Regional Economic Outlook

Europe

Strengthening Financial Systems

Executive Summary

Outlook: Through Financial Turbulence to Sustained Growth

Strong fundamentals should allow the European economy to weather the current financial turbulence relatively well. If the turbulence recedes, the impact on growth should be manageable. A buoyant global economy, combined with generally sound macroeconomic policies and increasing trade and financial integration in Europe, have yielded a buoyant regional economy with clear growth dividends for advanced economies and convergence benefits for emerging Europe. Nonetheless, growth is set to ease in 2008 in nearly all countries.

Protracted credit market tightness constitutes a key downside risk to this outlook, especially for advanced economies. While the broader financial system has continued to function well, money and credit markets remain tight. Direct exposure and the interconnection of money markets caused financial turbulence to spread quickly to advanced economies in Europe. Lack of information on exposures and difficulties in valuing assets triggered a reluctance to trade in money markets, causing difficulties for banks relying on short-term wholesale resources to fund long-term assets. A continuing tightness of credit would have downsides for the real economy.

Despite relatively high external vulnerabilities, emerging Europe has so far remained largely unscathed by the financial turbulence, owing to its limited reliance on interbank markets and complex financial products. Nonetheless, risks for emerging Europe have also risen, especially for those countries that have been funding large current account imbalances with foreign bank borrowing. In this regard, the financial turbulence may herald a healthy correction to past exuberance, bringing risk spreads closer to fundamentals, improving credit discipline, and helping to reduce external imbalances in emerging countries.

The unexpected uncertainty associated with unsettled credit markets has complicated policymakers' task of steering their economies to maintain growth without overheating, especially in advanced economies. While their response has been broadly effective so far, central banks will have to continue to stand ready to provide liquidity to deal with systemic risks. In the euro area and several other advanced economies, monetary policy has been appropriately kept on hold in view of the downside risks associated with the financial turmoil. Looking further forward, the baseline forecast presumes these risks to dissipate gradually, and a further tightening may then be required. Such a stance would of course need to be reconsidered if the risks materialized and the slowdown became protracted. In the emerging economies, inflationary pressures and external vulnerabilities will then warrant further interest rate increases in the central scenario. In those cases where monetary policy tools are ineffective or unavailable, the tightening will need to be achieved through fiscal restraint. Strong banking supervision will be critical throughout emerging Europe.

Recent events have underscored the need for financial sector reform. They reveal that private and public prudential frameworks have not kept up with developments in financial innovation and will need to do a better job going forward. Moreover, the tendency of new financial products to exploit gaps in prudential frameworks can prove problematic and needs to be guarded against. As argued in the analytical part of this paper, financial innovation has been and will remain an important source of strengthened performance over the medium term and must be encouraged. At the same time, a balanced review of prudential arrangements, financial safety nets, and crisis resolution mechanisms is necessary to strengthen their overall effectiveness.

Looking beyond the immediate turbulence, Europe faces major challenges if it is to sustain reasonably robust growth. To deal with expenditure pressures from population aging, fiscal consolidation—based on expenditure reduction—needs to return to a more ambitious track. For several advanced economies, this is also needed because deficits remain too high to deal comfortably with eventual downturns. In emerging Europe, more fiscal consolidation is desirable to mitigate convergence-related demand pressures and insure against risks posed by the rapidly rising indebtedness of the private sector. Consolidation, however, also needs to be aimed at and complemented by structural reforms to strengthen supply and deliver on the promise of income convergence, including measures to advance economic and financial integration.

Analytical Focus: Strengthening Financial Systems

Rapid financial deepening, innovation, and financial integration have substantially transformed the financial landscape in Europe. Consumers and businesses are benefiting from an ever-widening range of financing and investment options. The benefits are particularly apparent in the rapid income convergence enjoyed by many countries in emerging Europe. But rapid financial innovation and integration engender risks, and, as the turbulence has brought home, adverse shocks tend to be swiftly transmitted across borders. So what should policymakers do?

Current turbulence notwithstanding, advanced economies still stand to reap considerable efficiency gains by further expanding the range of financial activities offered by their financial systems (Part II, Chapter 1). Competitive and more diversified financial systems are better at distributing risk and allocating resources to sectors with high growth potential. The countries that have progressed most in exploiting the complementarities of bank- and market-based financing have benefited overall. In most economies, further reforms are needed to level the playing field for the various forms of financial intermediation and take advantage of their synergies.

But recent events warn that financial innovation can heighten risks stemming from gaps in prudential frameworks. Putting matters in perspective, though, all traditional forms of financial intermediation have gone through similar tests and bounced back: their benefits are no longer questioned. In response to the current turbulence, market participants and policymakers will need to develop safeguards to allow these benefits to accrue without incurring excessive risk. From this perspective, it will be important to improve risk assessment models, market and liquidity risk management, due diligence, and transparency regarding the loan origination process and counterparty risk exposure.

For the emerging economies, meanwhile, the prime challenge is to effectively manage rapid financial deepening in the context of convergence (Part II, Chapter 2). The blistering pace of credit growth and the rapid increase in private indebtedness in many of these economies have heightened risks and raised questions about sustainability. Policies have been unable to stem this tide, underscoring the importance

of reducing vulnerabilities and building safety margins. These objectives can be achieved by removing fiscal and other distortions affecting bank lending, improving the implementation of prudential and supervisory measures, and promoting better disclosure and understanding of risks. Where convergence has been associated with large external imbalances, the medium-term challenge will be to turn these imbalances around without painful adjustment. This will require that resources flow without hindrance to productive investments, particularly in the tradables sector. To assist this process, policymakers will need to strengthen their financial systems and make labor and capital markets more flexible.

Building on recent progress, all economies in emerging Europe can reap important benefits from sustained development of their financial systems in terms of efficiency, risk diversification, and resilience in coping with possibly volatile external capital flows (Part II, Chapter 3). For EU members, the integration process provides a unique opportunity to expedite financial development, as harmonization requirements, competition pressure, and supervisory risks make further comprehensive reforms more compelling. The emerging economies outside the European Union should focus on reinforcing the foundations of financial development: low and stable inflation, good institutional quality, and the rule of law. Creating a well-functioning government securities market, establishing strong corporate governance and creditor rights protection, and promoting the emergence of institutional investors would also be beneficial.