

World Economic and Financial Surveys

Regional Economic Outlook



Europe

Strengthening Financial Systems

.....



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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

Outlook, Risks, and Policy Priorities for Emerging Europe

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Overview

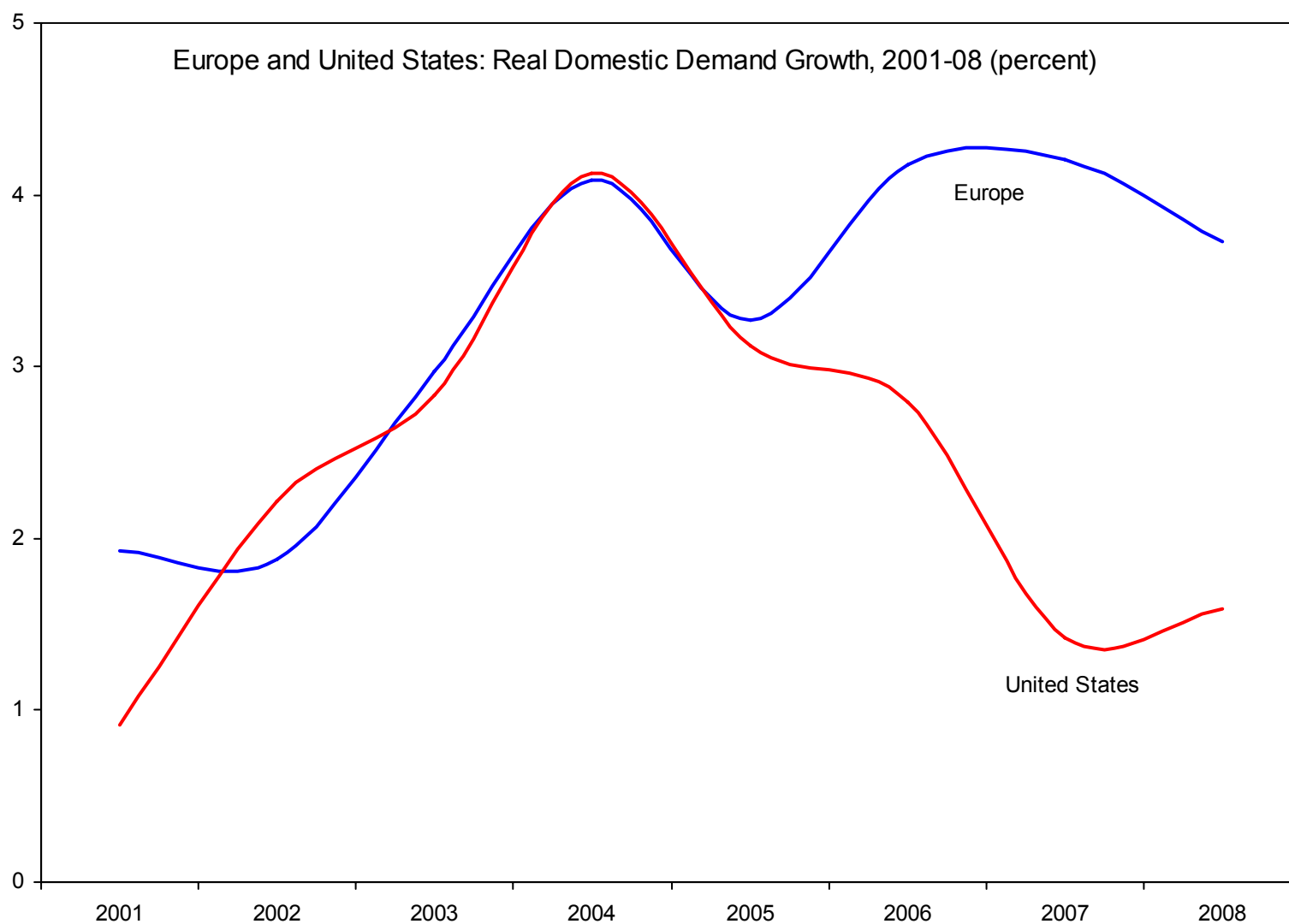
- What is the outlook for advanced and emerging economies in Europe?
- How do we interpret the risks for emerging Europe?
- What are the key policy priorities for emerging Europe?

What is the outlook for Europe?

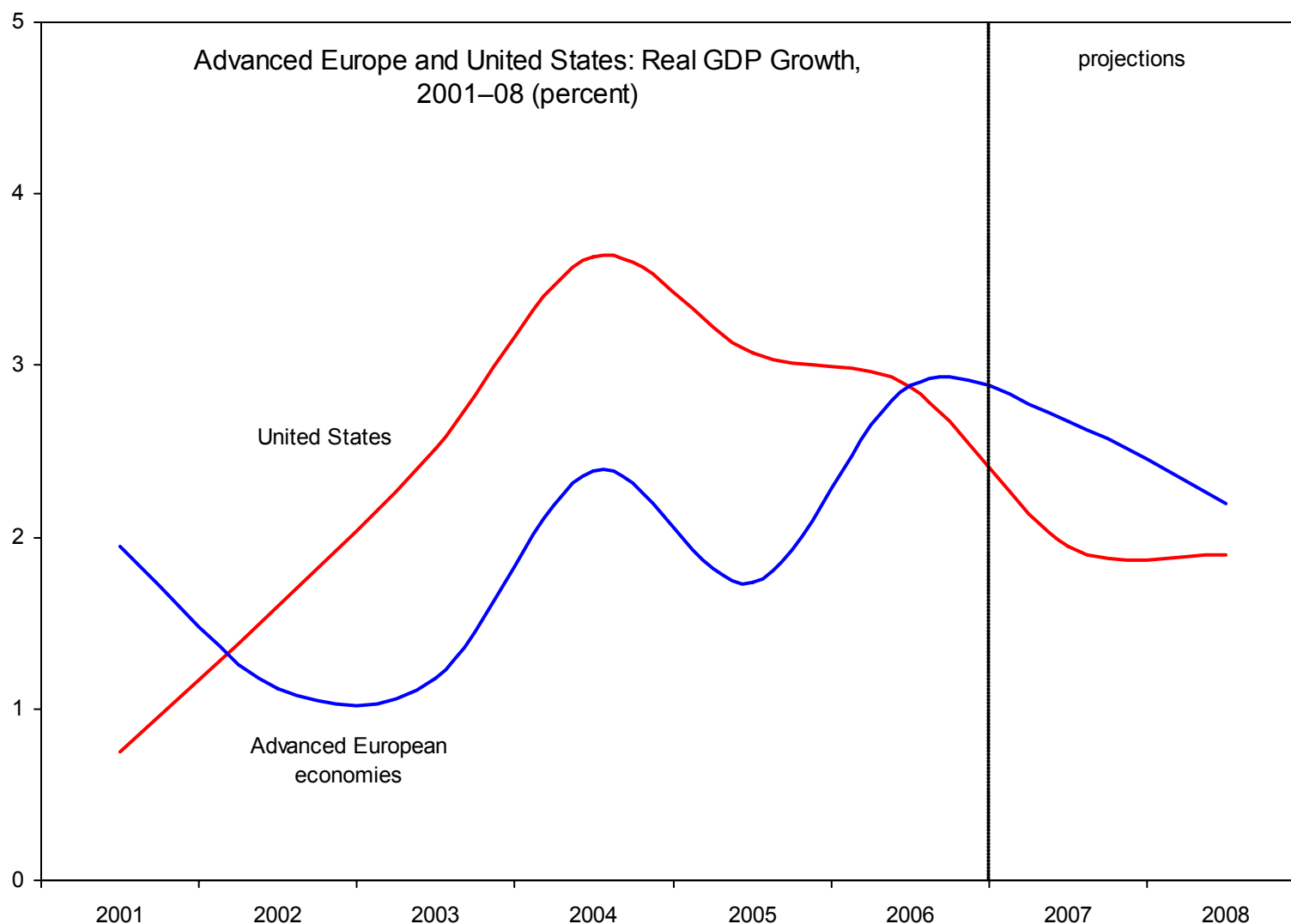
What is the outlook for Europe?

- Some slowing ahead, owing to lower US growth
- Strong fundamentals should help overcome financial turbulence
- Further financial turbulence is a downside risk, along with a sharper slowdown of global growth

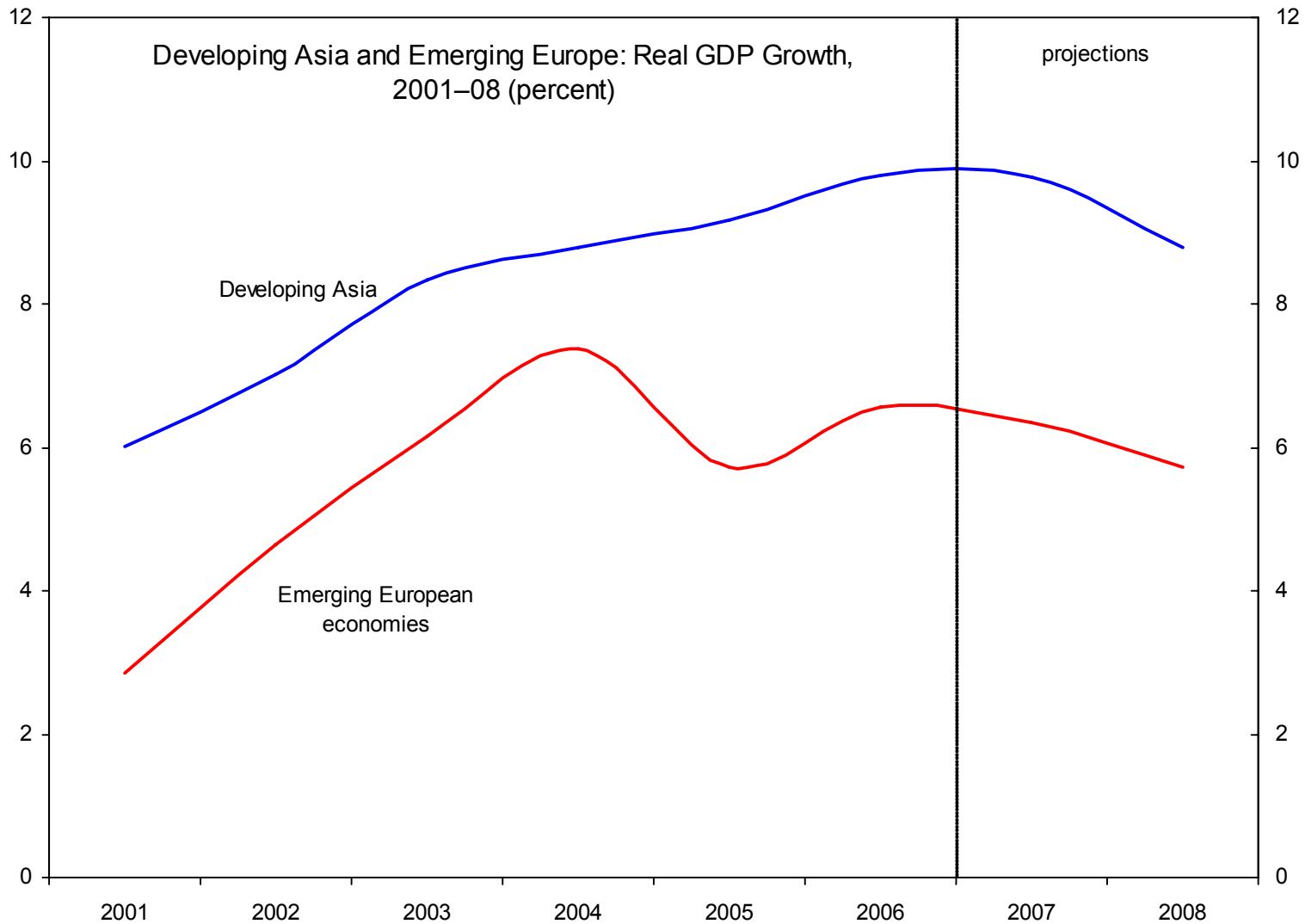
Some slowing ahead, owing mainly to lower US growth



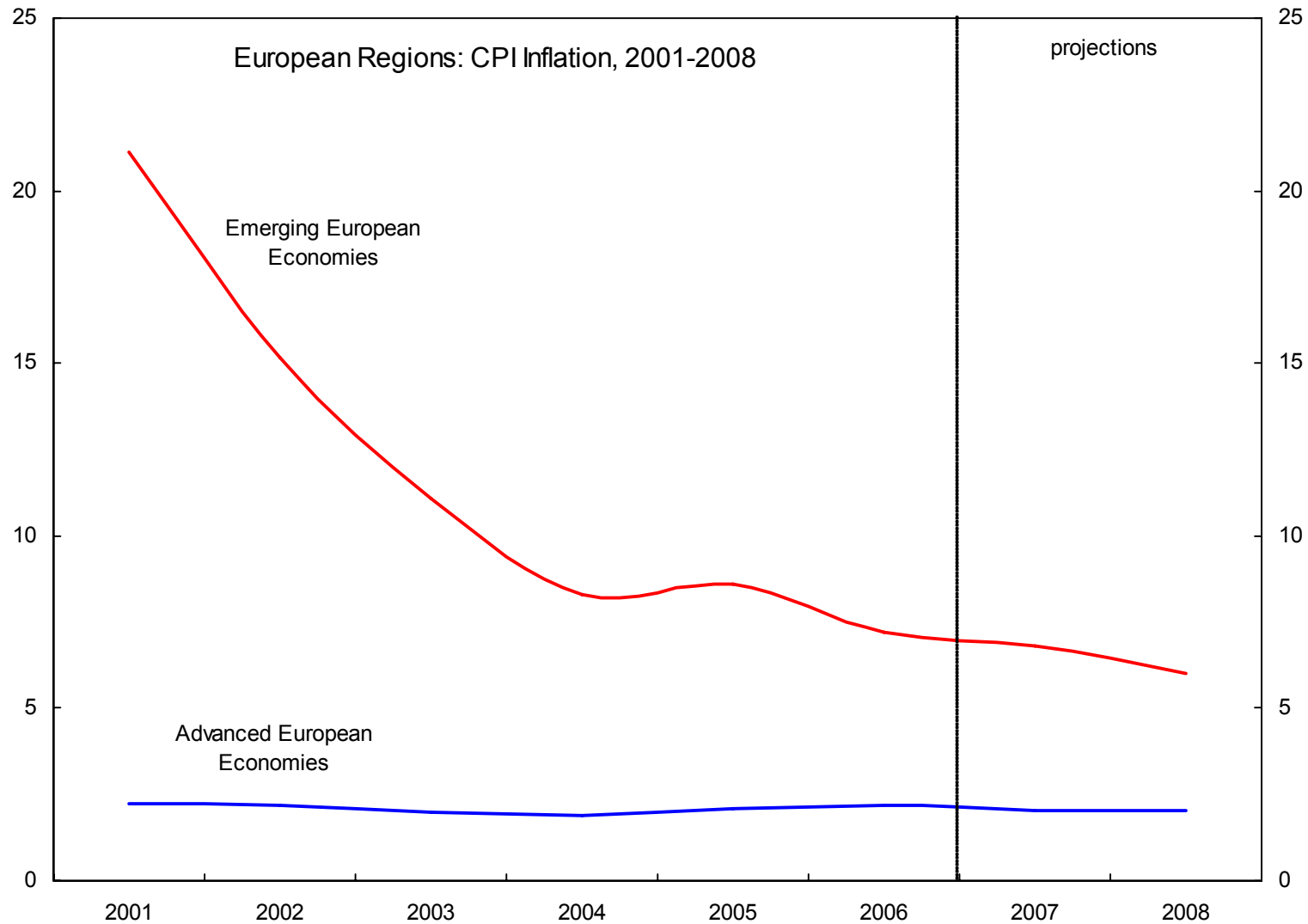
Advanced Europe is finally growing faster than the US



While growing rapidly, emerging Europe is still lagging booming Asia



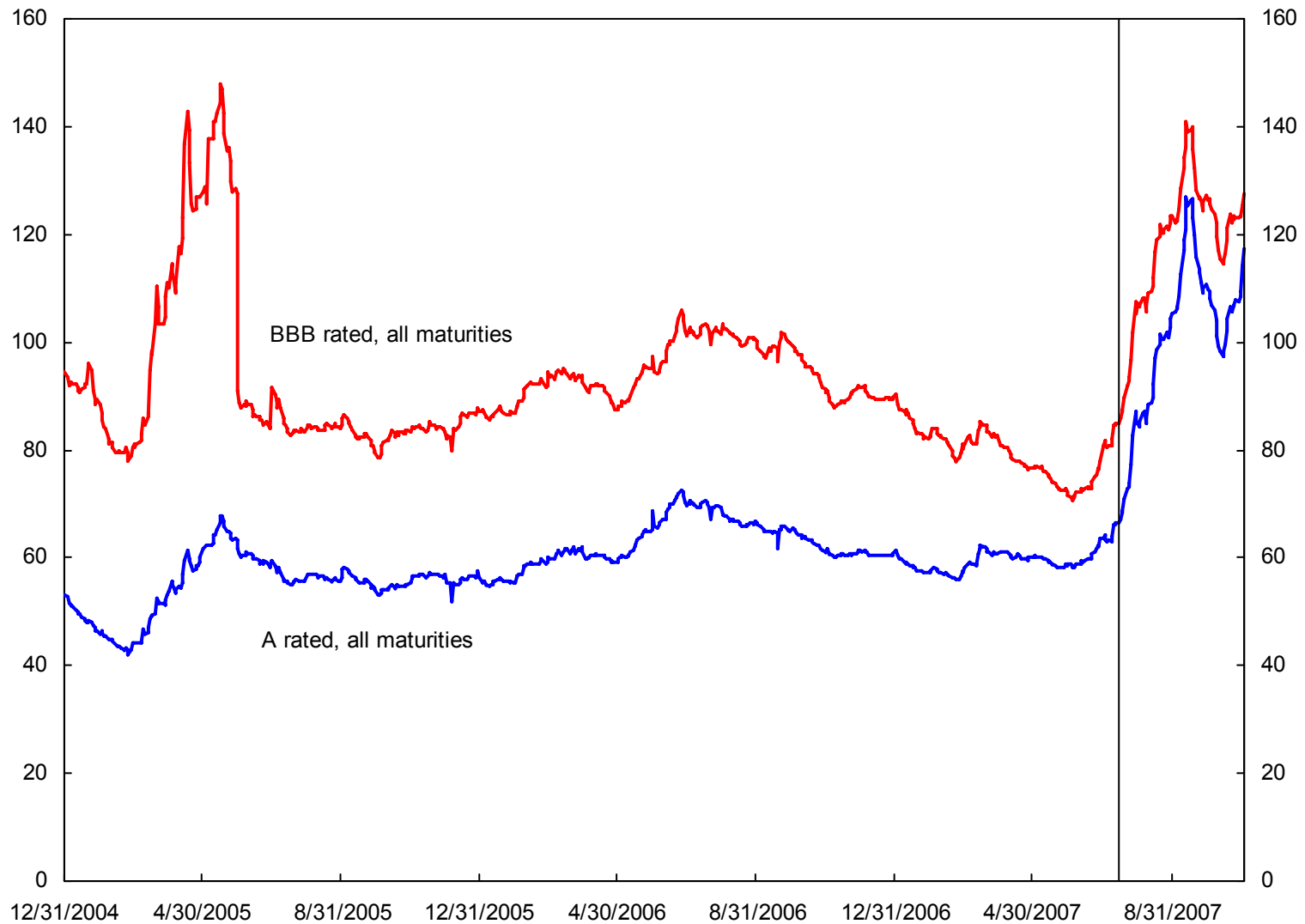
While inflation has been largely under control in recent years...



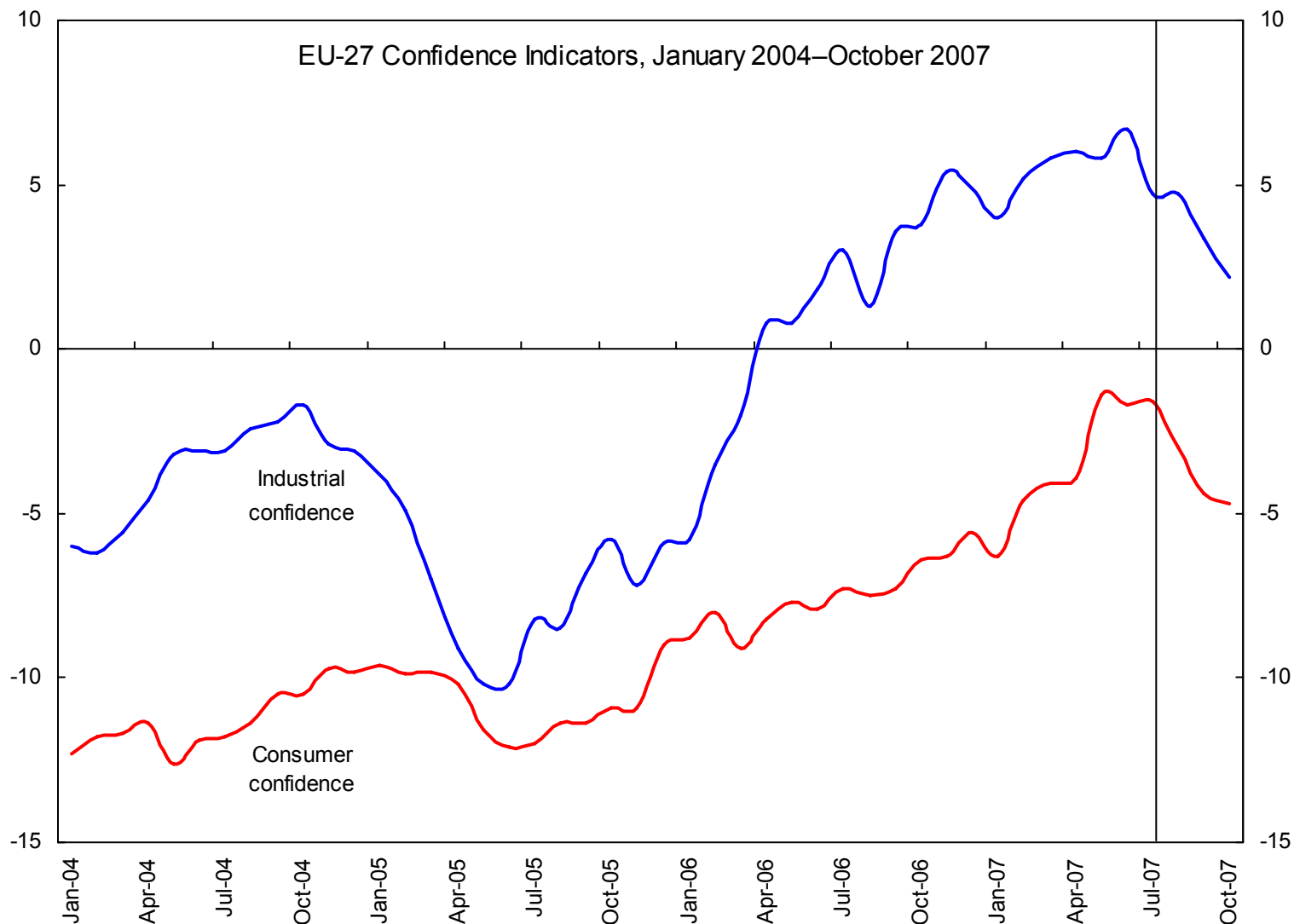
... both advanced and emerging economies are facing inflationary pressure

- **Advanced economies**
 - Recent inflationary pressures make life difficult in designing a response to financial turbulence
 - Holding the line seems right for now
- **Emerging economies**
 - Less affected by financial turbulence
 - Country-specific factors dominate
 - Responding to overheating is a concern in several countries

In advanced Europe, financial turbulence made financing more costly...



... and weakened consumer and business confidence somewhat



Nevertheless, strong fundamentals should help overcome financial turbulence

- **Advanced economies**
 - Sustained growth of domestic demand
 - More cautious lending behavior than in US
 - Generally sound macroeconomic policies
- **Emerging economies**
 - Rapid economic and financial integration
 - Attractive investment opportunities

Further turbulence is a downside risk, along with a sharper slowdown of global of growth

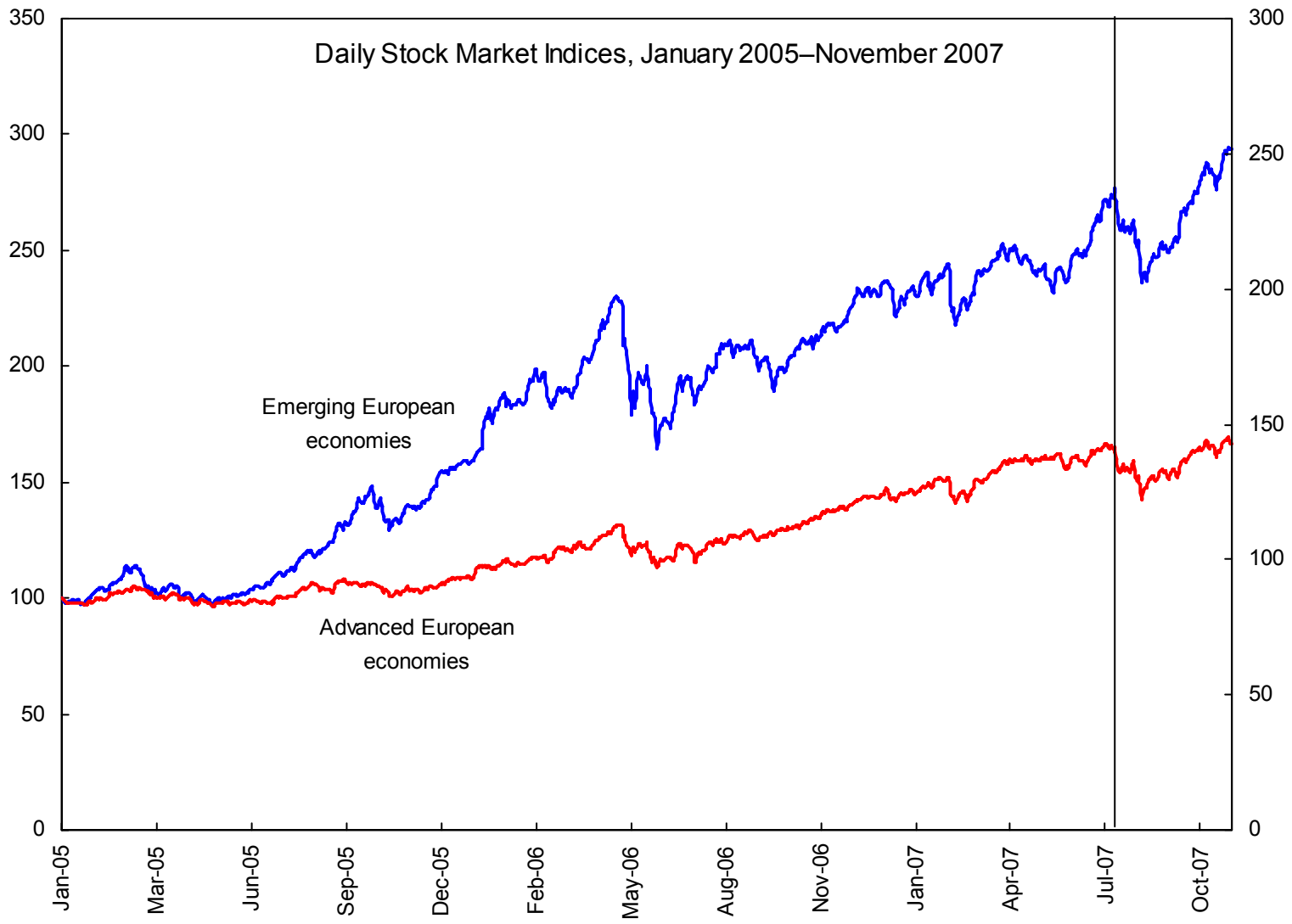
- A sustained deterioration in financial conditions could undermine the growth outlook
- A sharper than expected slowing of global growth poses further risk
- These risks add to existing concerns
 - Disorderly unwinding of global imbalances
 - Developments in energy and commodity prices
 - Political uncertainty in parts of emerging Europe

How do we interpret the risks for emerging Europe?

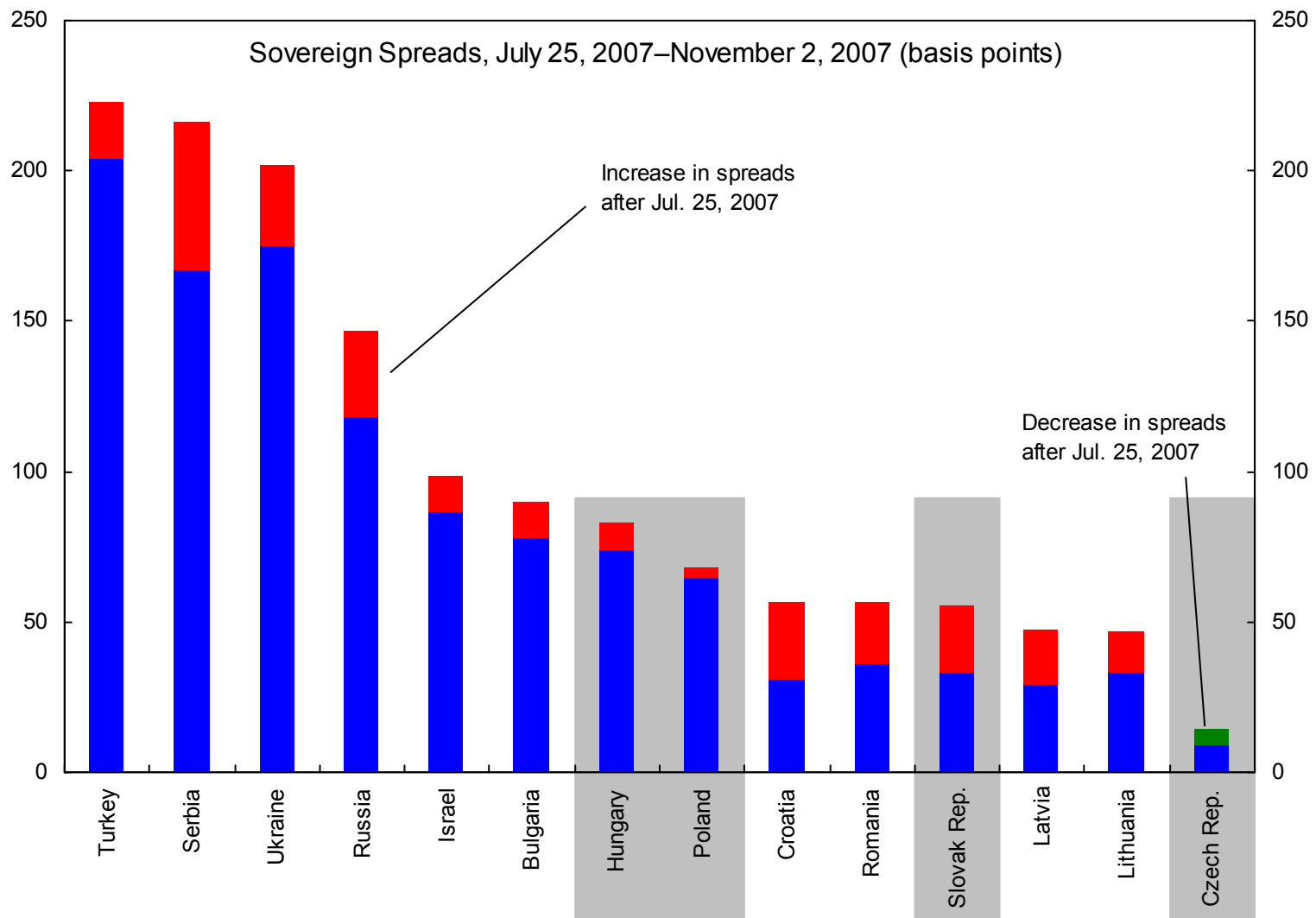
How do we interpret the risks for emerging Europe?

- Emerging Europe has shown resilience during recent financial turbulence
- The outlook remains positive, even if rapidly growing economies are set to slow
- Downside risks have risen, but these must be seen in perspective

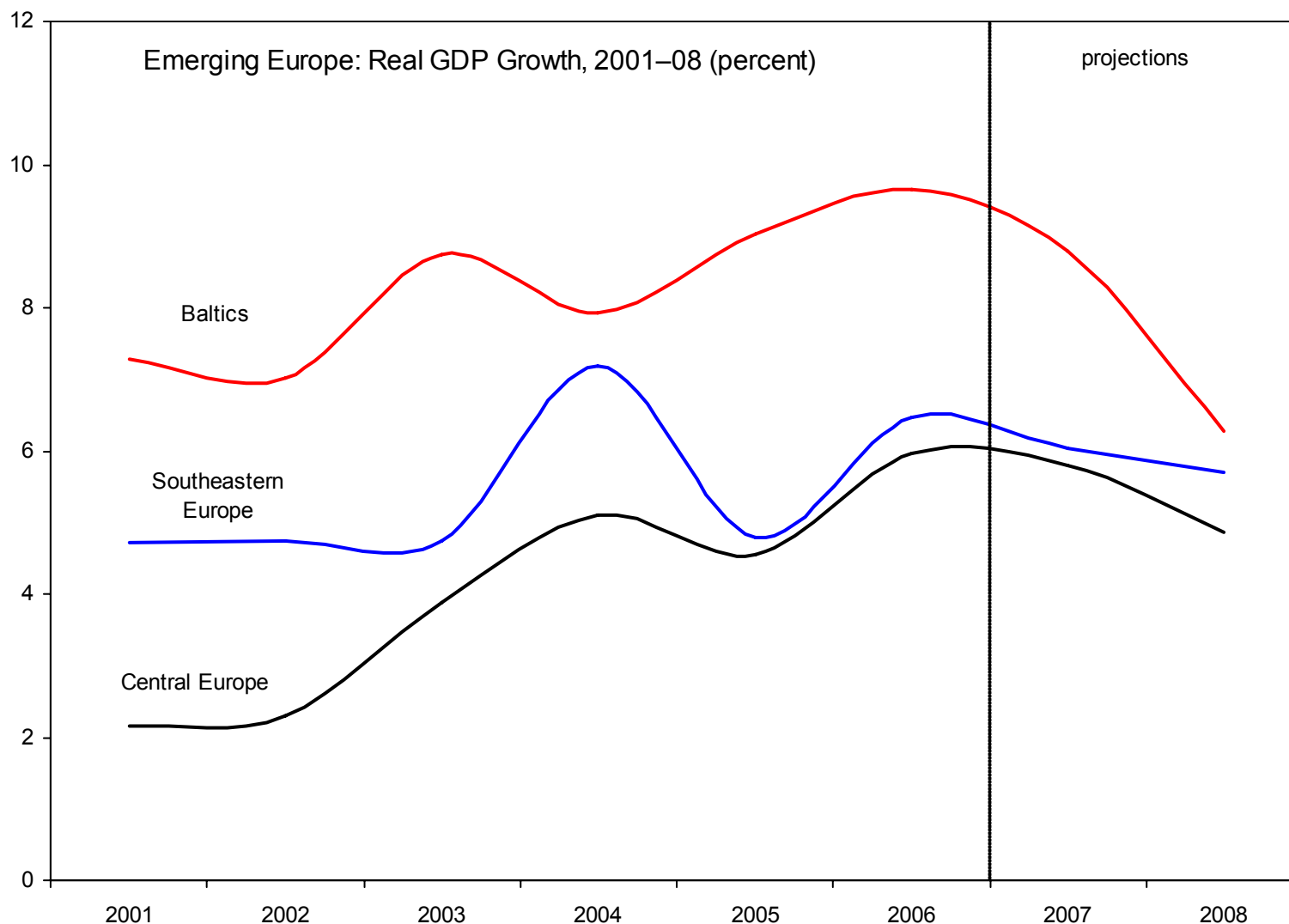
The impact of financial turbulence on stock markets has been short-lived...



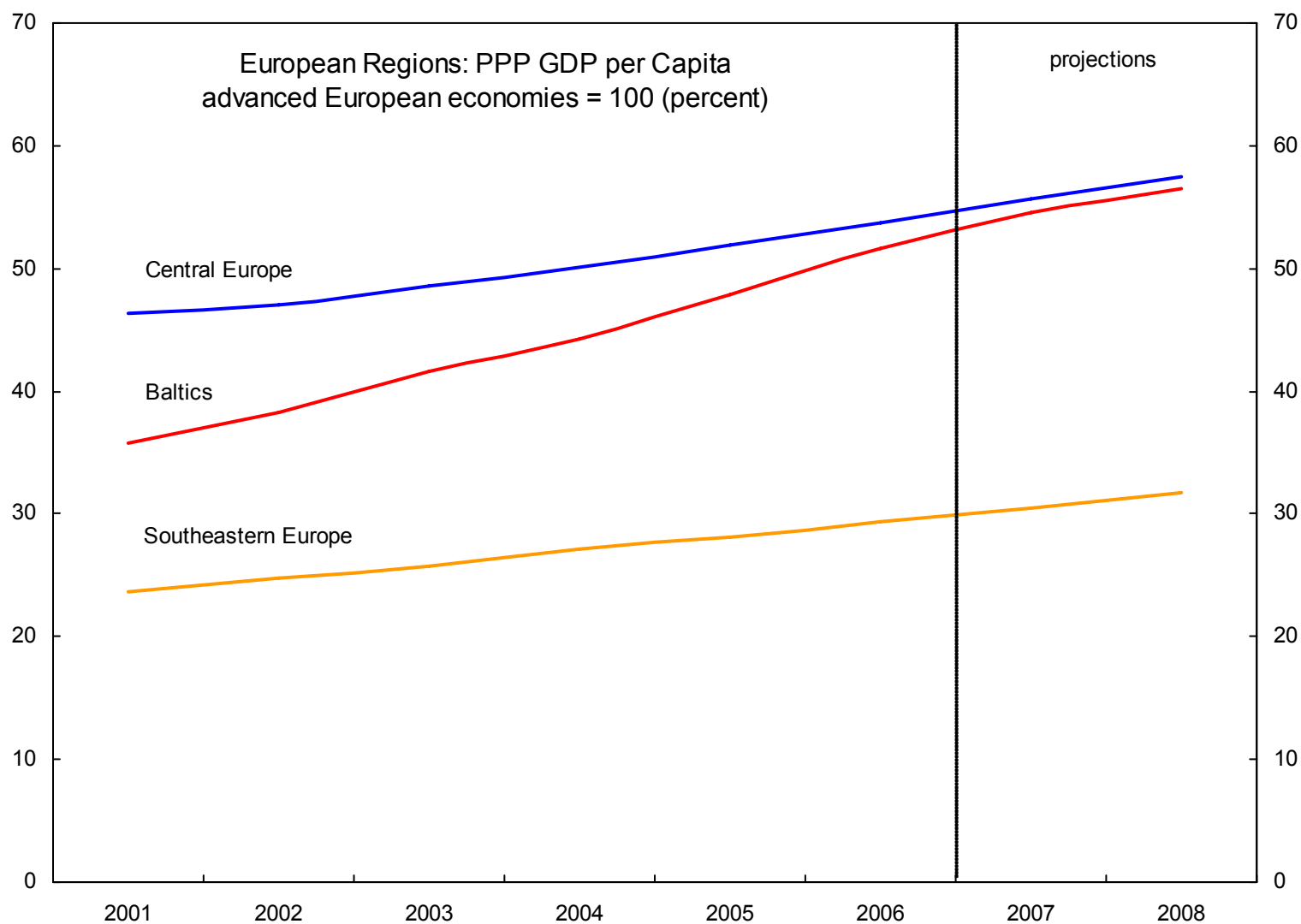
...and sovereign spreads have risen moderately from historically low levels



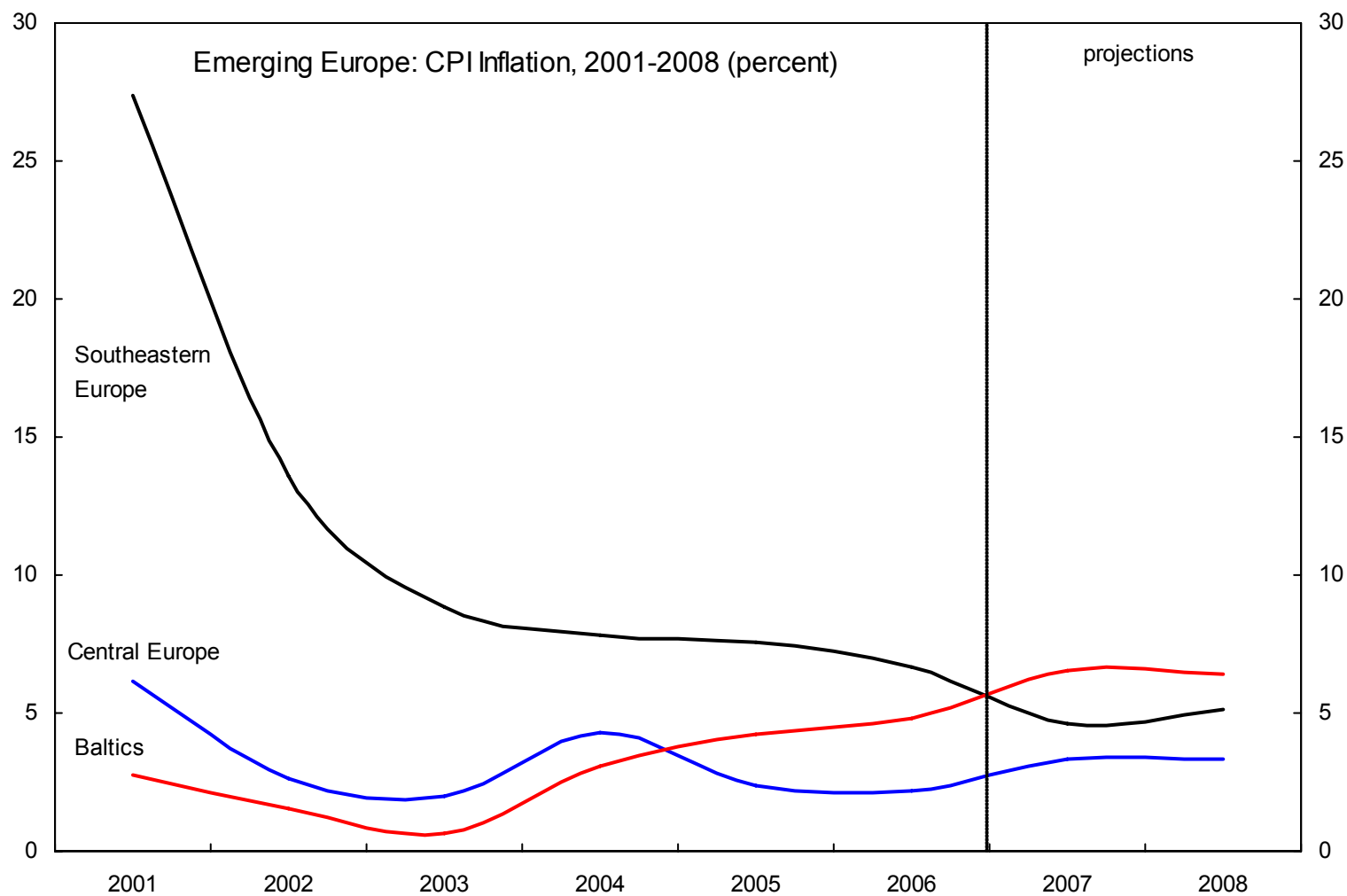
Outlook remains positive, but rapidly growing economies are set to cool



Fast growth has enabled rapid income convergence



The inflation picture is mixed going forward

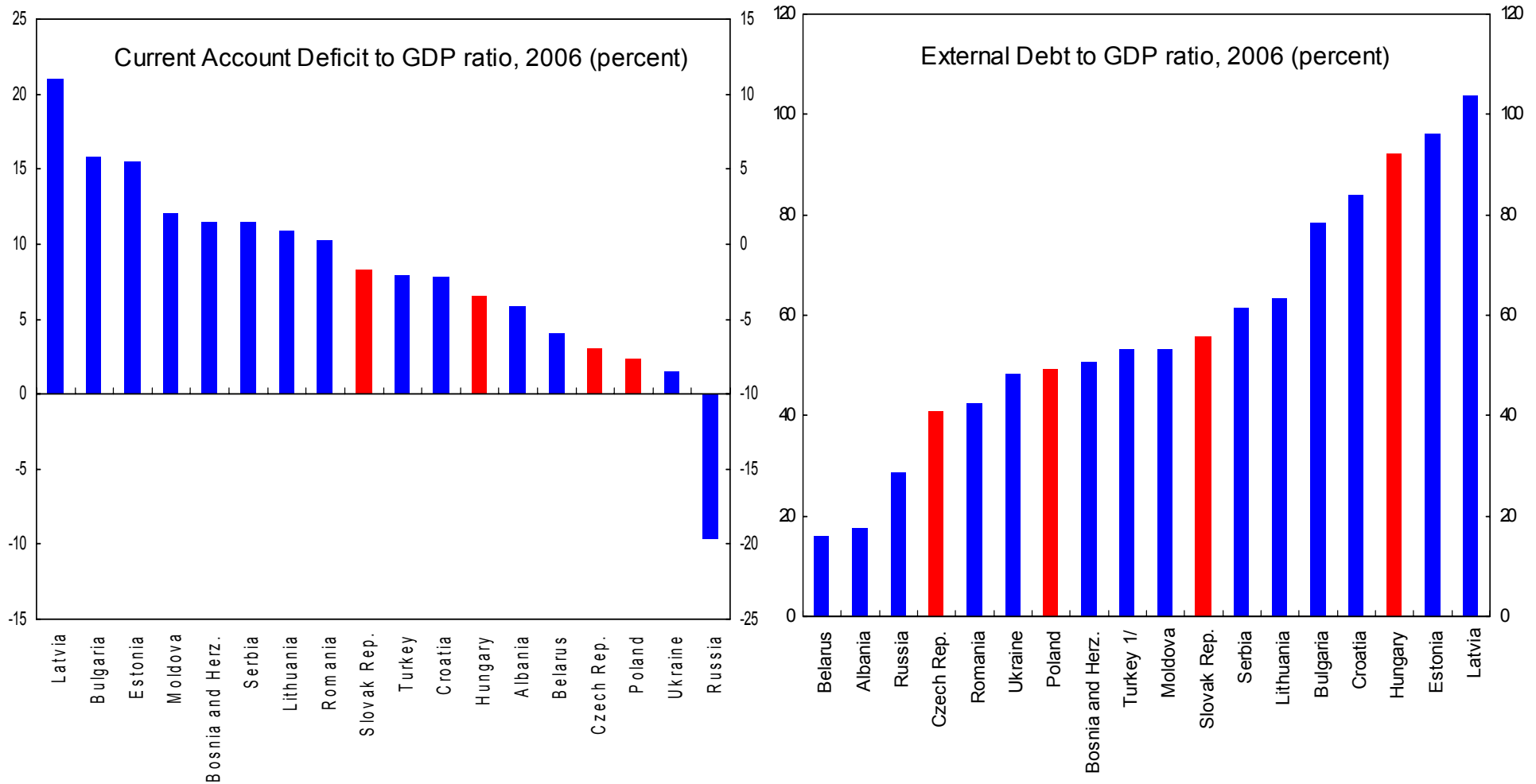


The downside risks have risen

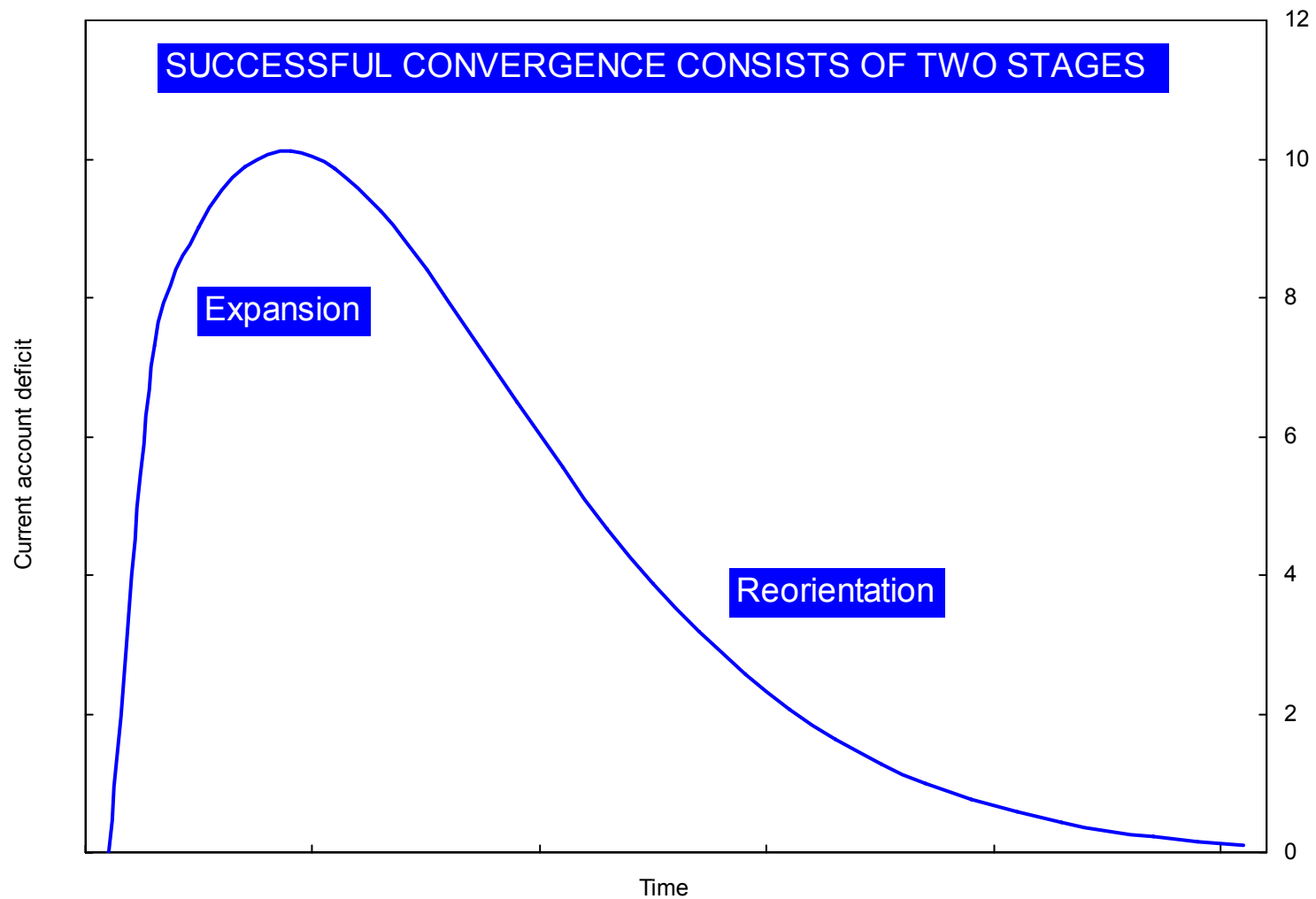
- Tighter global liquidity could limit credit growth sharply, weakening demand
- Rising risk premiums would raise external debt servicing costs
- Weaker global growth would lower export demand

... but for overheating economies, a slowdown would herald a healthy correction

External imbalances have raised concerns



... but it is common to lose sight of the big picture



Several factors make emerging Europe more resilient

- Rapid and deep financial integration has been a force for good
- Emerging Europe remains an attractive region for investors
- Actual and prospective EU membership anchors policies and spurs institutional reforms
- A large part of capital inflows is FDI, which insulates against risk

... so emerging Europe may well be different

Still, a happy ending is not guaranteed

- Imbalances may result in capital flow reversals
- Problems in one country may spread to another through cross-border contagion
- Expectations and risks assessments by borrowers and lenders may prove wrong
- Debt finance is becoming increasingly common
- EU accession is no panacea

... so the risks need to be managed carefully

What are the key policy priorities for emerging Europe?

What are the key policy priorities for emerging Europe?

- The immediate priority is to guard against the downside risks
- Structural reforms, including in the financial sector, are needed to support rapid convergence

Guarding against the downside risks

- Monetary policy generally needs tightening to contain inflationary pressures
- Fiscal tightening is needed for various reasons
 - to cool overheating economies with large current account deficits (Baltics and Southeastern Europe)
 - to reduce public debt and prepare for the effects of aging (Central Europe)
- Financial supervisors need to stay on the ball and ensure strong financial frameworks

Structural reforms to support rapid convergence

- Product and labor market reforms to ensure economic flexibility
- Cutting red tape and strengthening institutions to improve the business environment
- Strengthening financial systems to improve productivity

Financial development is still an unfinished business

- Debt and equity markets are still shallow
- Europe's financial integration has some way to go
- Improving institutions will reinforce the foundations of financial development for non-EU members

Conclusions

- What is the outlook for Europe?
 - Some slowing ahead, but outlook is positive
 - Risks are up, but fundamentals remain strong
- How do we interpret the risks for emerging Europe?
 - Emerging Europe has shown resilience
 - Risks have risen, requiring vigilance by policymakers
- What are the key policy priorities for emerging Europe?
 - Fiscal/monetary policies and financial supervision to guard against downside risks
 - Structural reform and financial development to support convergence