.5	−0.1	0.0	0.0
Slovak Republic	3.4	3.9	4.1	3.8	4.0	4.2	3.8	−0.1	−0.1	0.0
Slovenia	5.0	4.5	3.4	2.8	4.0	3.2	2.7	0.5	0.2	0.1
Spain	3.0	2.7	2.2	1.9	2.8	2.2	1.9	−0.1	0.0	0.0
Nordic Economies	2.1	2.2	2.1	1.9	2.3	2.1	2.0	−0.1	0.0	0.0
Denmark	2.3	2.0	1.9	1.8	2.0	1.9	1.8	0.0	0.0	−0.1
Iceland	4.0	3.7	2.9	2.8	3.2	3.0	2.8	0.5	−0.1	0.0
Norway	1.9	2.1	2.1	1.9	2.1	2.1	1.9	0.0	0.0	0.0
Sweden	2.1	2.4	2.2	2.0	2.6	2.2	2.1	−0.2	0.0	0.0
Other European Advanced Economies	2.0	1.9	1.8	1.8	2.0	1.9	1.8	−0.1	0.0	0.0
Czech Republic	4.3	3.1	3.0	2.5	3.5	3.0	2.5	−0.5	0.0	0.0
Israel	3.3	3.6	3.5	3.3	3.3	3.5	3.0	0.3	−0.1	0.3
San Marino	1.9	1.4	1.0	0.8	1.3	1.3	1.3	0.1	−0.3	−0.5
Switzerland	1.7	3.0	1.8	1.7	2.3	2.0	1.9	0.7	−0.2	−0.2
United Kingdom	1.7	1.4	1.5	1.5	1.6	1.5	1.5	−0.3	0.0	0.0
Emerging European Economies	3.8	2.9	2.0	2.4	3.1	2.7	2.5	−0.2	−0.7	−0.1
Central Europe	4.5	4.3	3.5	2.9	4.0	3.4	2.9	0.3	0.0	0.0
Hungary	4.0	4.0	3.3	2.6	3.8	3.0	2.6	0.2	0.3	0.0
Poland	4.6	4.4	3.5	3.0	4.1	3.5	3.0	0.3	0.0	0.0
Eastern Europe	1.7	2.0	1.9	1.9	1.9	1.7	1.7	0.1	0.3	0.2
Belarus	2.4	4.0	3.1	2.5	2.8	2.4	2.0	1.1	0.6	0.5
Moldova	4.5	3.8	3.8	3.8	3.5	3.8	3.8	0.2	0.0	0.0
Russia	1.5	1.7	1.8	1.8	1.7	1.5	1.5	0.0	0.3	0.3
Ukraine	2.5	3.5	2.7	3.0	3.2	3.3	3.5	0.3	−0.5	−0.4
Southeastern European EU Member States	5.7	3.7	3.3	3.0	4.5	3.3	3.0	−0.8	0.0	0.1
Bulgaria	3.6	3.6	3.1	2.8	3.8	3.1	2.8	−0.2	0.0	0.0
Croatia	2.8	2.8	2.6	2.4	2.8	2.6	2.4	0.0	0.0	0.0
Romania	6.9	4.0	3.4	3.3	5.1	3.5	3.1	−1.1	−0.1	0.2
Southeastern European Non-EU Member States	2.4	3.5	3.4	3.7	3.4	3.5	3.8	0.1	0.0	0.0
Albania	3.8	4.0	3.7	3.9	3.7	3.8	3.9	0.3	−0.1	0.0
Bosnia and Herzegovina	3.0	3.2	3.5	3.7	3.2	3.5	3.7	0.0	0.0	0.0
Kosovo	3.7	4.0	4.0	4.0	4.0	4.0	4.0	0.0	0.0	0.0
Macedonia, FYR	0.0	1.6	2.6	2.8	2.8	3.0	3.2	−1.2	−0.4	−0.4
Montenegro	4.3	3.7	2.5	3.0	3.1	2.4	3.0	0.6	0.1	0.0
Serbia	1.9	4.0	3.5	4.0	3.5	3.5	4.0	0.5	0.0	0.0
Turkey	7.4	3.5	0.4	2.6	4.4	4.0	3.6	−0.9	−3.6	−1.0
Memorandum										
World	3.7	3.7	3.7	3.7	3.9	3.9	3.8	−0.2	−0.3	−0.1
Advanced economies	2.3	2.4	2.1	1.7	2.5	2.2	1.7	−0.1	−0.1	0.0
Emerging market and developing economies	4.7	4.7	4.7	4.9	4.9	5.1	5.1	−0.3	−0.4	−0.1
European Union	2.7	2.2	2.0	1.8	2.5	2.1	1.8	−0.3	−0.1	0.0
United States	2.2	2.9	2.5	1.8	2.9	2.7	1.9	0.0	−0.1	0.0
China	6.9	6.6	6.2	6.2	6.6	6.4	6.3	0.0	−0.2	0.0
Japan	1.7	1.1	0.9	0.3	1.2	0.9	0.3	−0.1	0.0	0.0

Sources: IMF, *World Economic Outlook* (WEO); and IMF staff calculations.
[1]Numbers in this column may differ from the difference between October and April projections due to rounding.