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

Real GDP Growth (percent)

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

Spreads of international three-month interbank rates to three-month expected policy rates (in basis points)

Source: Bloomberg.

Regional Economic Outlook
Estimated bank losses look similar

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

<table>
<thead>
<tr>
<th>Country/Region</th>
<th>Total Reported</th>
<th>Total Expected</th>
<th>Remaining Subprime-Related Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>80</td>
<td>121</td>
<td>41</td>
</tr>
<tr>
<td>United States</td>
<td>95</td>
<td>144</td>
<td>49</td>
</tr>
</tbody>
</table>

Sources: Goldman Sachs; UBS; and Fund staff estimates.
Credit standards have tightened

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

Regional Economic Outlook
The euro has strengthened

U.S. dollar-euro exchange rate (right scale)

Real effective exchange rate (CPI based; 1999-2007=100)

Source: IMF

Regional Economic Outlook
Food and oil prices have surged...

![Graph showing food and oil price indices](image)

**Average petroleum spot price index 1/ 2/**

**Commodity food price index 1/**

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.

Regional Economic Outlook
...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

Current account deficit in 2007 (percent of GDP)

Region of Economic Outlook
Growth is slowing throughout the region with risks on the downside

**Growth in Emerging Europe, 2001–09**

*Percent*

- **Baltics**
- **Central and eastern European countries**
- **Other emerging economies**

**Projections**
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

Weight of food in CPI (percent)

Log of PPP per capita income (U.S. dollars)
...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

iBoxx Euro-Corporate Bond Spread over Five-year German Bond Rate, January 2006–March 2008 (Basis points)

Source: Datastream.
But, safer funding for homegrown mortgages...

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

- Retail Deposits: 66%
- Covered Bonds: 17%
- Mortgage Backed Securities: 5%
- Other: 12%

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)*

<table>
<thead>
<tr>
<th></th>
<th>Euro Area 1/</th>
<th>United Kingdom</th>
<th>Other Advanced European Economies 2/</th>
<th>New EU Member States 3/</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>100-basis-point increase in corporate spreads for two years in all advanced economies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>2009</td>
<td>-0.4</td>
<td>-0.4</td>
<td>-0.2</td>
<td>-0.2</td>
<td>-0.3</td>
</tr>
<tr>
<td><strong>100-basis-point increase in the spread between lending and deposit rate for two years in all advanced economies</strong></td>
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<td><strong>15 percent decline in equity prices for one year in advanced and emerging economies</strong></td>
<td></td>
<td></td>
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<td>0.0</td>
</tr>
</tbody>
</table>

*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)*

<table>
<thead>
<tr>
<th></th>
<th>Czech Republic</th>
<th>Estonia</th>
<th>Hungary</th>
<th>Romania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>-0.7</td>
<td>-2.0</td>
<td>-0.7</td>
<td>-1.3</td>
</tr>
<tr>
<td>Year 2</td>
<td>-0.8</td>
<td>0.7</td>
<td>0.1</td>
<td>0.7</td>
</tr>
</tbody>
</table>

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

Average growth of PPP per capita GDP, 2002–06

Linear (rest of the world)
Linear (Europe)

Rest of the world
Europe

Regional Economic Outlook
Productivity improvements have been key.

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

Total factor productivity
Labor
Capital

Regional Economic Outlook
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

- Potential growth without reform
- Potential growth with reforms
- Actual growth 2003-2007

Regional Economic Outlook
Financial intermediation has considerable scope to deepen and broaden, but the pace may slow.
Current account deficits are high, especially in the Baltics and South-Eastern Europe.

**Current account deficit (in percent of GDP)**

- Emerging Asia
- Latin America
- Central Europe
- Baltics
- Bulgaria & Romania

Region: Europe

**Regional Economic Outlook**
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)

Regional Economic Outlook
Emerging Europe: Change in Current Account Balance and Real Effective Exchange Rate Appreciation, 2003–07

(Percent)

Appreciation in real effective exchange rate, 2003-07

Change in current account balance/GDP, 2007

External imbalances: some reassuring trends

Exchange rate appreciations do not explain high c/a deficits…
External imbalances: some reassuring trends

...and lack of competitiveness is not a problem

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

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

External imbalances: some reassuring trends
C/A deficits in some countries are much higher than supported by fundamentals
External imbalances: Concerns

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

Short-term debt / reserves, 2007

Regional Economic Outlook
External imbalances are closely linked to financial deepening.

- Change in credit to private sector 2002-2007 (in ppt of GDP)
- Change in external private debt 2002-2007 (in ppt of GDP)
Although lending to emerging Europe is relatively a small share in the portfolio of banks in advanced Europe...
… 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

Credit to Nonfinancial Corporations, 2000-2007
- Real estate and construction
- Other nontradables
- Tradables

Credit to Households, 2000-2007
- Housing purposes
- Consumer and other

External imbalances: Concerns
Loose monetary conditions

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

- Baltic States
- Southeastern Europe
- Central-eastern Europe
- Other emerging Europe
Room for more fiscal consolidation

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

- Room for more fiscal consolidation
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?