Regional Economic Outlook: Europe
Reassessing Risks
April 2008

Executive Summary

Outlook: Navigating Turbulent Waters

The spread of the crisis in financial markets has significantly dampened the outlook for the European economy. Even though Europe faced the financial turbulence from a position of strong fundamentals, spillovers from the expected mild recession in the United States, the global reassessment of risks, and the strains in the financial system are sapping its economy's strength. The appreciation of the euro and the sharp increase in inflation, driven by food and energy prices, are adding to these troubles. Growth in Europe is expected to decline sharply, by 1¼ percentage points in 2008, with growth rates in the advanced economies projected to fall well below potential for some time.

The risks to the growth outlook are substantial. On the downside, spillovers from weaker global growth could be even larger than expected; global imbalances could unwind suddenly, accompanied by a further appreciation of the euro; and the credit squeeze could turn into a full-blown credit crunch. Risks are greater in countries that are going through a correction in housing prices, though this factor is mitigated in Europe by the limited reliance of households on borrowing against home equity collateral. Emerging economies with large current account deficits or high external debt ratios would be especially vulnerable to shifts in investor confidence. On the upside, domestic demand could be stronger than projected, especially in the short run, as labor markets are still strong.

The challenges facing policymakers in advanced economies are to restore confidence in the financial system and minimize the impact of the financial sector crisis on the real economy, while maintaining hard-won inflation credibility and long-term fiscal sustainability. The immediate priorities are to rebuild counterparty confidence and reinforce the soundness of financial institutions. Liquidity should continue to be provided as needed. Central banks will have to strike the right balance between supporting the real economy and preventing second-round effects from the recent rise in inflation. In the euro area, while current inflation is uncomfortably high, prospects point to its falling back below 2 percent during 2009 in the context of an increasingly negative outlook for activity. Accordingly, the European Central Bank (ECB) can afford some easing of the policy stance. For countries with fiscal room, automatic stabilizers should be allowed to operate fully to cushion the downturn. In the event of a more severe contraction in growth, timely, temporary, and well-targeted fiscal stimuli could be effective in supporting the economy for a few countries.

The economies of emerging Europe continue to grow rapidly, but their dynamism is being challenged by the slowdown in advanced economies, the repricing of risk, and the rise in commodity prices. The financial turbulence is starting to affect the cost and availability of financing: sovereign and private bond spreads have risen, short-term cross-border financial flows have moderated, and credit growth is starting to slow in some countries. For most countries, growth is expected to weaken only moderately, adjusting toward potential rates and limiting the risks of overheating. However, the growing risks of a hard landing in countries with large external imbalances call for a continued focus on reducing vulnerabilities and managing demand pressures.

Financial Turbulence: Testing Resilience and Dampening Growth

Financial turmoil has spread quickly through Europe's financial systems (see Chapter 2). Direct valuation and income losses on subprime-related securities dented the capital and profitability of European financial institutions. With uncertainty about exposures and counterparty risk becoming pervasive, credit risk has been reappraised, but asymmetrically across the various asset classes. The erosion of risk appetite has generated unprecedented pressures in the commercial paper and interbank money markets.

Despite the depth and width of the turmoil, Europe's financial systems have held up relatively well so far. The soundness of the major systemic players has been maintained, as shareholders and outside investors have injected fresh capital where needed. Partly as a result of this and partly because "plain vanilla" debt instruments have been less affected, bank lending in advanced economies in Europe has held up, and spillovers to emerging Europe have been limited.

But the test of Europe's financial systems is not over. A range of estimates suggest that loss recognition in many financial institutions still needs to catch up with reality. Meanwhile, until U.S. housing market conditions stabilize, the values of subprime mortgage products will likely fall further. The continuing financial distress is spreading to other forms of debt and debt default insurance and, through its impact on parent banks in advanced economies, may spill over into emerging Europe. Moreover, liquidity remains seriously impaired despite aggressive responses by major central banks.

An overarching concern is the toll of the unfolding crisis on the real economy. Analytical work suggests that the effects on growth—from the rising cost of finance and the credit supply squeeze, as well as from knock-on effects through equity and housing price corrections—are likely to be significant. A more severe credit crunch remains a distinct possibility and would amplify the slowdown.

Emerging Europe: Sustaining Convergence and Addressing Vulnerabilities

Analysis of the prospects and vulnerabilities of emerging Europe (see Chapter 3) suggests that the convergence trend of the region is based on strong fundamentals and will therefore continue, albeit at a slower pace. Structural reforms have progressed in most countries, thanks to which growth has been driven primarily by productivity improvements. However, growth rates in recent years have been above estimates of potential for most countries and an adjustment is already under way.

Fast growth has been associated with rising external imbalances in several economies, including large current account deficits and high levels of external debt, raising risks of a hard landing. Although fundamentals justify relatively large current account deficits in the region, deficits in some countries may be excessive, suggesting the need for adjustment in the medium term. High external debt levels and balance sheet exposures in some countries are an additional source of vulnerability.

Macroeconomic policies and structural reforms will need to do more to address emerging Europe's imbalances. Monetary conditions tend to be on the loose side in most of the region and should be tightened where possible. Fiscal consolidation has not always taken full advantage of the strong cycle and needs to play a more prominent role in managing domestic demand, particularly in countries where monetary policy focuses on exchange rate stability. Our analysis also reveals a strong link between structural reforms and potential growth, suggesting that further progress in these reforms may be essential to ensure a smooth convergence in emerging Europe. Moreover, structural reforms will facilitate the gearing of resources toward the tradable sector, thereby helping to reduce external imbalances.