Regional Economic Outlook: EUROPE
Dealing with Shocks
October 2008

Executive Summary

Multiple adverse shocks have combined to dampen economic activity in Europe. High commodity prices have depressed real incomes and consumption, and propelled inflation to levels not seen in a decade. A strong euro and slowing demand from trade partners have acted as a drag on exports. And extraordinary financial stresses have been negatively affecting advanced economies, while testing the resilience of emerging economies.

Activity is expected to stagnate in most advanced economies in the near term, as asset price and consumption booms deflate and financial institutions curb credit to reduce leverage. In most emerging economies, growth is projected to slow significantly. With the adjustment in the financial system likely to be arduous and protracted, a modest recovery is expected only later in 2009. Intensifying strains in the financial sector and a mutually reinforcing deterioration in financial and economic conditions constitute key downside risks. Increases in oil and food prices should ordinarily not generate a sustained rise in inflation. However, these increases have been so broad and sizable that concerns have arisen about demands for higher wages, which would put upward pressure on all prices. Emerging markets in which prior overheating pressures prevailed are particularly prone to a wage-price spiral. In advanced economies, the projected sharp weakening of activity together with the recent reduction in several key commodity prices should lead to a steady decline in inflation.

Stabilizing financial conditions is the policy priority. Achieving this goal necessitates global action, including liquidity provision when needed, and the restoration of healthy financial balance sheets by encouraging loss recognition and rebuilding of capital bases. European leaders will need to make a commitment to concerted and coordinated action to alleviate financial stresses. Given the importance of cross-border financial institutions, the ongoing financial turmoil has made it clear that the European Union needs to put in place joint responsibility and accountability for financial stability to avoid the serious risk of backtracking on European financial integration.

While containing inflation remains a policy concern, nurturing the recovery is likely to gain policy prominence. In most advanced economies, headline inflation is projected to drop to levels below central bank objectives as a result of the very weak outlook for activity. In these circumstances and with further downside risks emanating from the financial sector, scope for easing monetary policy has emerged. Meanwhile, operation of automatic fiscal stabilizers should support activity, but safeguarding long-term fiscal sustainability requires deficits to be kept within the limits of fiscal rules. Exceptions can be considered, if and when public resources are needed to directly alleviate financial stresses. In many emerging economies,

macroeconomic policy settings may need to be tightened further to address inflationary pressures and external vulnerabilities. And contingency plans should be put in place to deal with possible financial instability and hard landings.

Advanced economies are better positioned than their emerging counterparts to head off second-round effects on inflation from the surge in commodity prices (Chapter 2). Though vestiges of indexation remain in some countries, improved labor market flexibility, strong monetary policy credibility and the weak outlook for activity should limit the pass-through of commodity price shocks to core inflation. The risks of spillovers of price pressures to a broad range of goods are greater in the emerging economies, for which food and fuel account for a substantial share of consumption. For some of these economies, the rise in commodity prices adds to existing price pressures from overheating. Moreover, inflation may be more difficult to control in emerging markets with fixed exchange rates or limited monetary policy credibility.

The appropriate policy response to the commodity price increases depends on the source of the price pressures, the credibility of policymakers, and the degree of labor market flexibility. Because global demand factors played an important role in the run-up of commodity prices, a tighter-than-usual monetary policy stance may be warranted, especially in some emerging economies and in countries with greater labor market rigidities. Past experience suggests that policymakers should resist the temptation to try to maintain high growth in the face of adverse commodity price shocks. Rather, fiscal and structural policies are best aimed at easing supply bottlenecks and providing the right incentives to producers and consumers.

As the ongoing financial market turmoil underscores, financial systems are inherently subject to cycles, with important but dissimilar consequences for real activity across countries (Chapter 3). Developments in national housing and corporate finance systems—which are reinforcing the role of financial assets as borrowing collateral—have the potential to make bank lending procyclical. In this way, the financial sector can amplify business cycle fluctuations, as well as the impact of monetary policy shocks and asset price movements on real activity. Cross-border ownership of assets further bolsters this mechanism. Analysis suggests that emerging economies are likely to be more vulnerable than advanced economies to the current downturn in the credit cycle, though with large differences across countries.

What can policymakers do to lessen the undesirable macroeconomic volatility associated with asset price dynamics? While there is no consensus yet on this issue, the introduction of a countercyclical element in prudential regulation could substantially reduce the volatility of investment, particularly in financially integrated economies with tighter borrowing limits. In this respect, financial integration remains essential to foster smooth and growth-oriented adjustment. At the same time, supervision needs to keep pace with increasingly complex linkages across borders by ensuring adequate coordination of financial policies across Europe, and especially within the euro area.

Along with international capital, the flow of labor across the borders of the European Union's New Member States has been a key feature in their convergence process (Chapter

4). Since the onset of transition, these labor movements have intensified appreciably and become increasingly diverse and flexible. Labor mobility has significant advantages: it speeds up convergence, boosts economy-wide capital-labor ratios, supports aggregate demand through remittances, and may help augment skills through the reintegration of returning migrants in domestic labor markets.

Contrary to some perceptions, restricting labor mobility is not the answer to overheating pressures; policies to improve overall labor mobilization are a much better avenue. Rather than being a source of overheating, labor mobility is more likely to play a moderating role. Indeed, the wage increases during economic booms diminish the incentive to seek employment abroad and instead attract immigrants, both of which lessen pressure on domestic wages. However, outward labor mobility speeds up the wage increases normally associated with the process of income convergence. In the presence of labor market rigidities, such increases could set off second-round inflationary effects, which would need to be kept in check to preserve competitiveness. In addition, differences in age and skills composition between labor outflows and inflows could contribute to labor market mismatches. Policies to improve mobilization and utilization of labor are therefore key to supporting sustainable growth and securing a smooth domestic reallocation of resources.