

World Economic and Financial Surveys

Regional Economic Outlook

annualized percent change

2.14%

1.62%

cial and Eco

Europe

Reassessing Risks



APR **08**

I N T E R N A T I O N A L M O N E T A R Y F U N D

Regional Economic Outlook

Europe

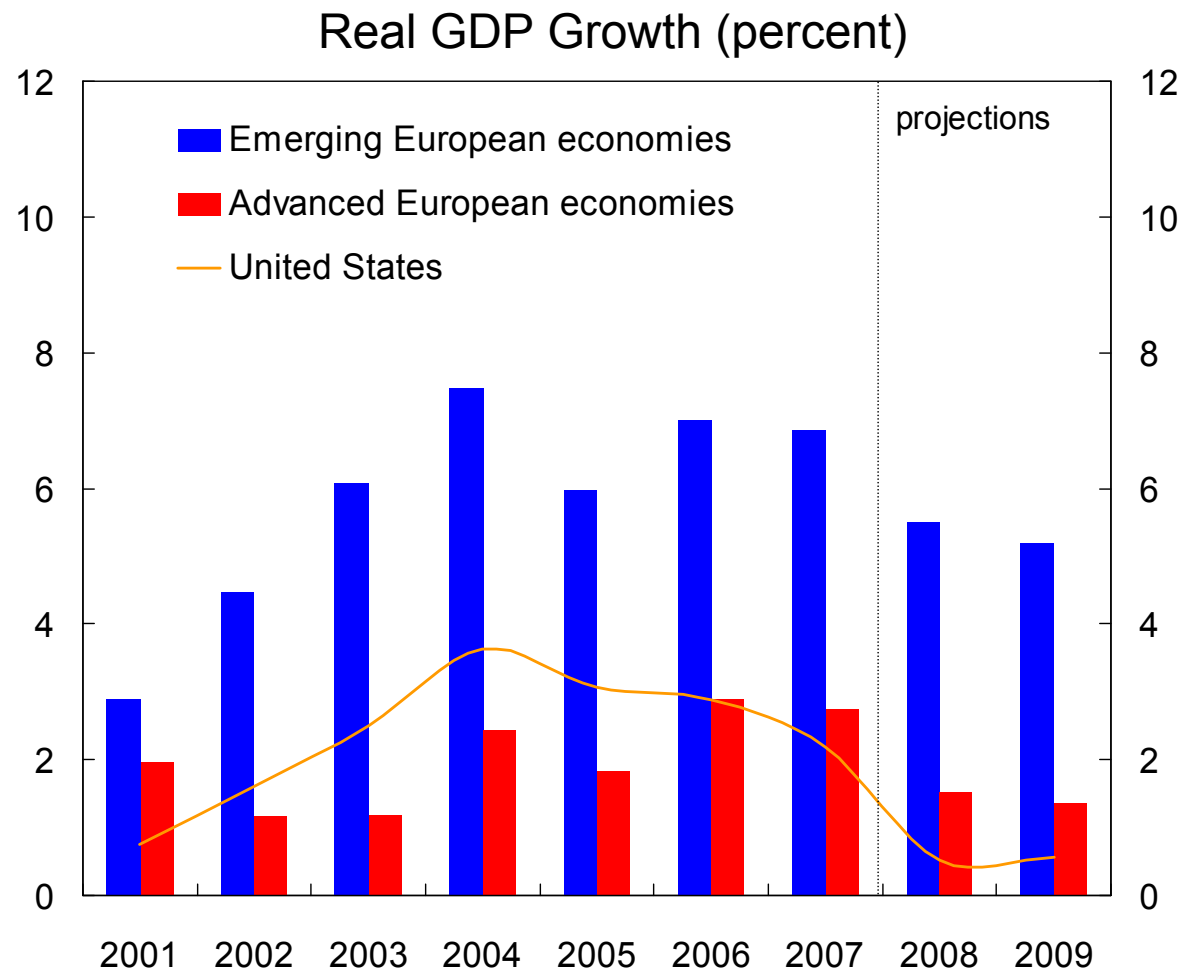
Outline

- Outlook: Navigating Turbulent Waters
- Financial Turbulence: Testing Resilience and Dampening Growth
- Convergence in Emerging Europe: Sustainability and Vulnerabilities

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Europe: Moderate Slowing Ahead

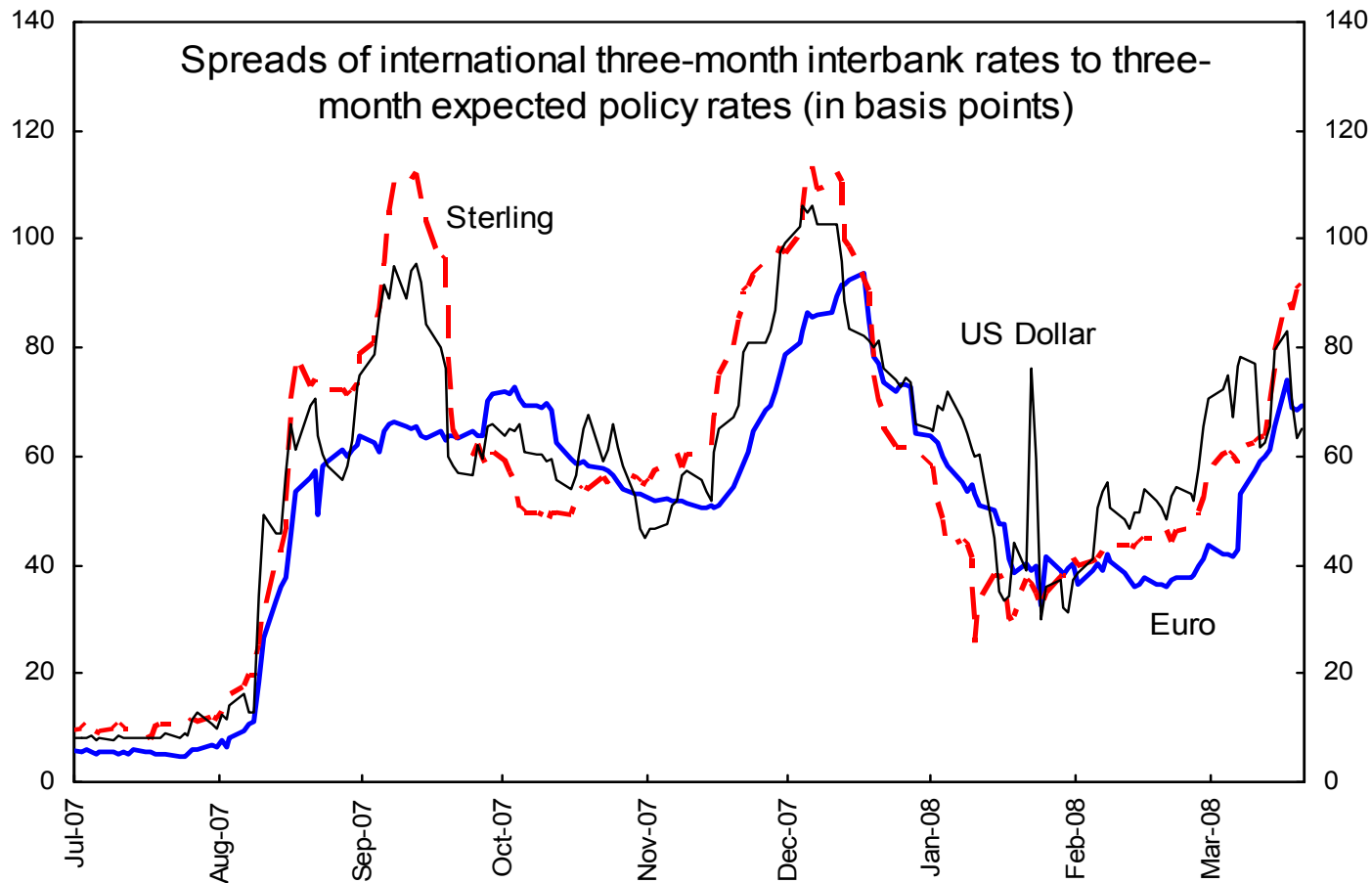


Source: IMF World Economic Outlook

Why is Europe Slowing?

- Spillovers from the United States
US is projected to be in a mild recession in 2008
- Financial turmoil
- High oil and energy prices
- Euro appreciation

Globalized interbank funding markets are facing stress



Source: Bloomberg.

Estimated bank losses look similar

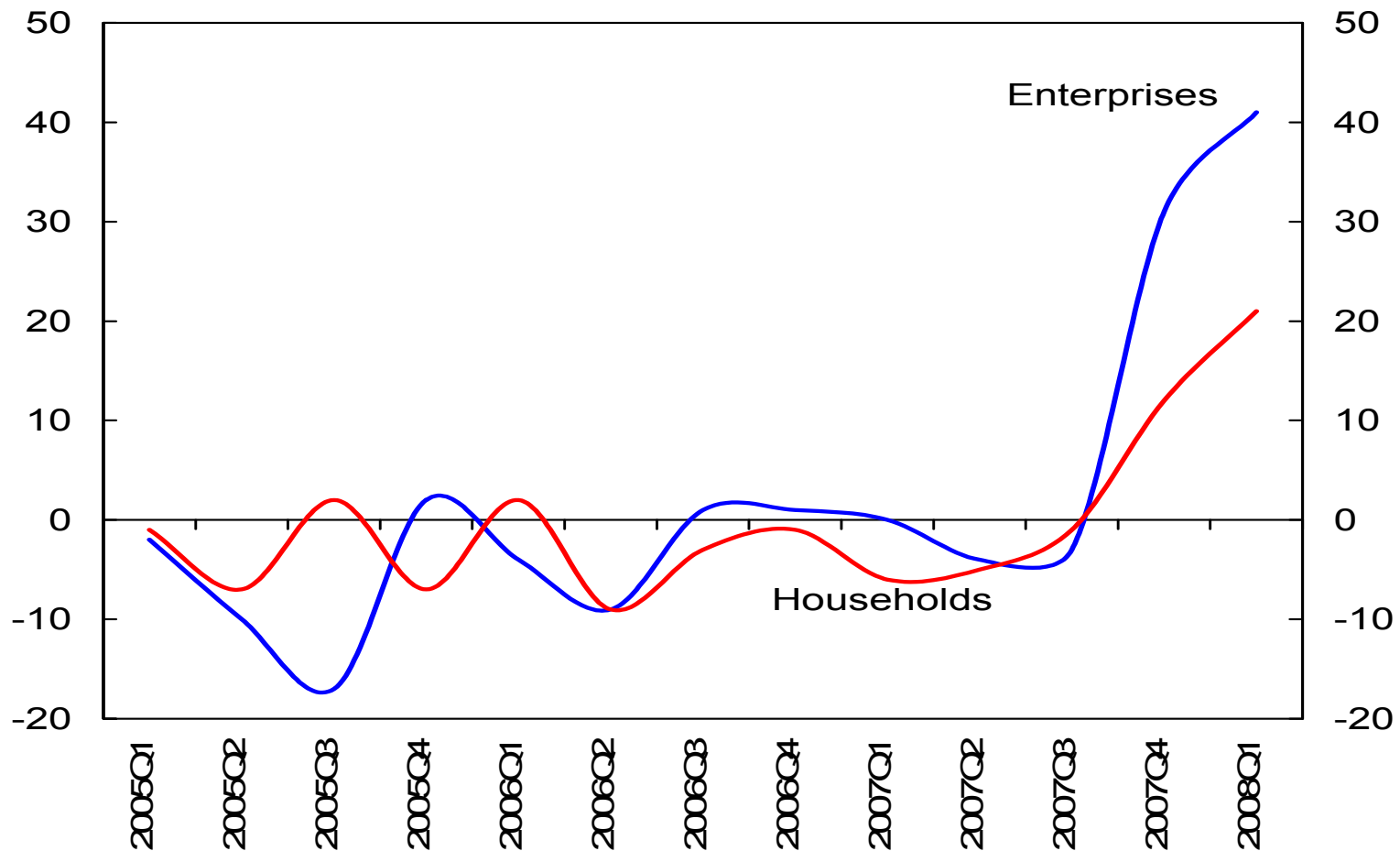
Global Bank Subprime Losses as of February 2008 (in billions of U.S. dollars)

Country/Region	Total Reported	Total Expected	Remaining Subprime-Related Losses
Europe	80	121	41
United States	95	144	49

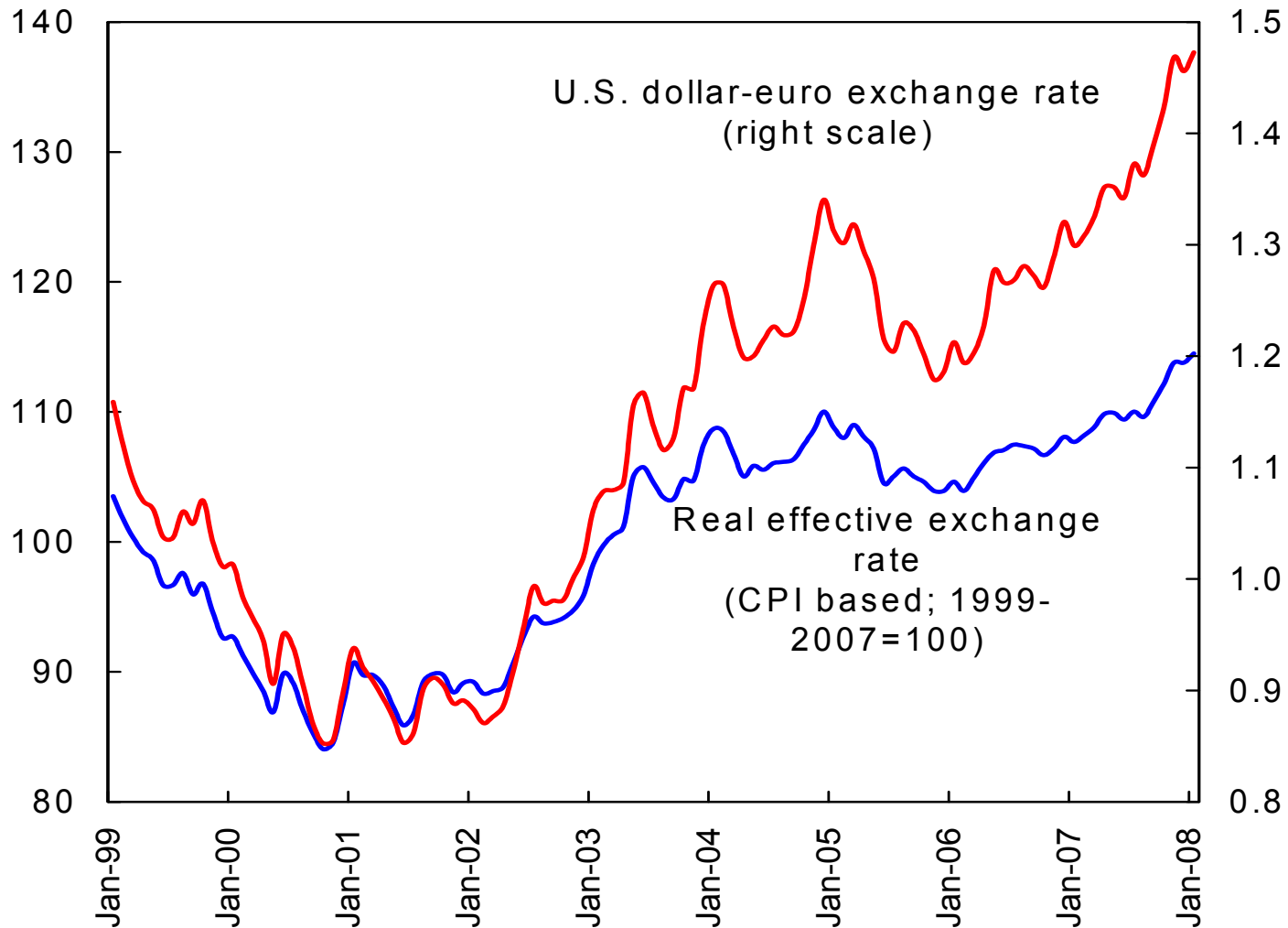
Sources: Goldman Sachs; UBS; and Fund staff estimates.

Credit standards have tightened

Changes in Credit Standards for Loans to Enterprises and Households, 2005–08

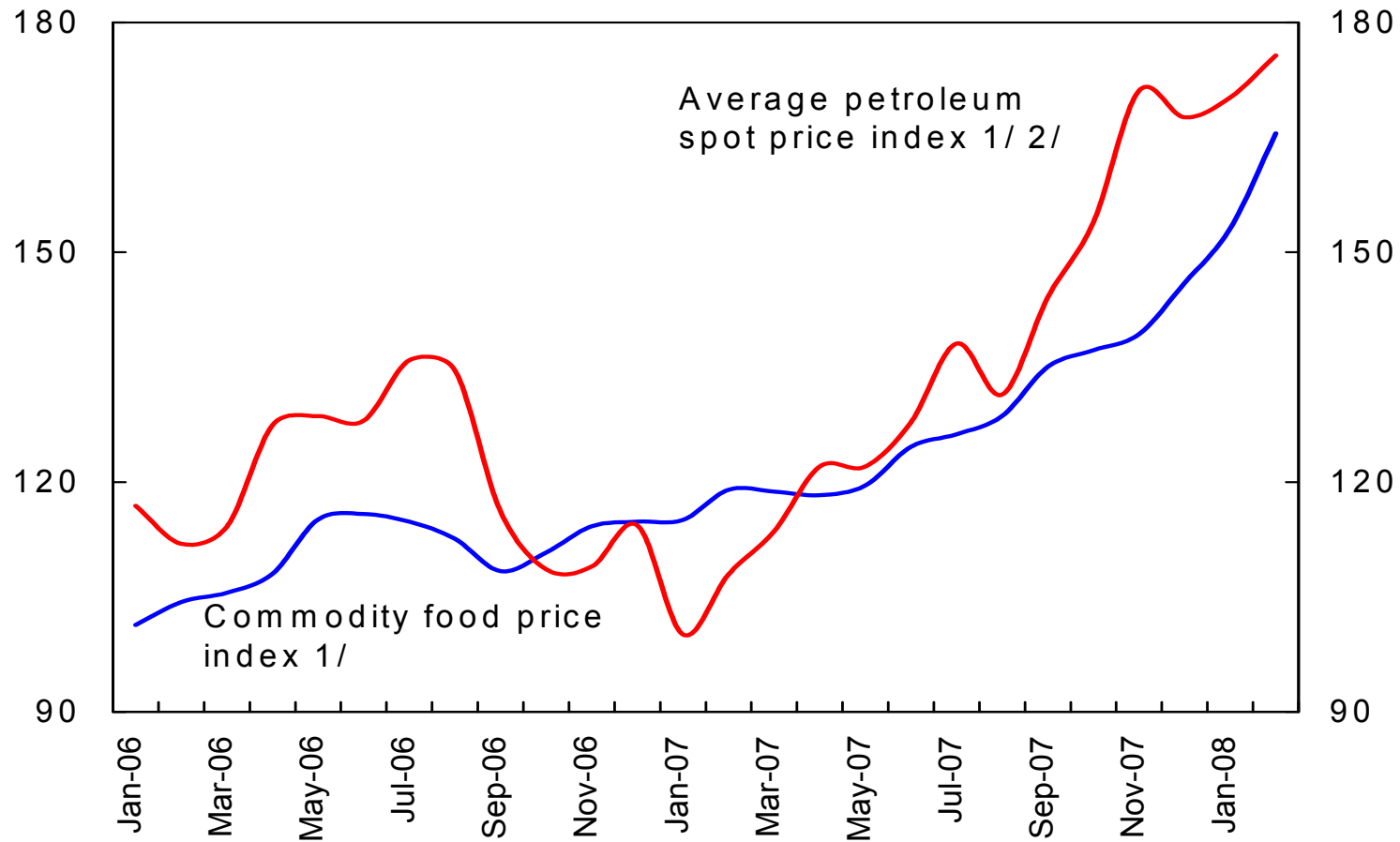


The euro has strengthened



Source: IMF

Food and oil prices have surged...



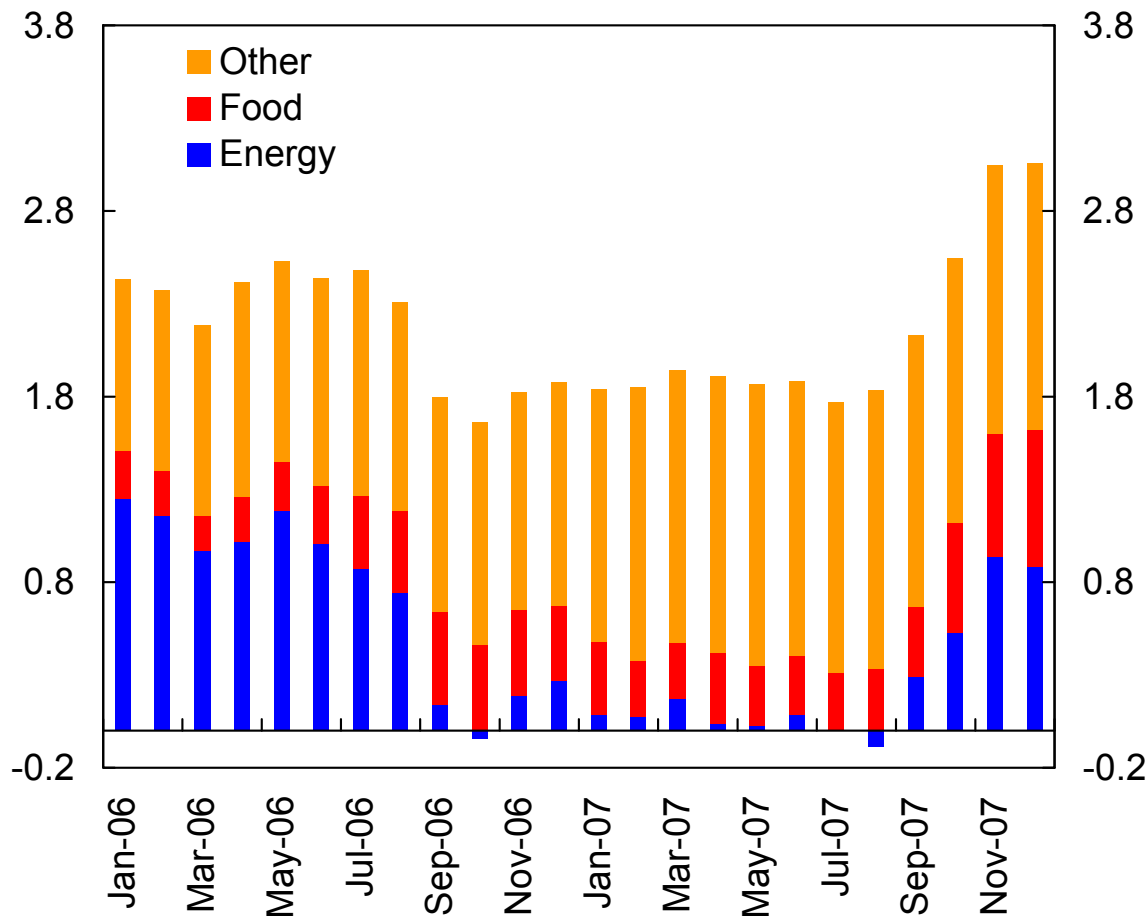
Source: IMF staff calculations.

1/ In terms of U.S. dollars, 2005 = 100.

2/ Average of U.K. Brent, Dubai, and West Texas Intermediate, equally weighted.

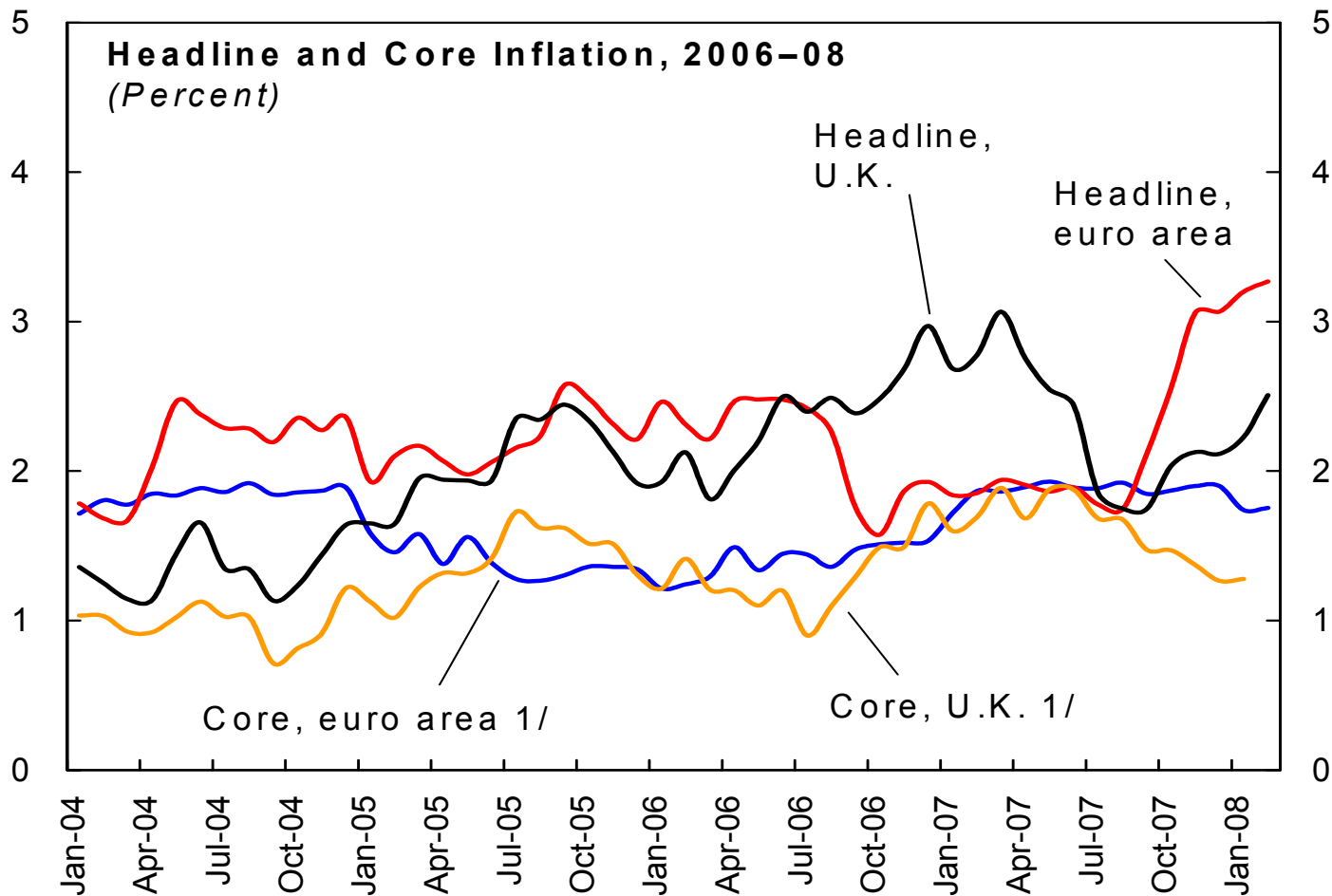
...pushing up headline inflation...

Euro Area: Contribution of Food and Energy to Headline Inflation



Sources: Eurostat; and IMF staff calculations.

...but core inflation has remained subdued



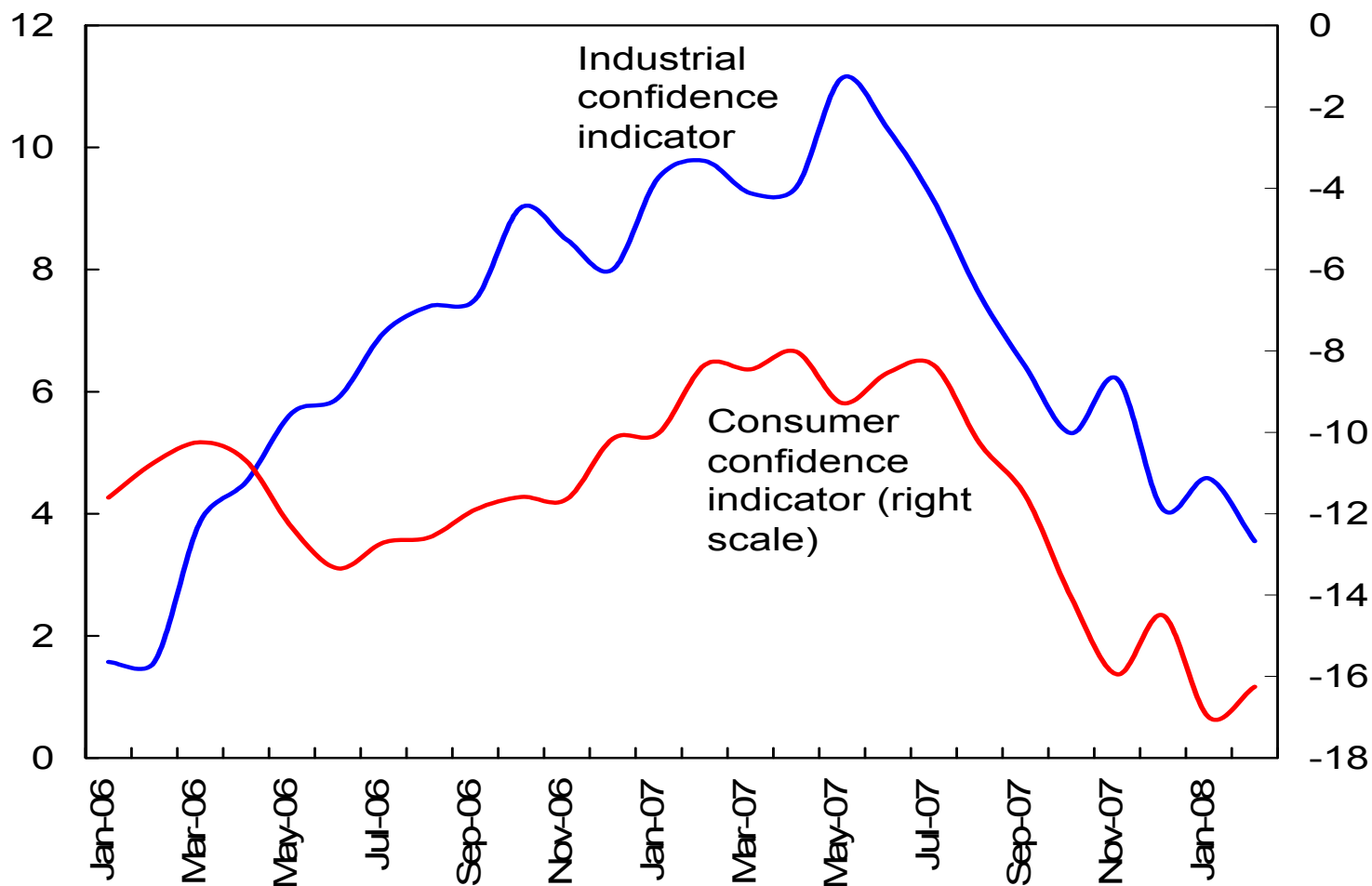
Source: Eurostat.

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

Emerging Europe is not immune

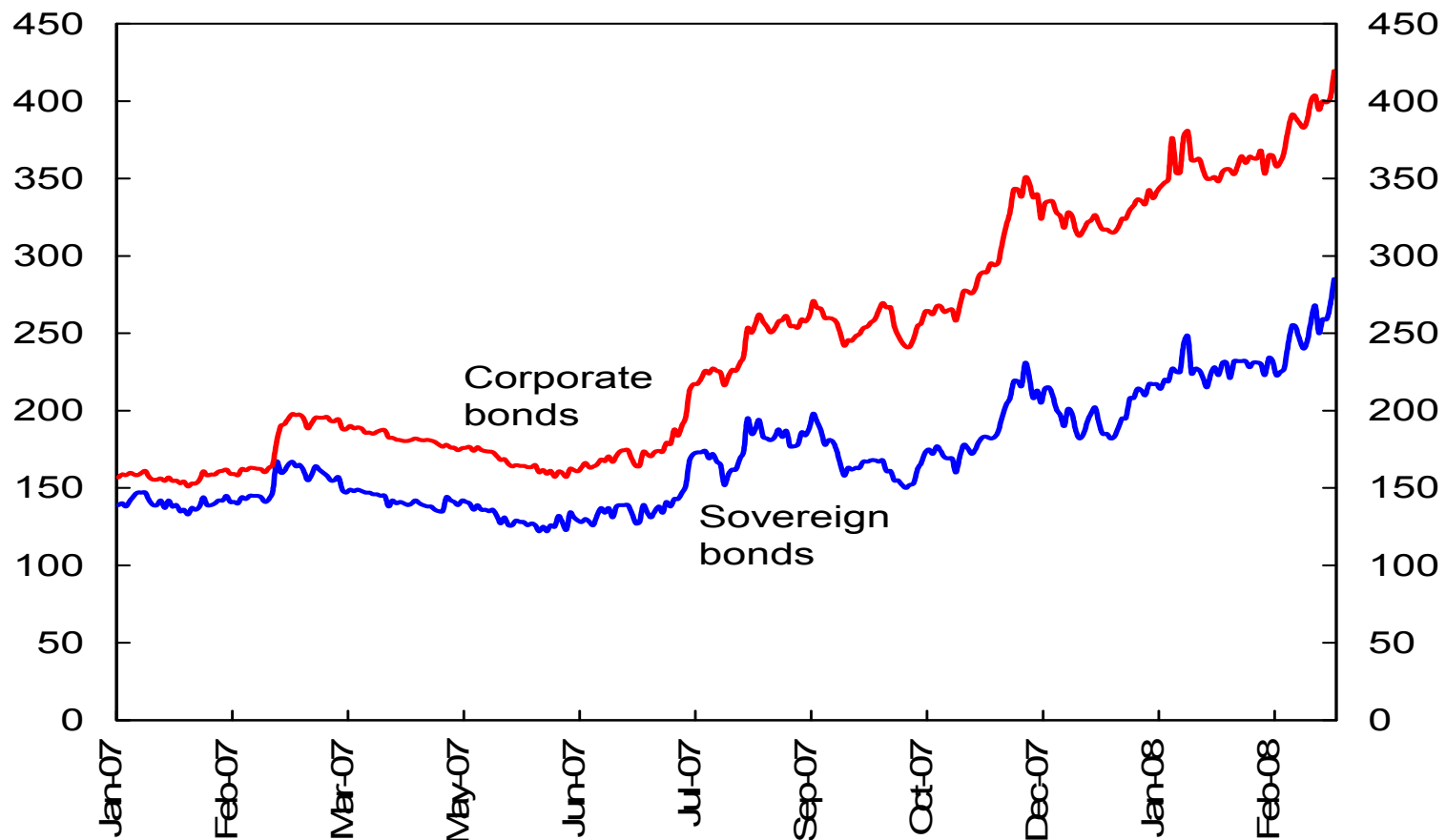
Emerging Europe: Confidence Indicators, January 2006–February 2008

(Percentage balance)



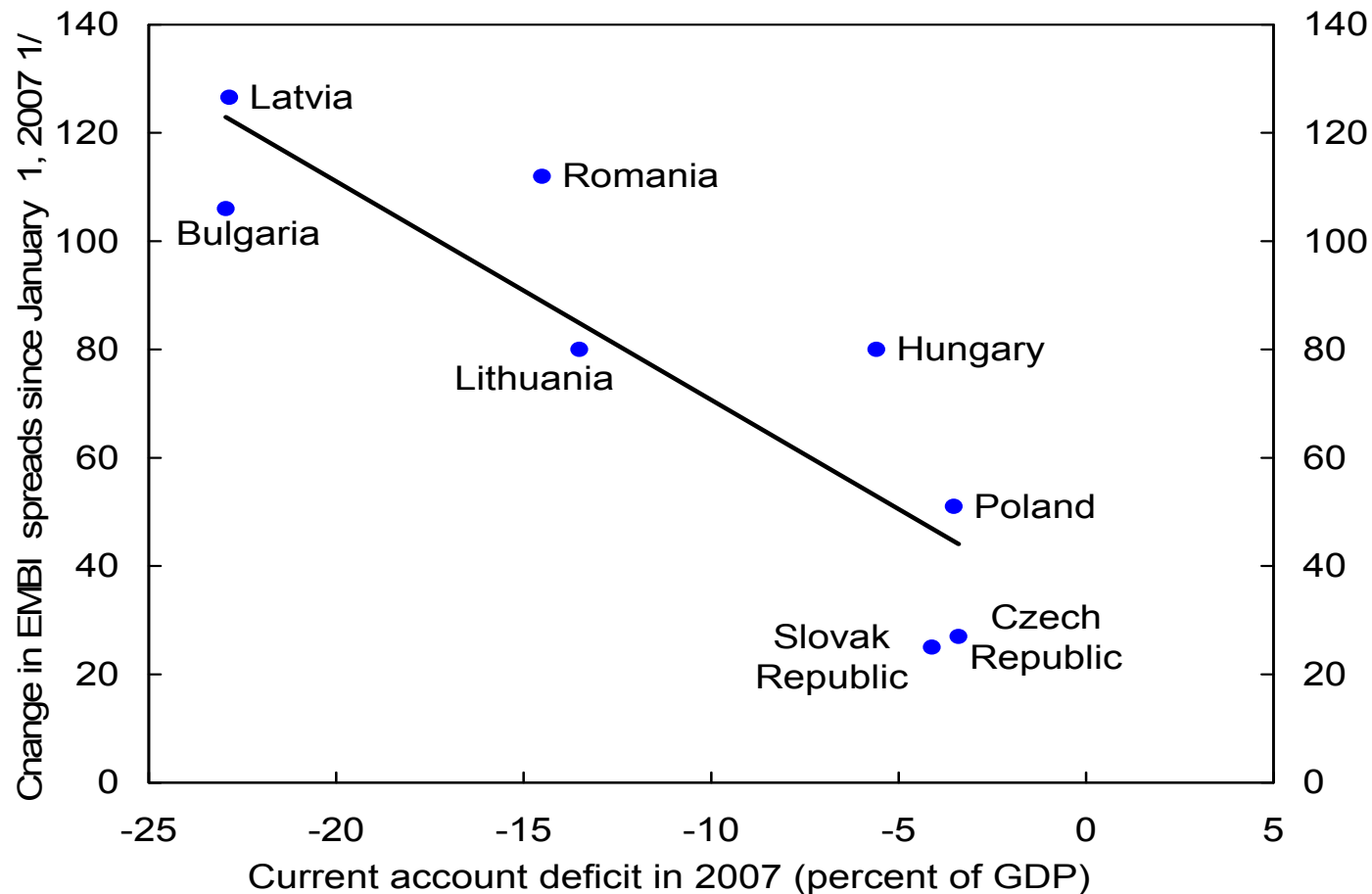
Borrowing costs have increased...

Emerging Europe: Sovereign and Corporate Bond Spreads,
January 2007–March 2008 *(Basis points)*



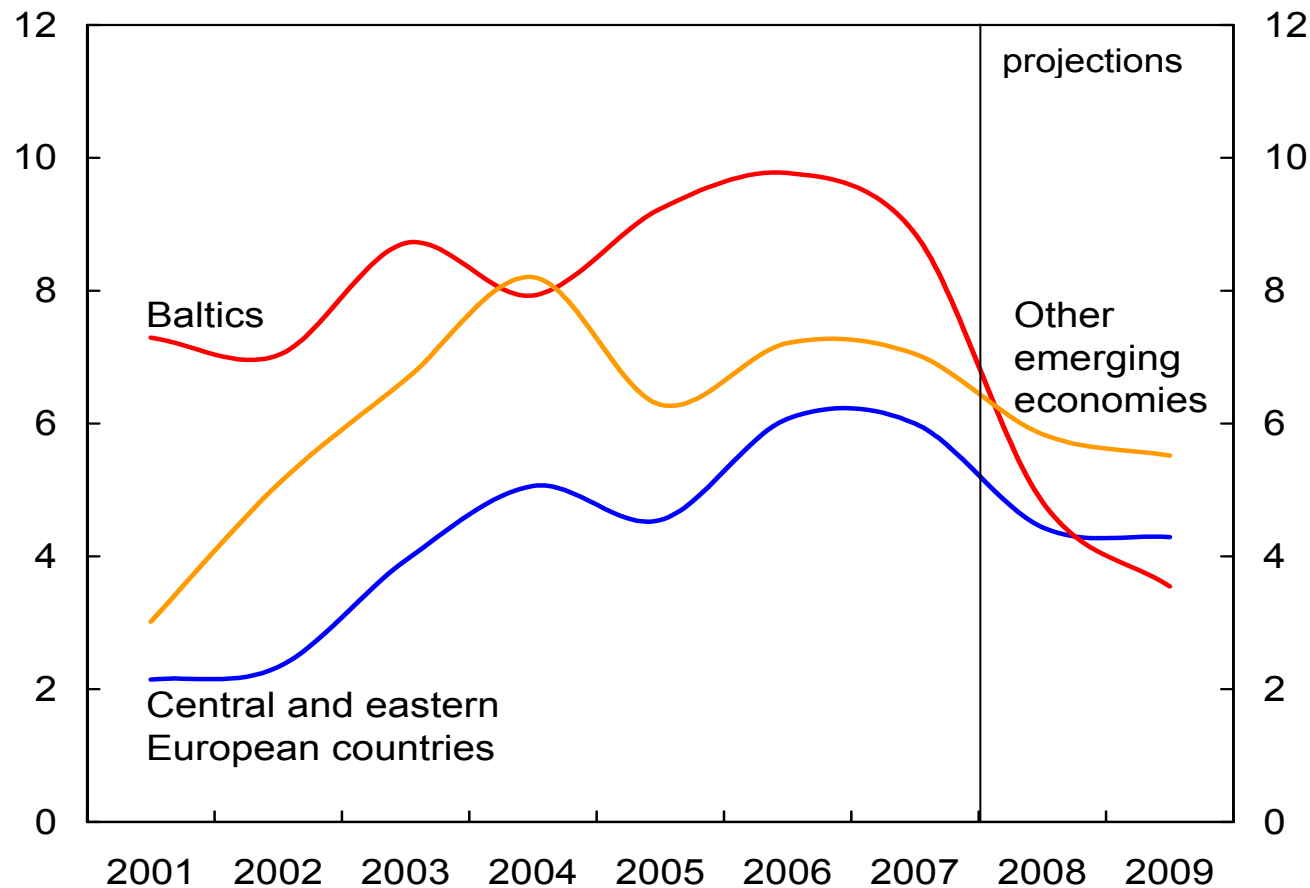
...particularly in countries with large external imbalances

Emerging Europe: Bond Spreads and Current Account Deficits



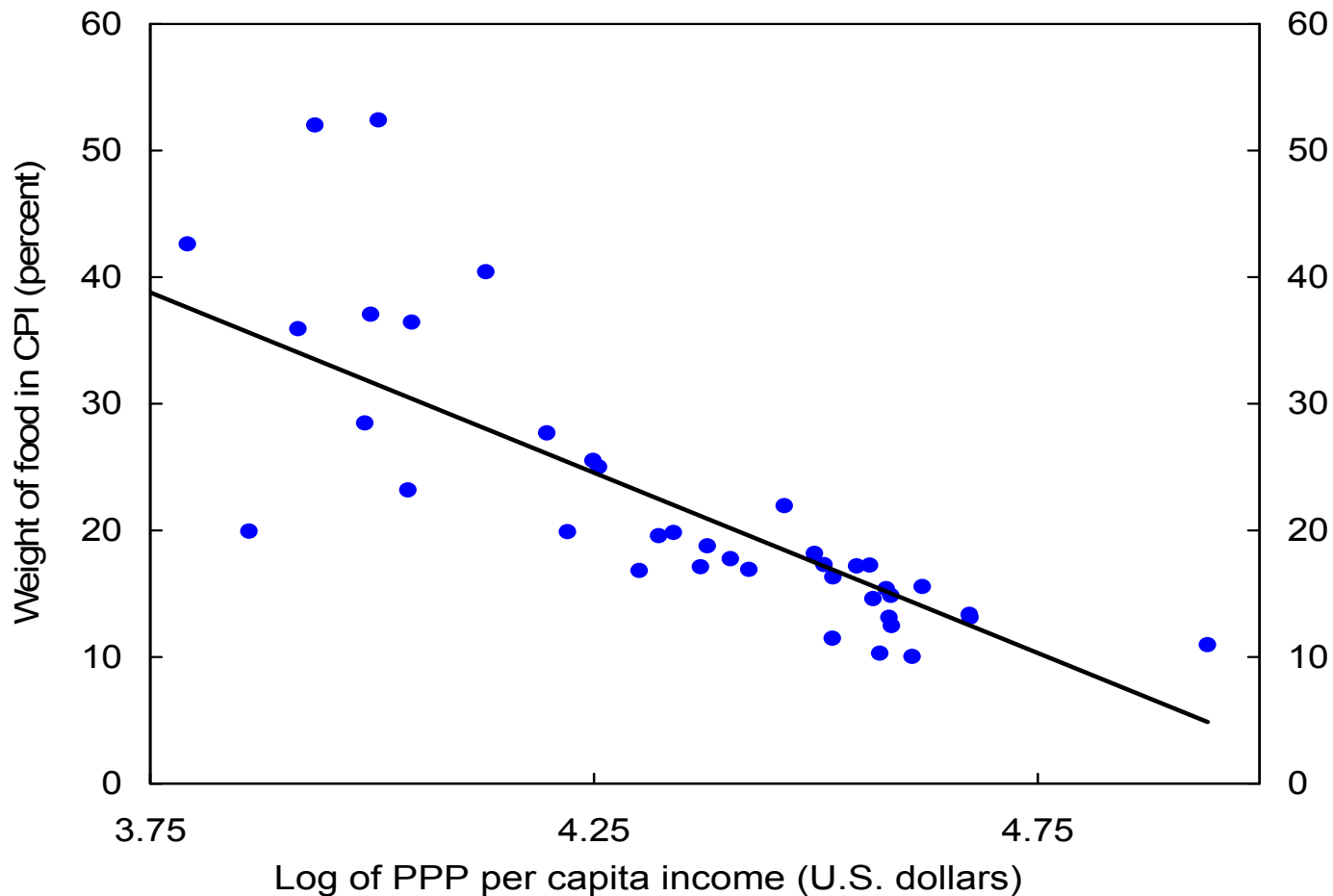
Growth is slowing throughout the region with risks on the downside

Growth in Emerging Europe, 2001–09
(Percent)



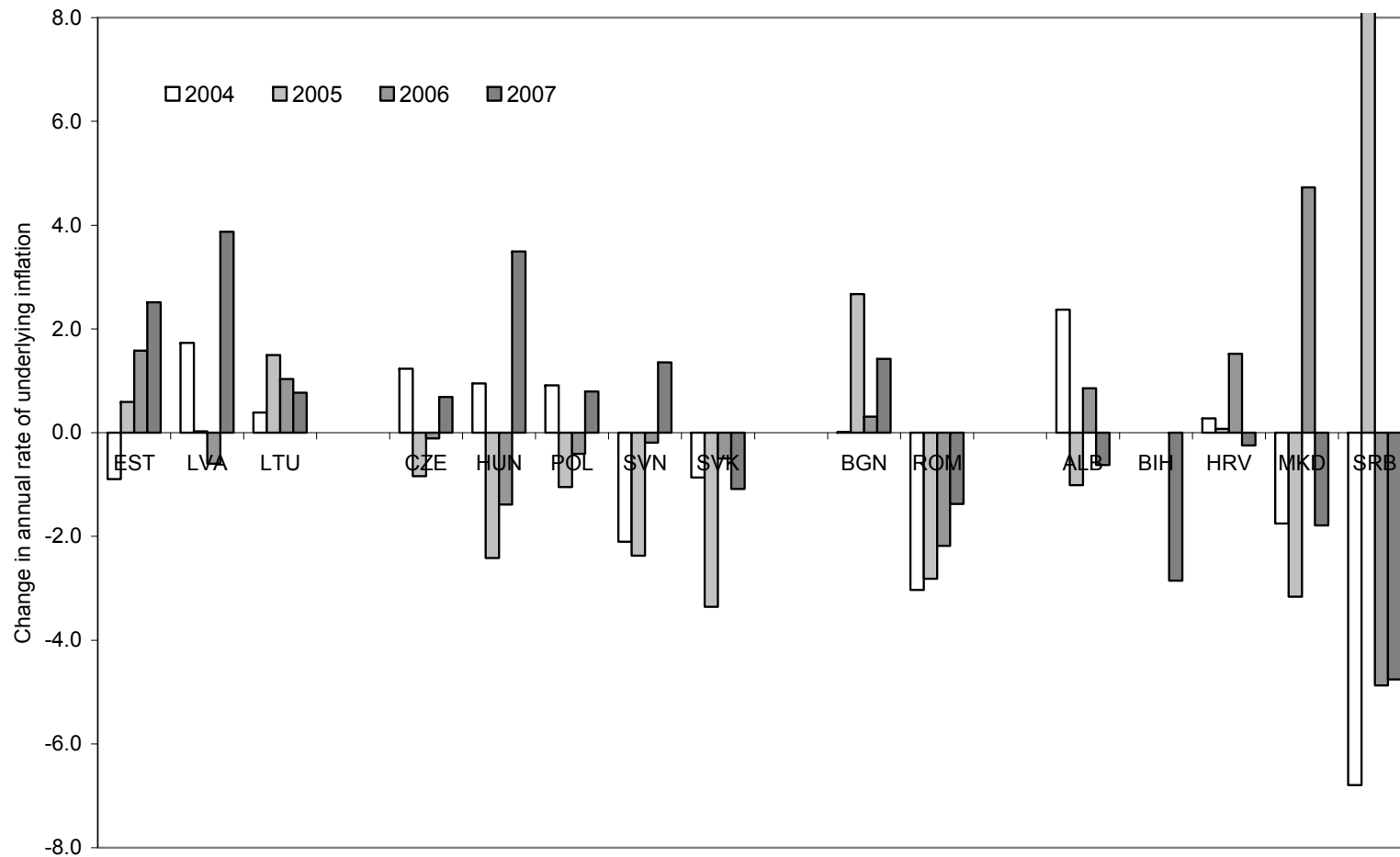
Inflation is also rising, partly due to the high share of food in the CPI basket...

Share of Food Expenditures and Per Capita Income in European Countries, 2007



...but also because of overheating

Change in annual rate of underlying inflation (In percentage points)



* CPI inflation excluding energy, food, alcohol and tobacco.

Policy challenges

- Restore confidence in financial markets
- Supportive macroeconomic policies
- Reforms of the financial stability framework
- Structural reforms

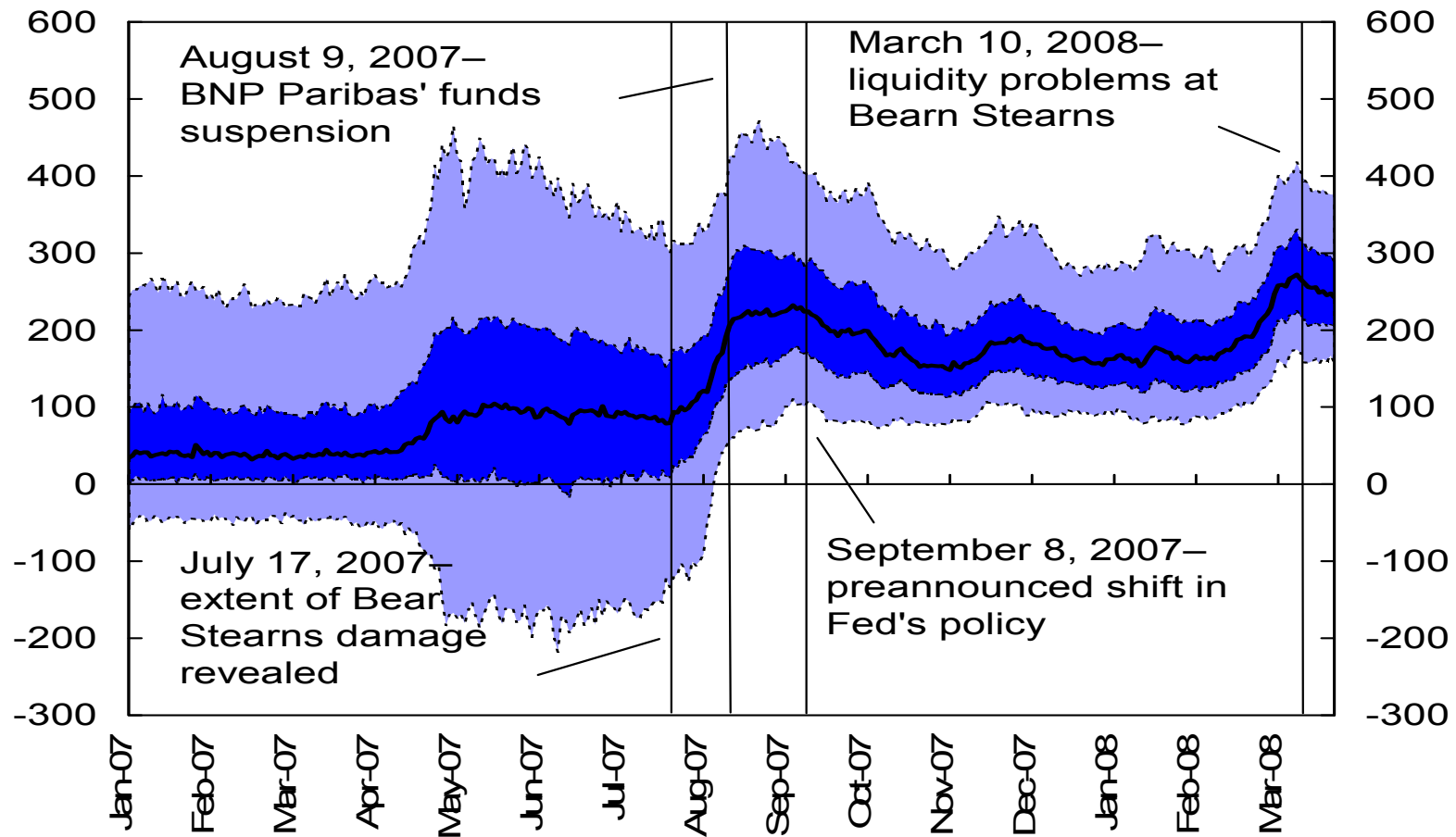
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Risk has been re-priced

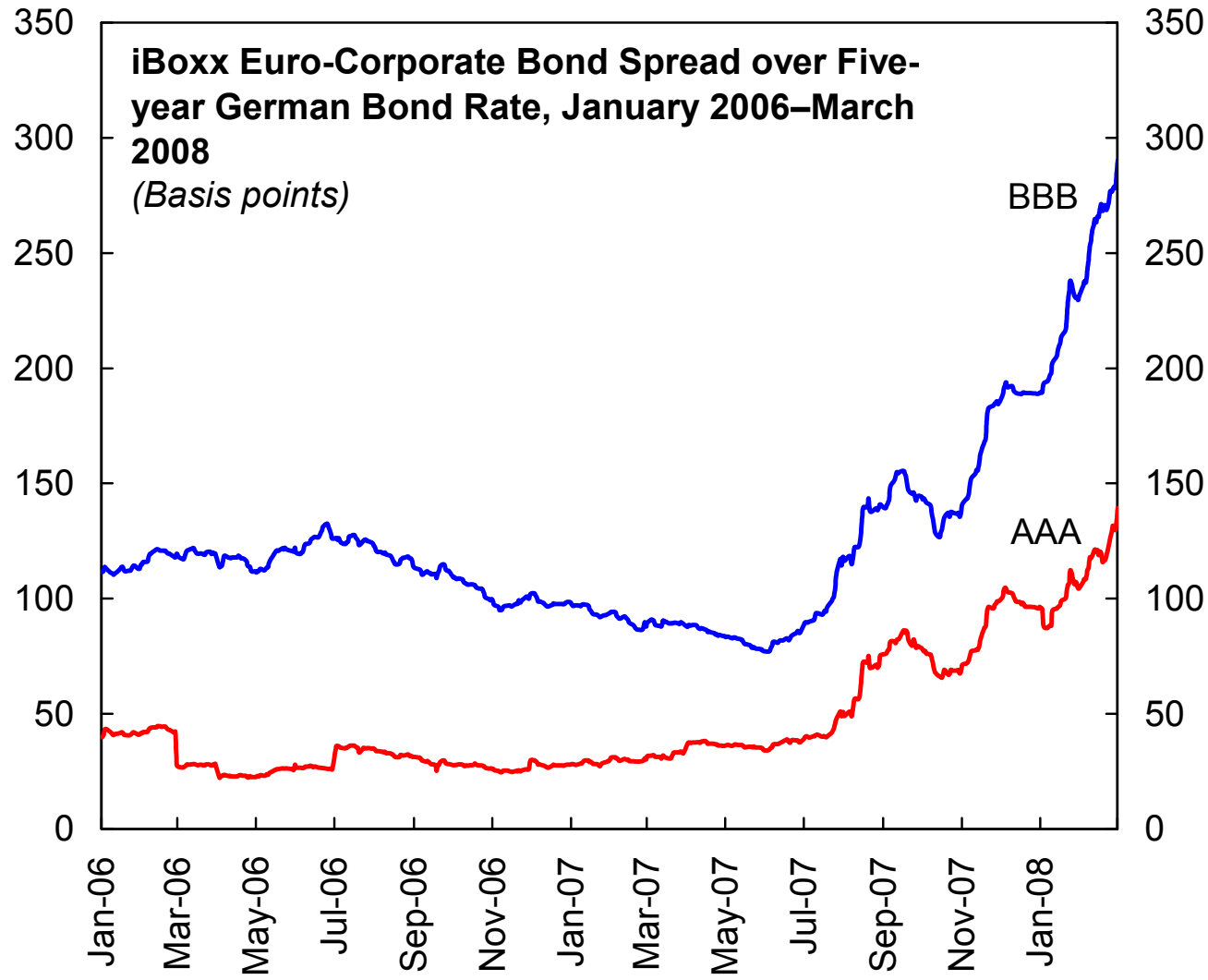
Estimating Shifts in the Global Price of Risk

(Basis points)



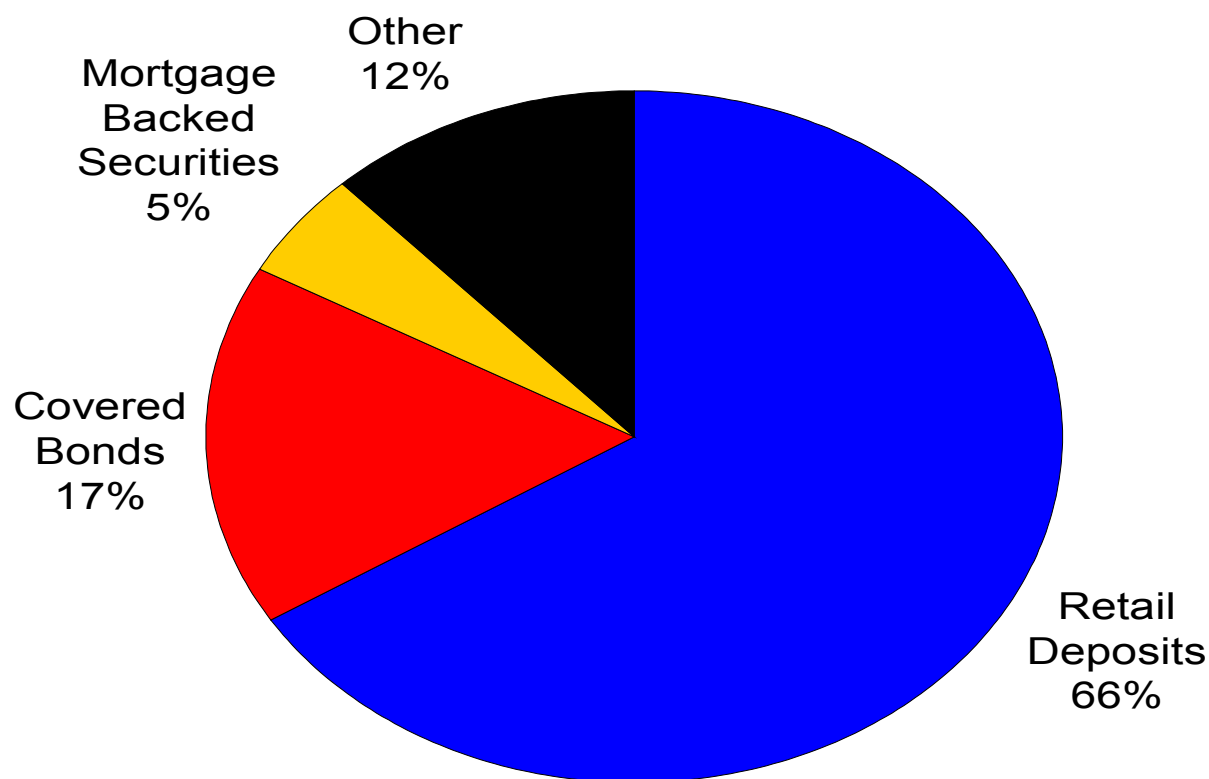
Sources: Bloomberg L.P.; and IMF staff calculations.

The cost of financing has risen



But, safer funding for homegrown mortgages...

Sources of Mortgage Funding in Europe (Percent of total funding)

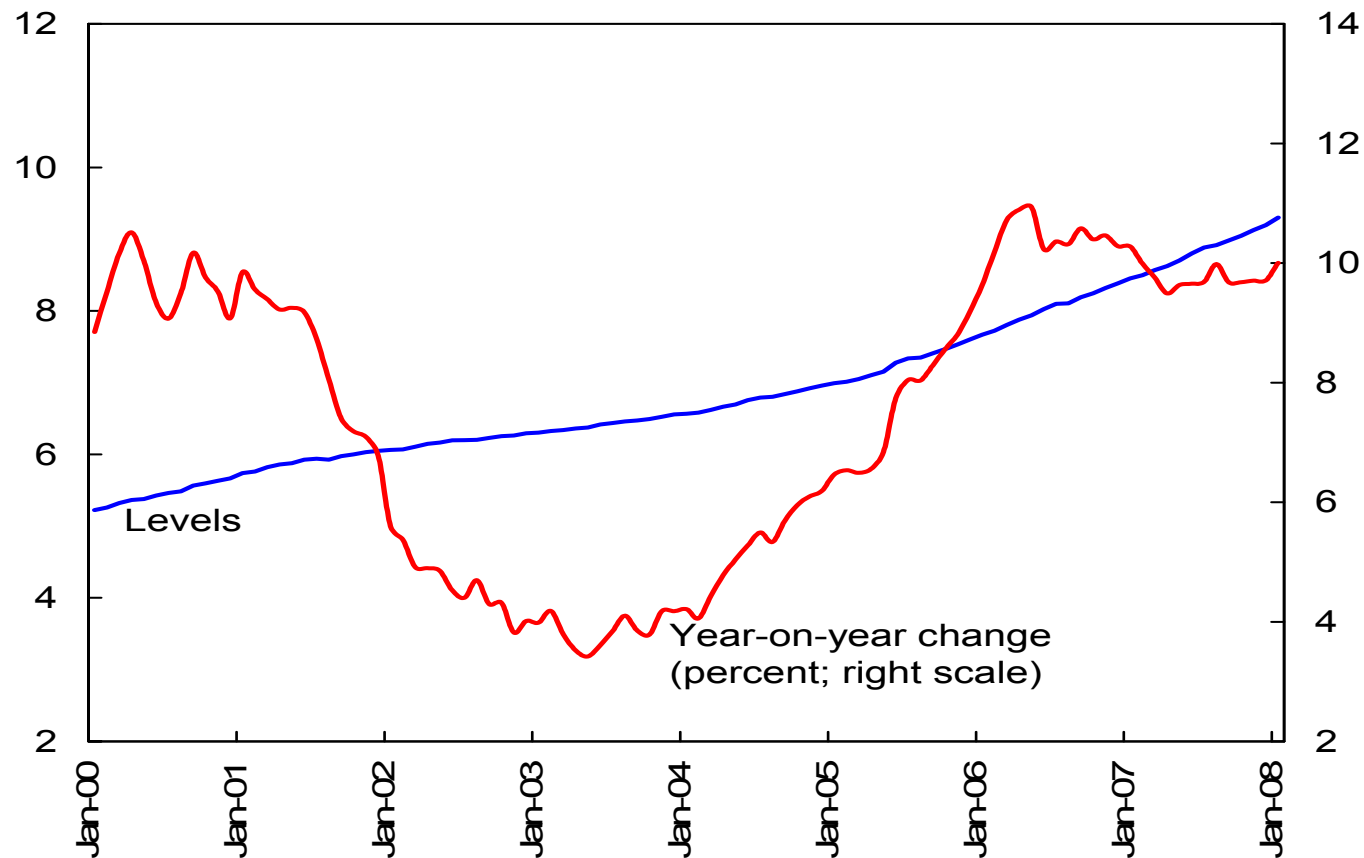


Sources: European Mortgage Federation (2006)

...and continuing growth in lending

Euro Area Lending to Nonfinancial Corporations and Households, 2000–08

(Trillions of euros)



Sources: European Central Bank (2008).

The financial turmoil is dampening growth

Output Response to Financial Shocks: Simulation Results

(Real GDP percent deviations compared with a no-shock scenario)

	Euro Area 1/	United Kingdom	Other Advanced European Economies 2/	New EU Member States 3/	United States
100-basis-point increase in corporate spreads for two years in all advanced economies					
2008	-0.3	-0.3	-0.1	-0.1	-0.2
2009	-0.4	-0.4	-0.2	-0.2	-0.3
100-basis-point increase in the spread between lending and deposit rate for two years in all advanced economies					
2008	-0.1	-0.1	-0.1	-0.1	-0.1
2009	-0.1	-0.1	0.0	0.0	-0.1
15 percent decline in equity prices for one year in advanced and emerging economies					
2008	-0.2	-0.2	-0.2	-0.4	-0.4
2009	-0.1	0.0	0.0	-0.1	0.0
Housing prices decline in the United States, United Kingdom, Spain, and Ireland					
2008	-0.1	-0.5	-0.1	-0.2	-0.5
2009	-0.3	-0.8	-0.2	-0.2	-1.1

Source: IMF staff estimates.

1/ Excluding Cyprus and Malta.

2/ Denmark, Norway, Sweden, and Switzerland.

3/ Bulgaria, Estonia, the Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, and the Slovak Republic.

Worse, in case of a credit squeeze

Response of GDP Growth to a 10-Percentage-Point Decline in Credit Growth *(Percentage points, year-on-year)*

	Czech Republic	Estonia	Hungary	Romania
Year 1	-0.7	-2.0	-0.7	-1.3
Year 2	-0.8	0.7	0.1	0.7

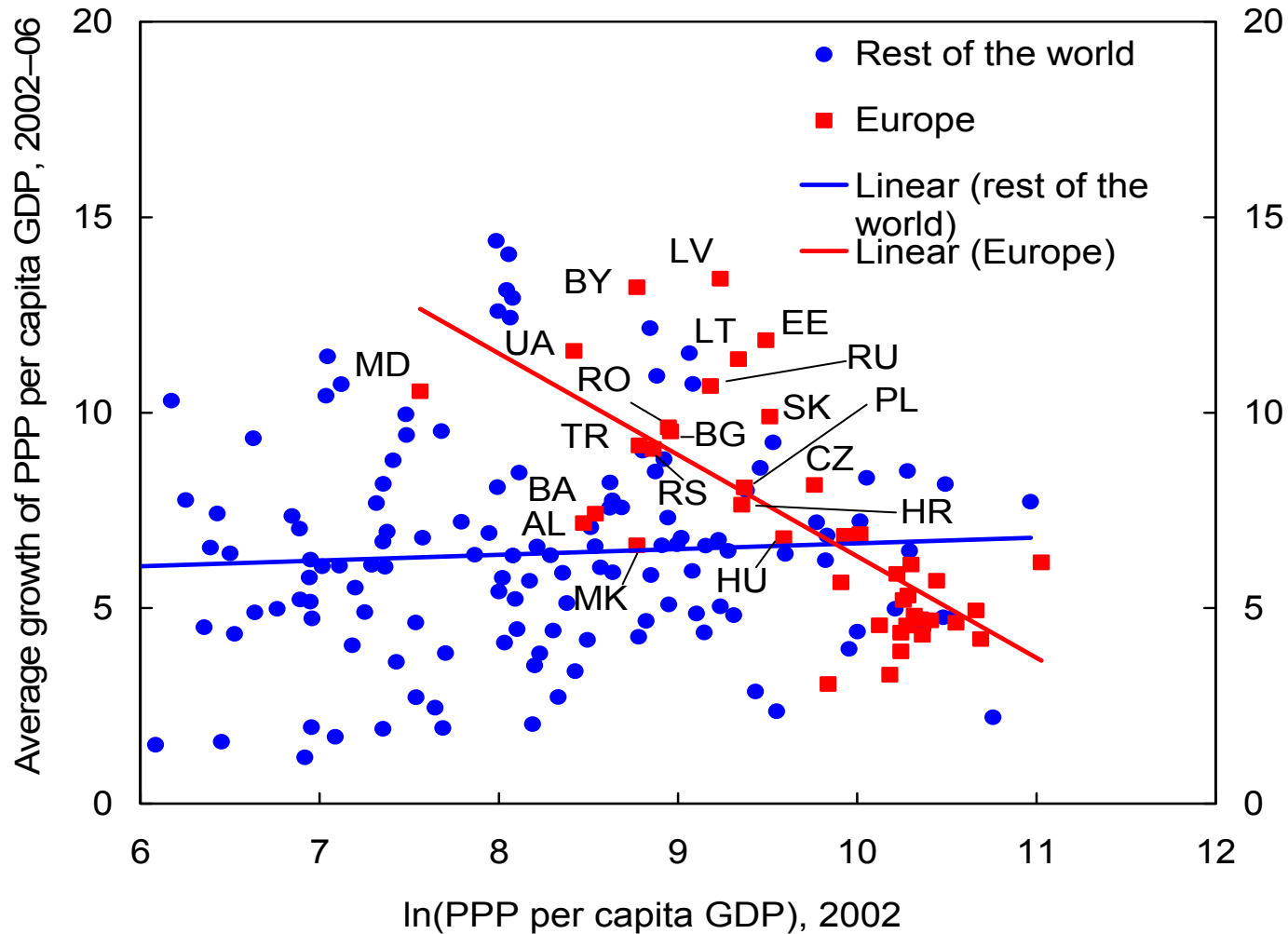
Source: IMF staff estimates.

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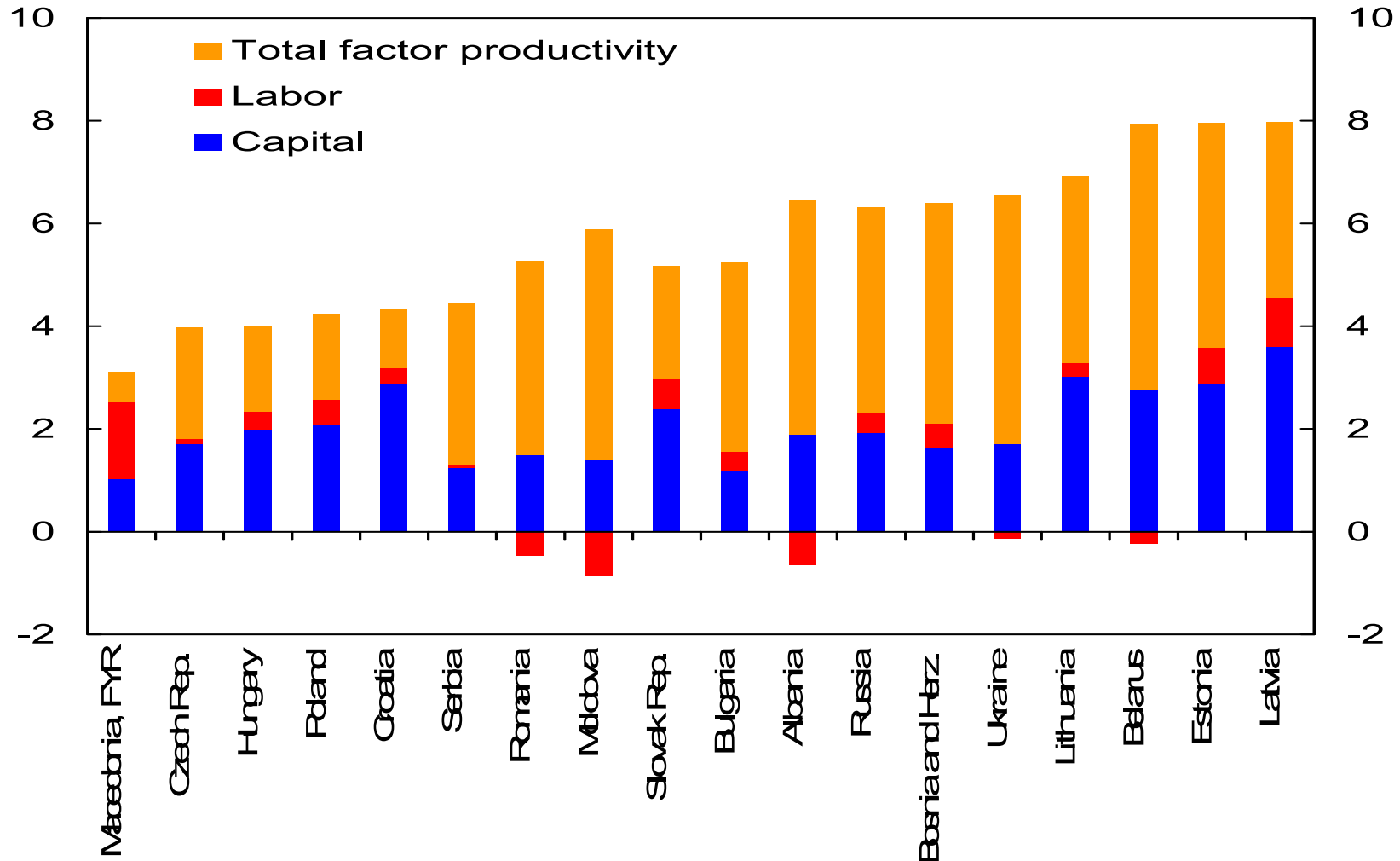
Emerging Europe is converging fast

Convergence in Emerging Europe and in the Rest of the World, 2002–06



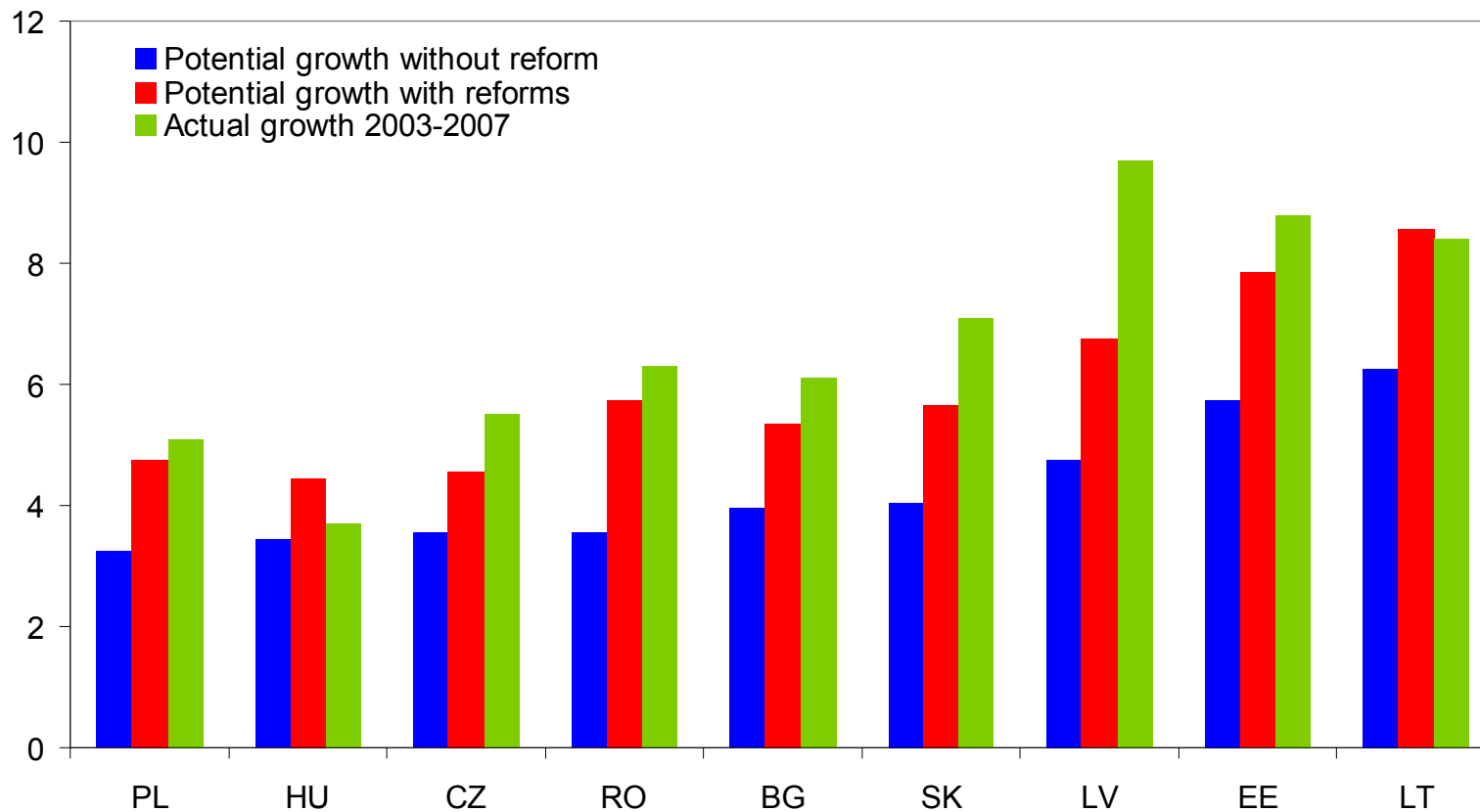
Productivity improvements have been key

Emerging Europe: Growth Accounting, 2002–06
(Percent per year)



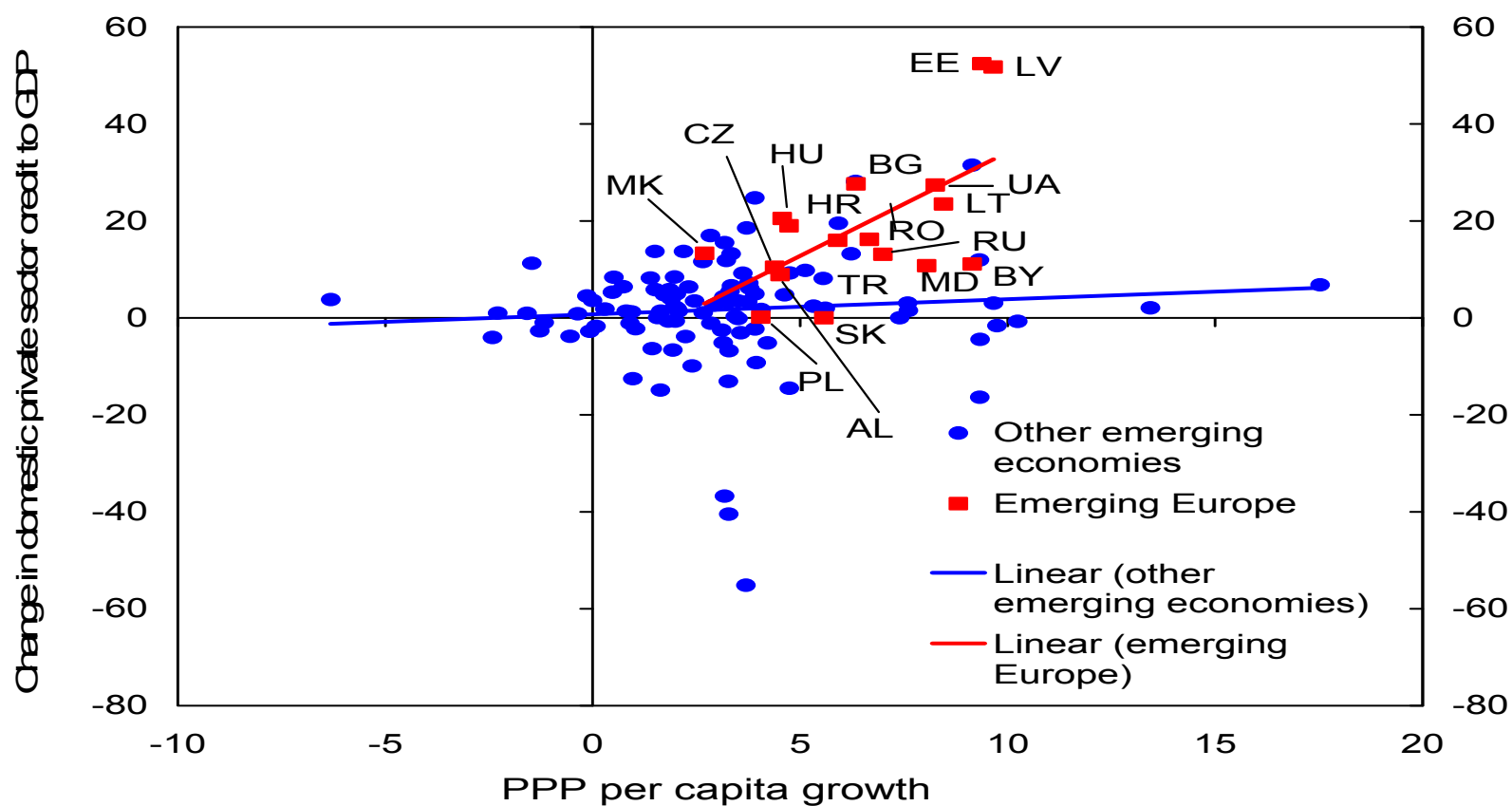
Convergence based on strong fundamentals and likely to continue, but its pace likely to ease;
structural reforms key to increase potential growth

Potential and Actual Growth of Real GDP in Emerging Europe
(Percent)

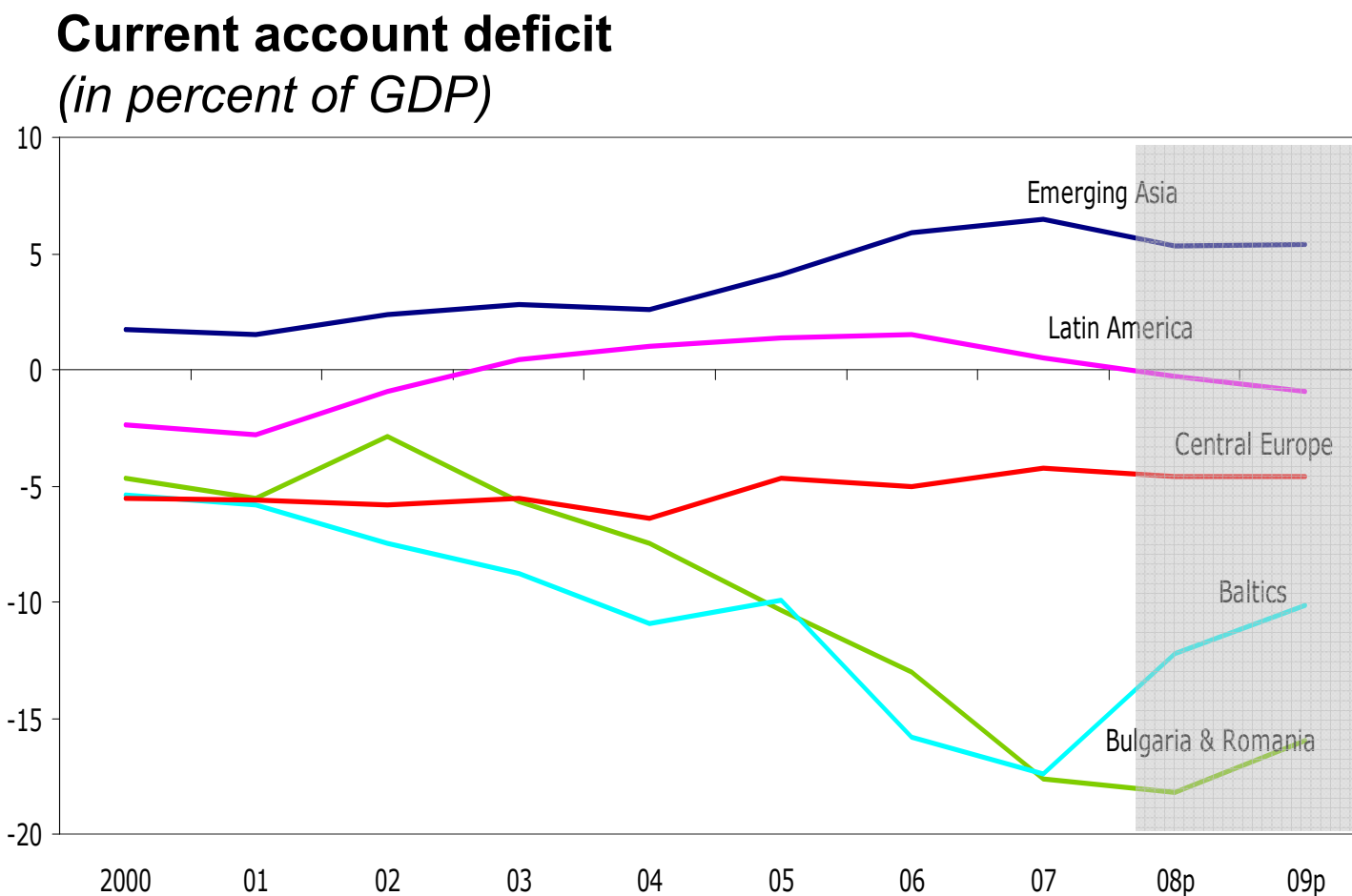


Financial intermediation has considerable scope to deepen and broaden, but the pace may slow

Growth and Private Sector Credit Growth, 2002–06
(Percent)

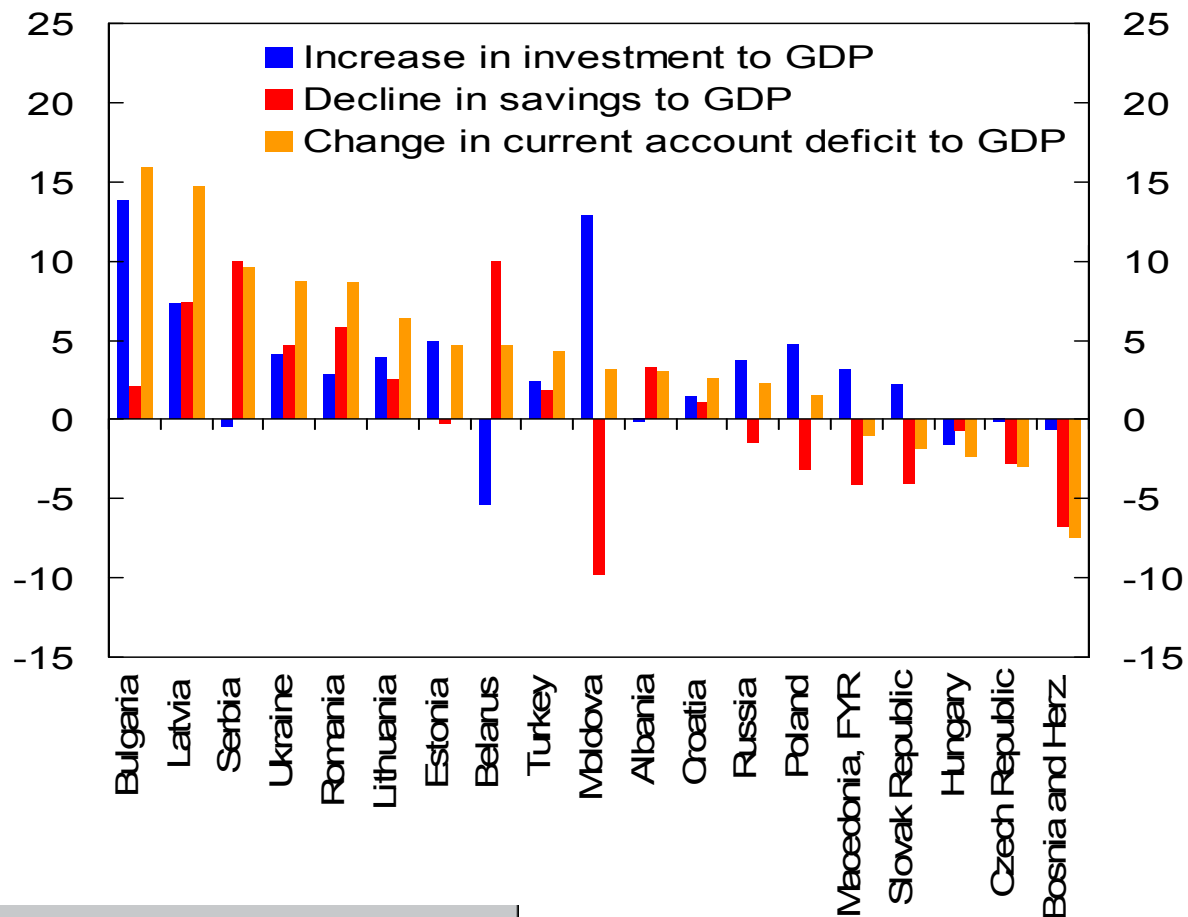


Current account deficits are high, especially in the Baltics and South-Eastern Europe



Most of the deterioration of C/A balances is driven by an increase in investment...

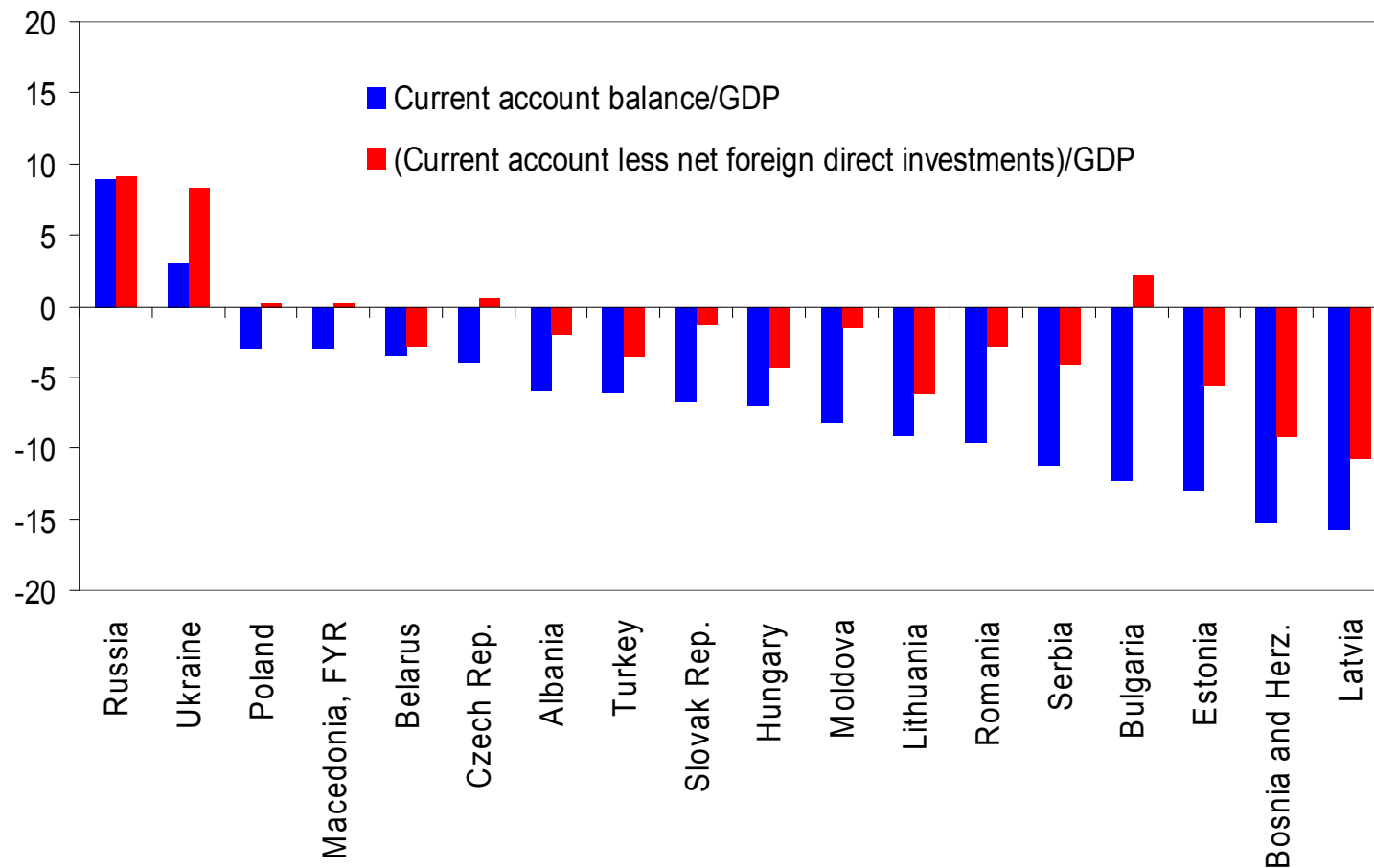
Emerging Europe: Contributions to Current Account Deficit, 2003–07
(Percent)



External imbalances: some reassuring trends

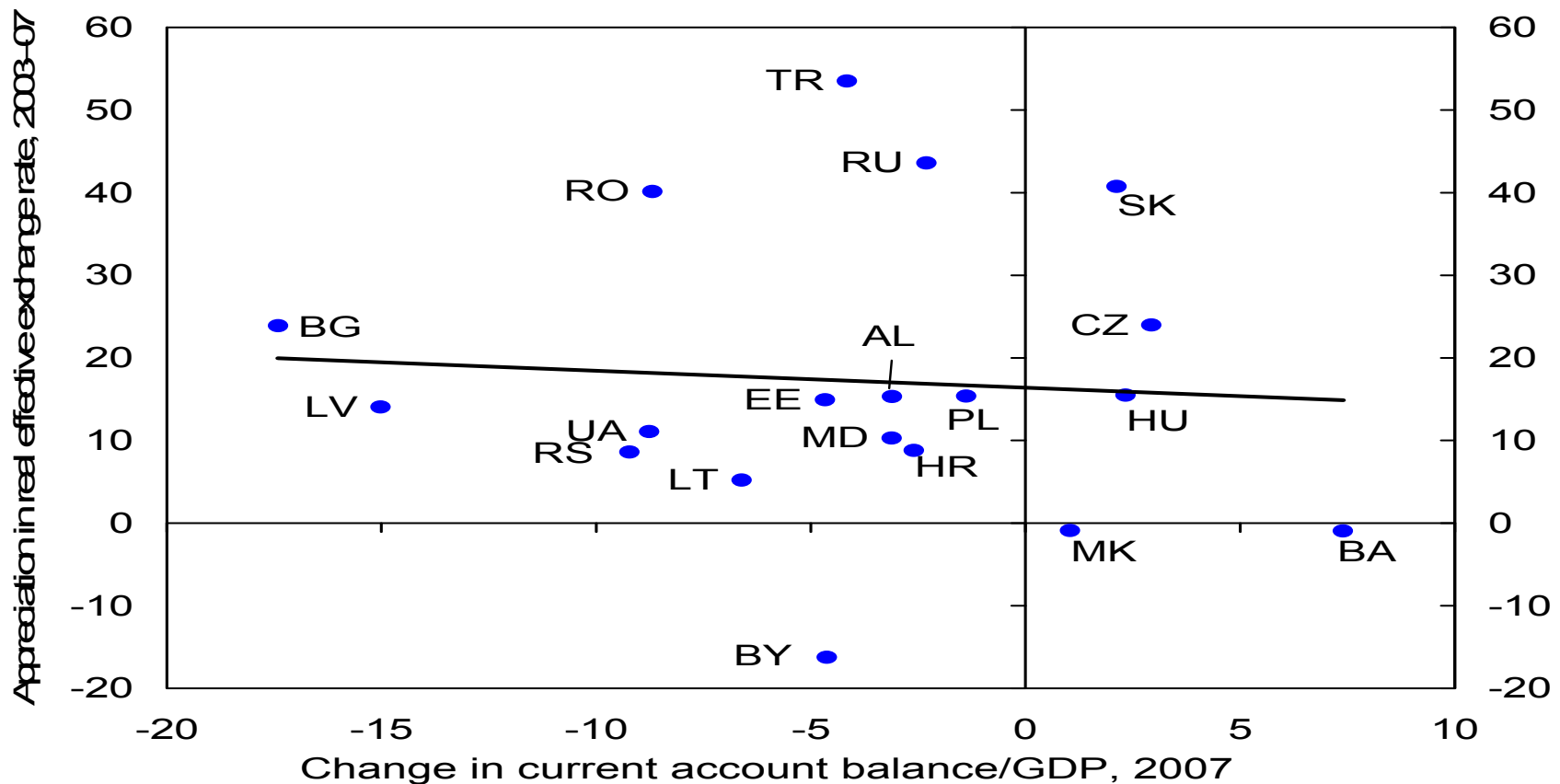
... and financed by FDI (and borrowing from foreign parent banks)

C/A minus net FDI, 2002-2006 average
(percent of GDP)



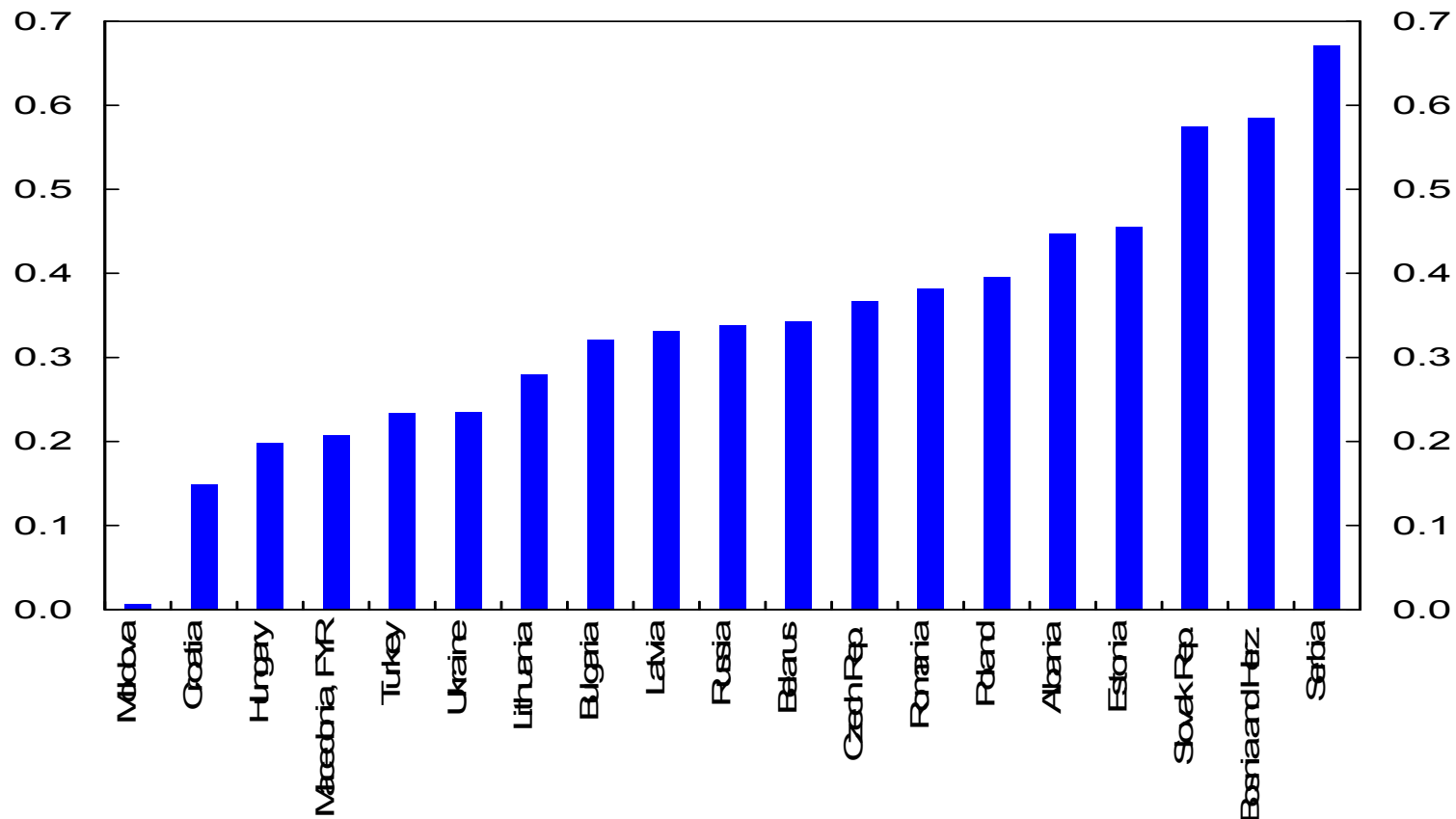
Exchange rate appreciations do not explain high c/a deficits...

Emerging Europe: Change in Current Account Balance and Real Effective Exchange Rate Appreciation, 2003–07
(Percent)



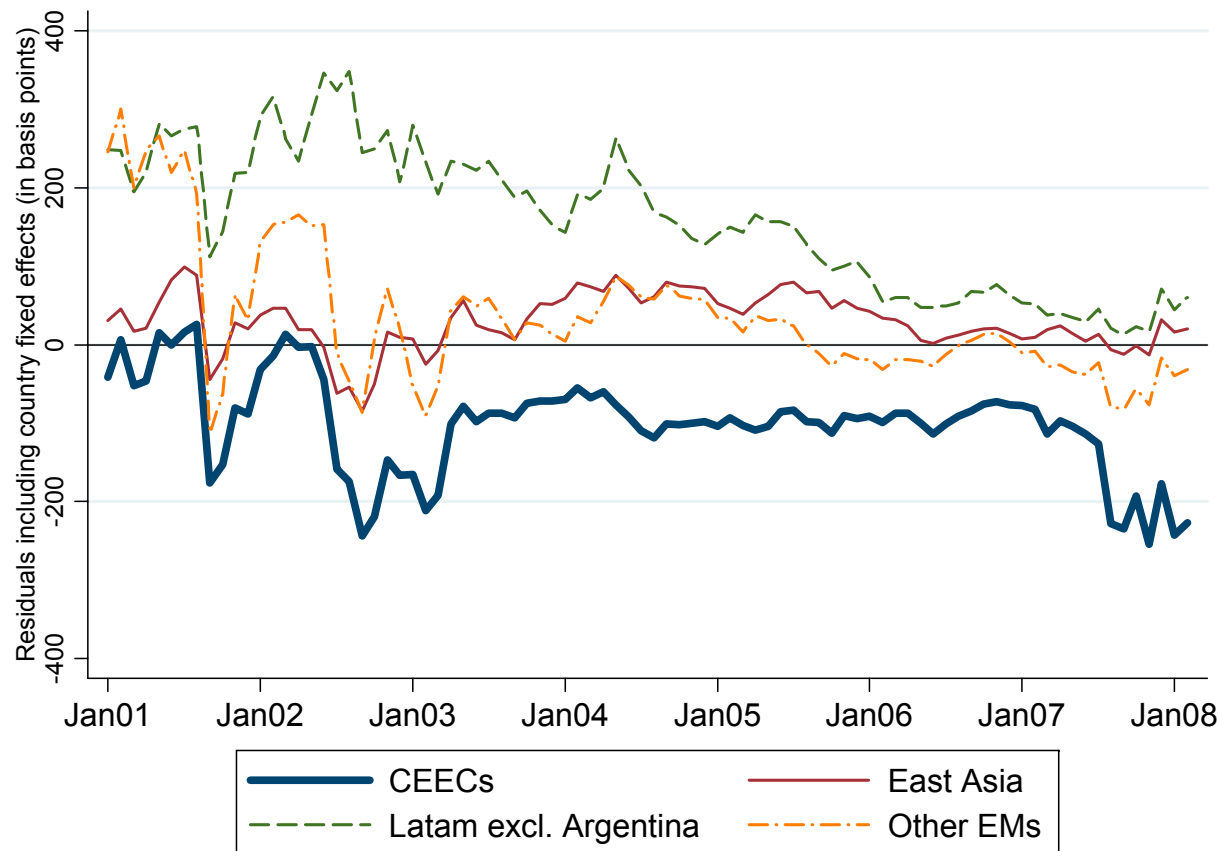
...and lack of competitiveness is not a problem

Emerging Europe: Percentage Change in Export Market Shares in the World Economy, 2002–06 1/



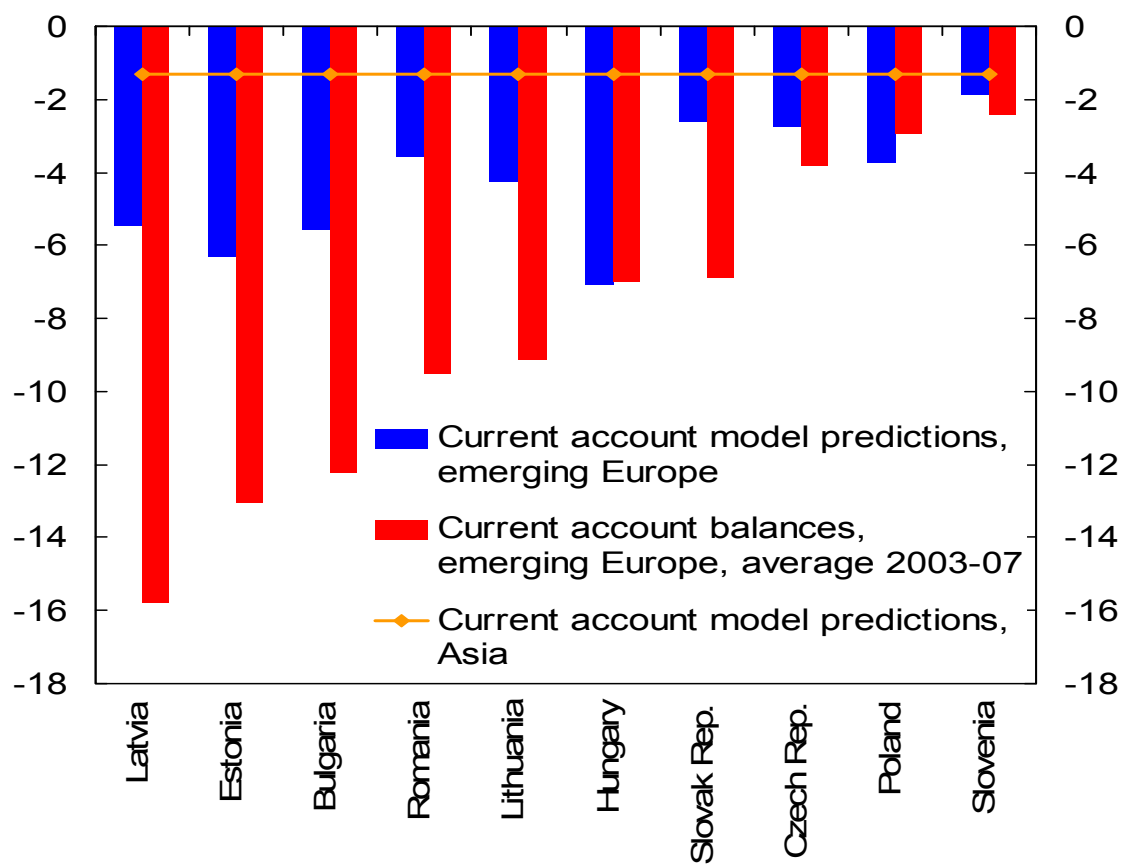
The “EU halo effect”: markets continue to reward EU membership

Risk premium: difference from fundamentals



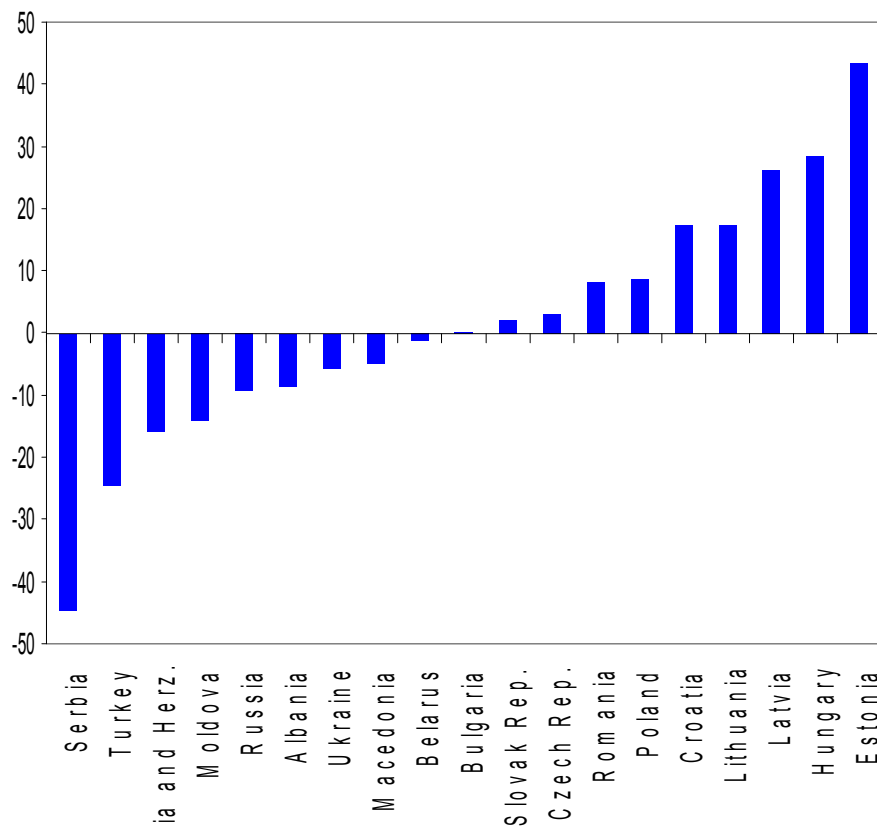
C/A deficits in some countries are much higher than supported by fundamentals

Current Account Balances and Model Predictions
(Percent of GDP)

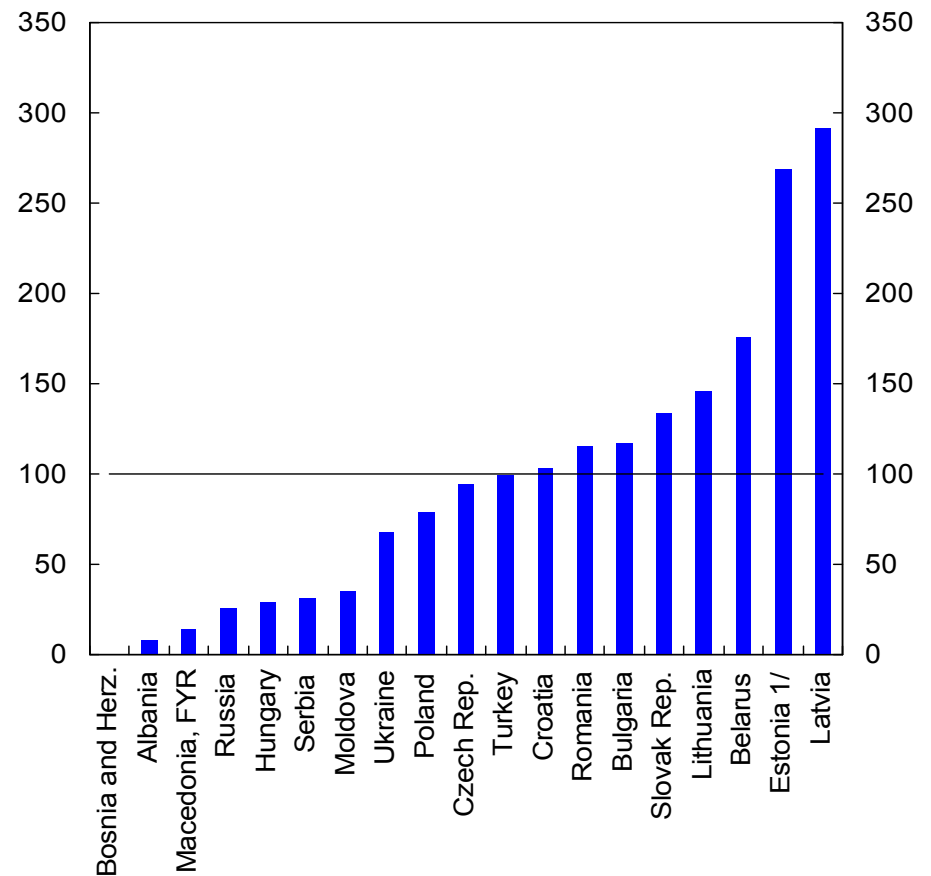


External debt is growing and reserve coverage is insufficient in some countries

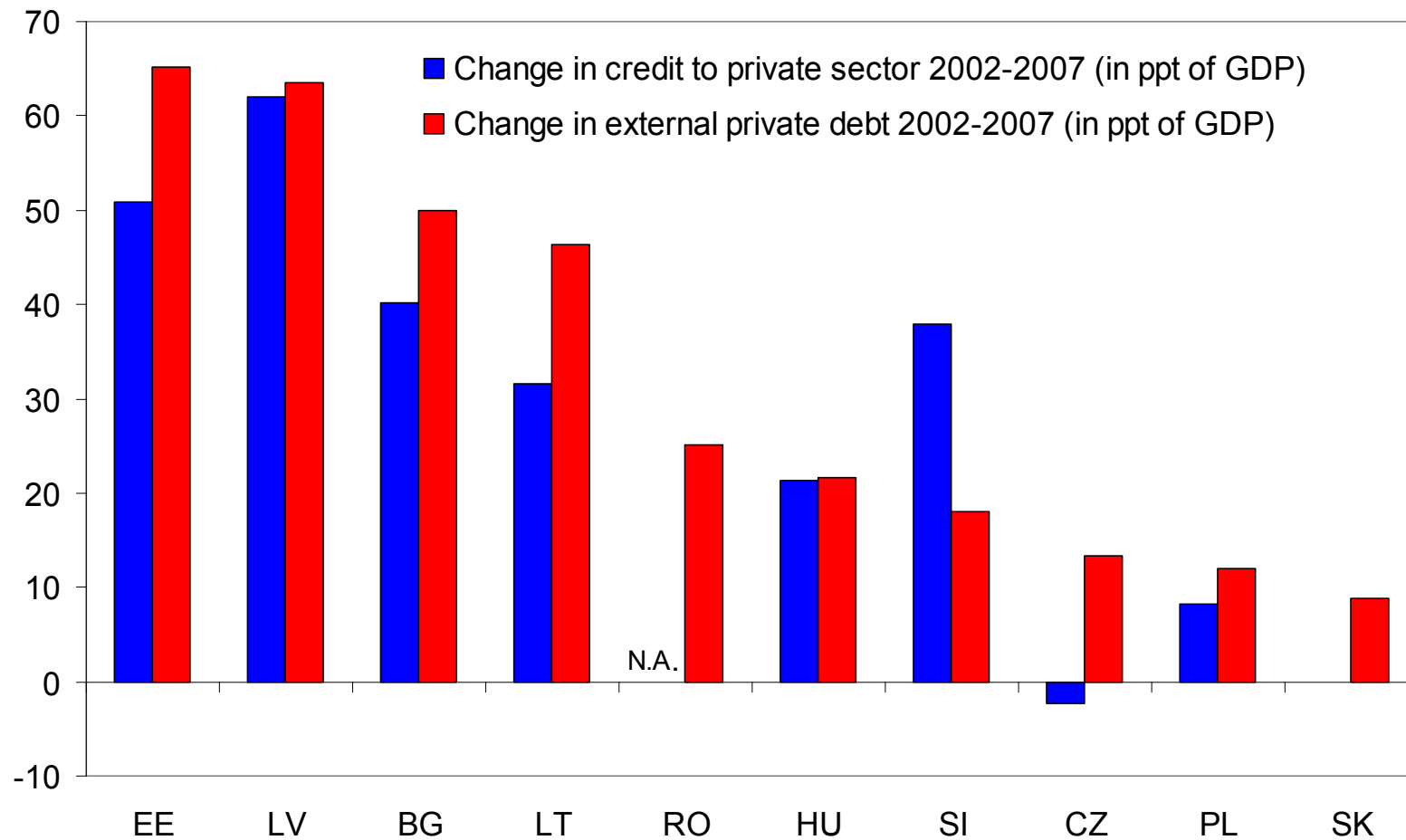
**External debt to GDP
Change 2002-2007**



Short-term debt / reserves, 2007



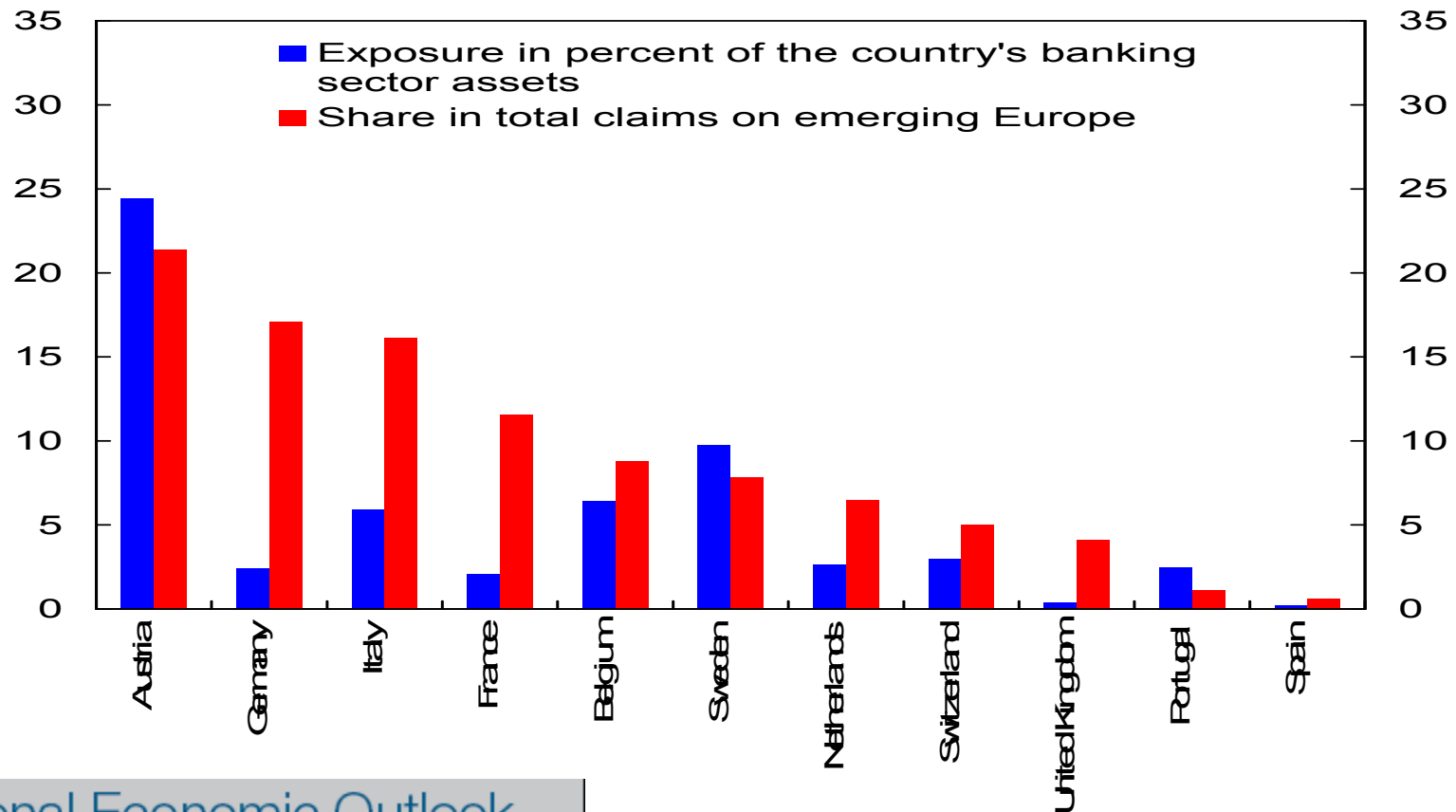
External imbalances are closely linked to financial deepening



External imbalances: Concerns

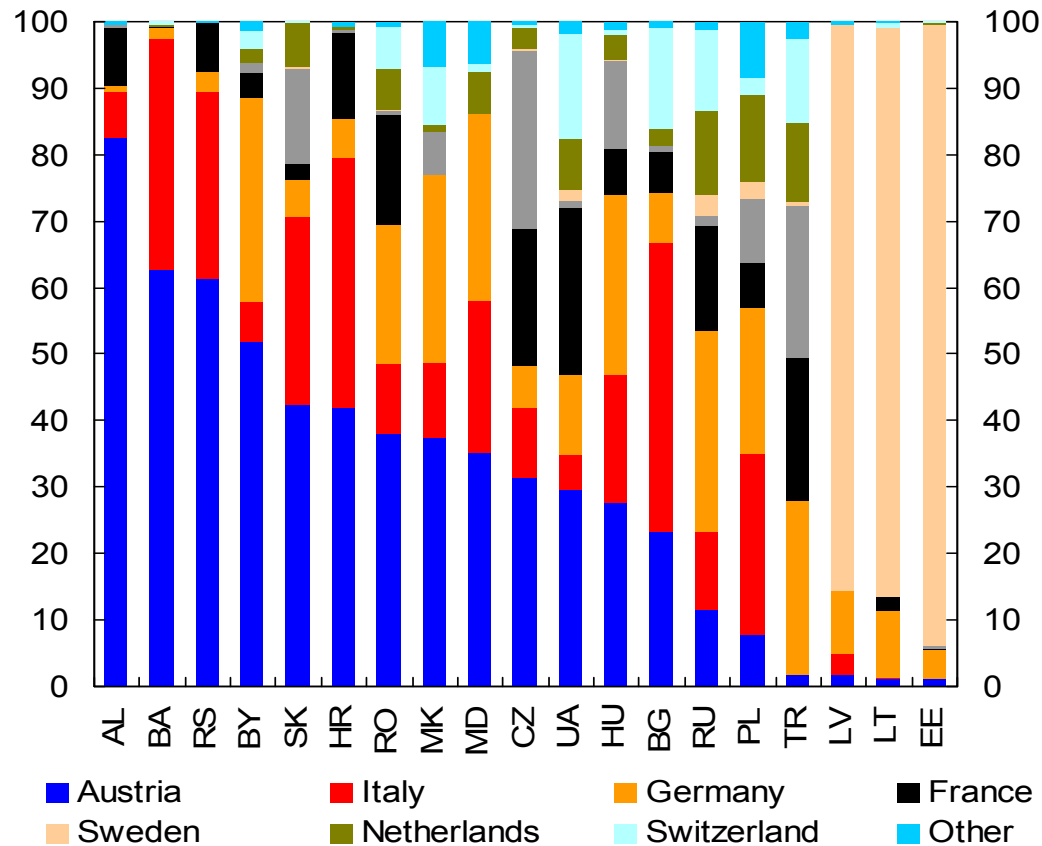
Although lending to emerging Europe is relatively a small share in the portfolio of banks in advanced Europe...

Relative Magnitudes of Funding Exposure for Emerging and Western Europe, June 30, 2007 (Percent)

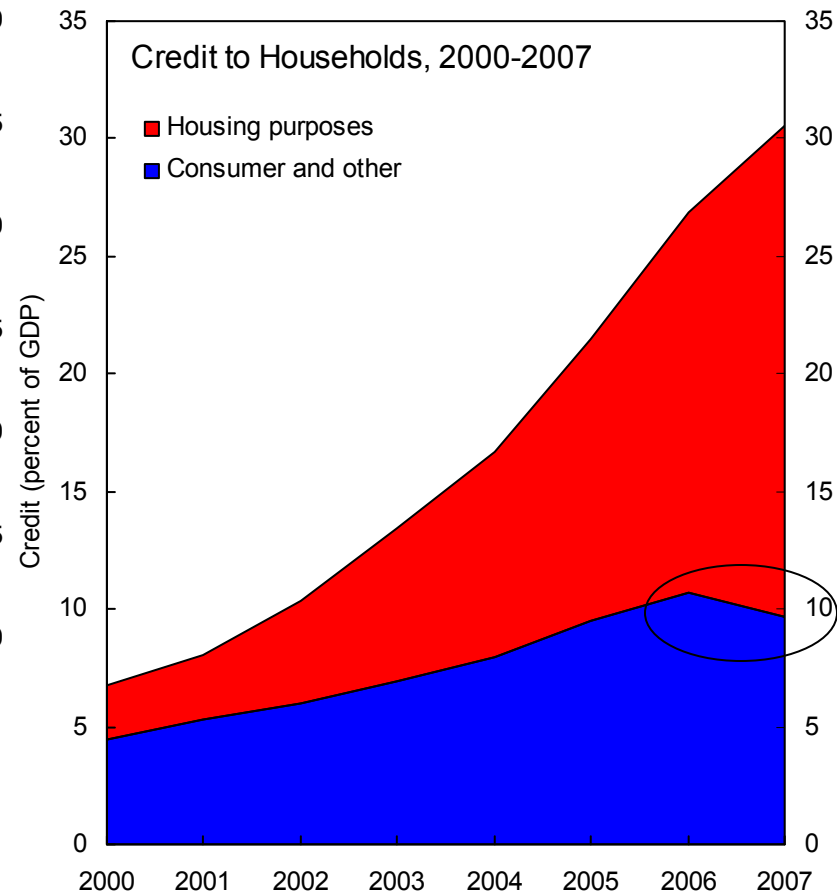
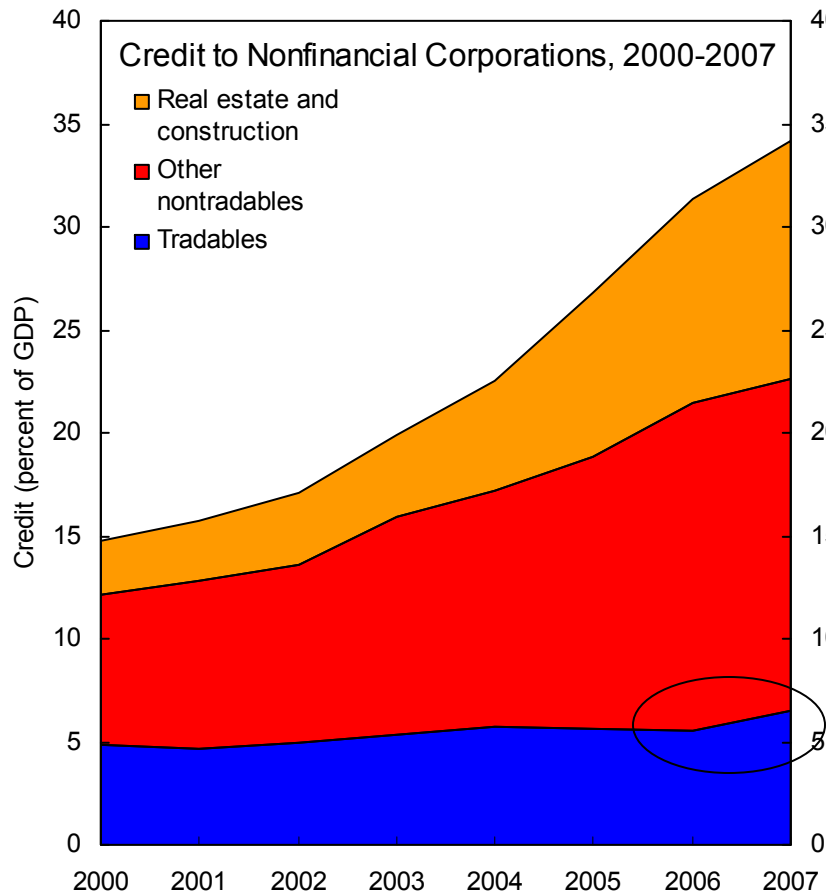


... it exposes the region to common-lender contagion risk

Concentration of Emerging Europe Exposure to Western Europe, June 30, 2007
(Percent)

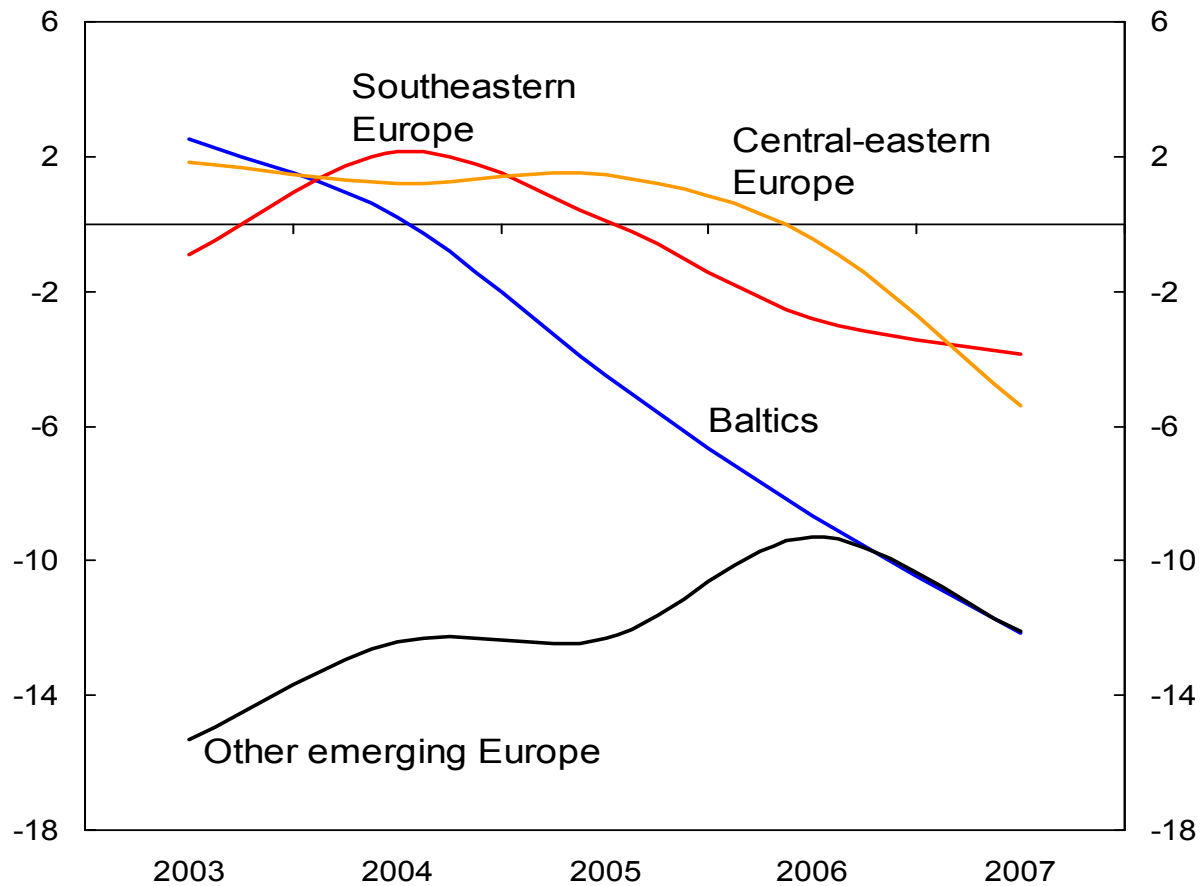


Credit is concentrated on households and nontradables



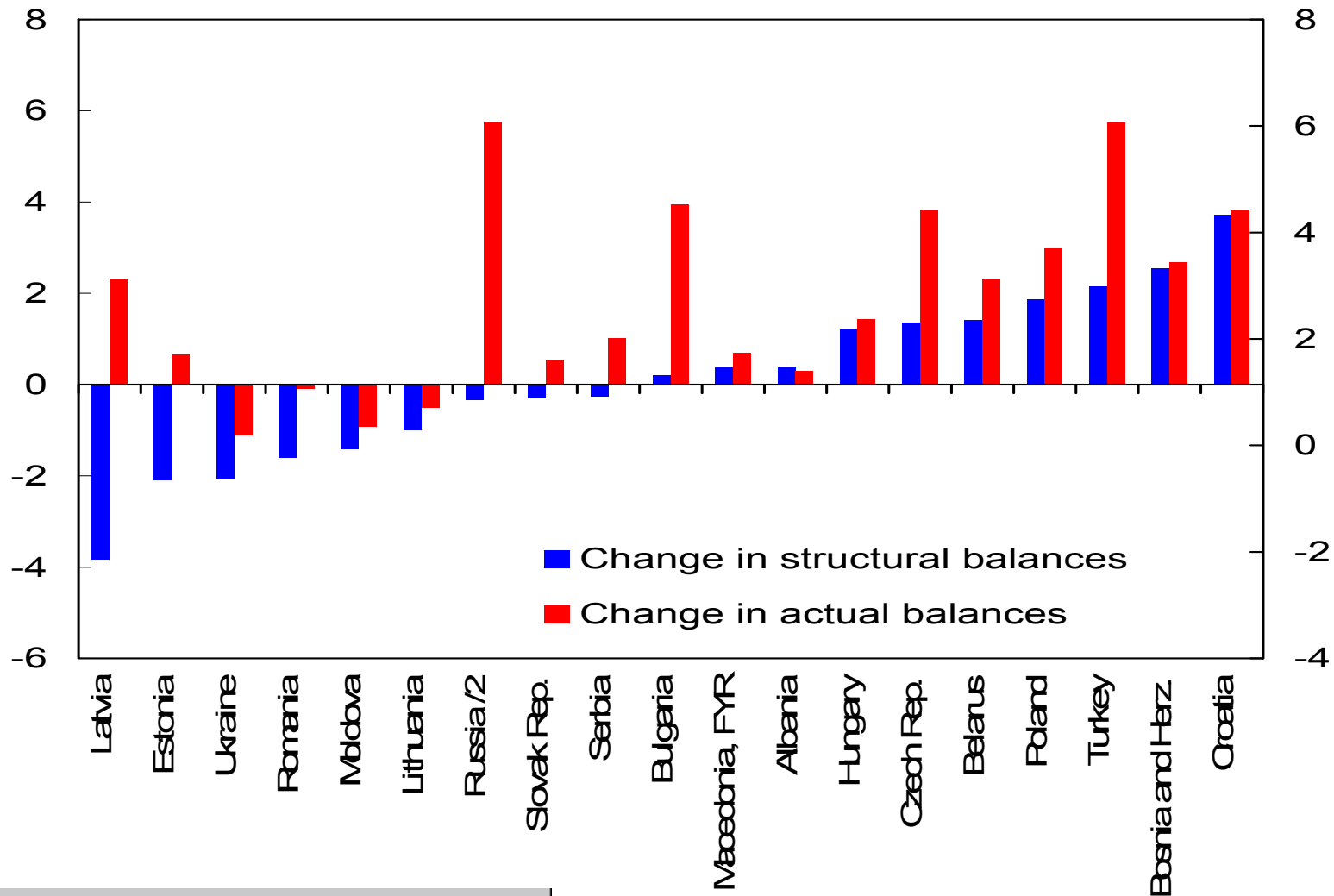
Loose monetary conditions

Emerging Europe: Lending Interest Rate–Taylor Rule Interest Rate, 2003–07



Room for more fiscal consolidation

Change in Actual and Structural Fiscal Balances, 2003–07 1/
(Percent of GDP)



Policy Agenda

Fixed exchange rate regime

- Supervisory and prudential policies
- Fiscal policy, including avoiding tax-induced distortions
- Incomes policies
- Structural reforms

Flexible exchange rate regime

- Timely tightening of monetary policy and enhancing central bank credibility and transparency
- Increasing exchange rate flexibility
- Supervisory and prudential policies
- Fiscal policy, including avoiding tax-induced distortions
- Structural reforms

Questions?

