REGIONAL ECONOMIC OUTLOOK

EUROPE

EUROPEAN DEPARTMENT

European Outlook and Policy Challenges

MAY 12, 2022

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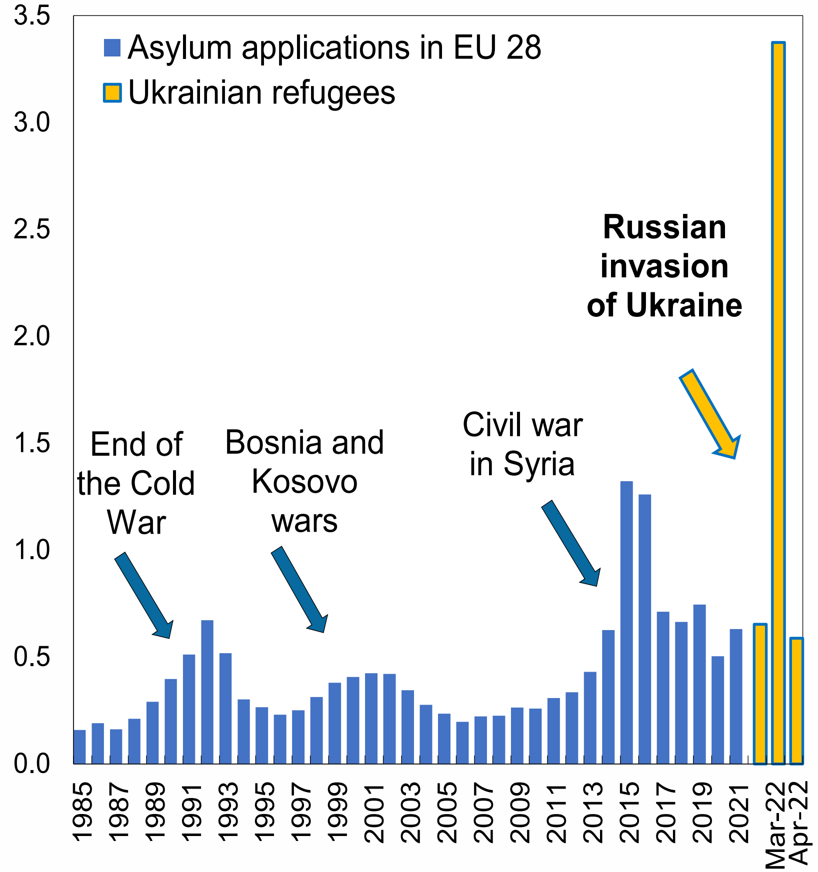
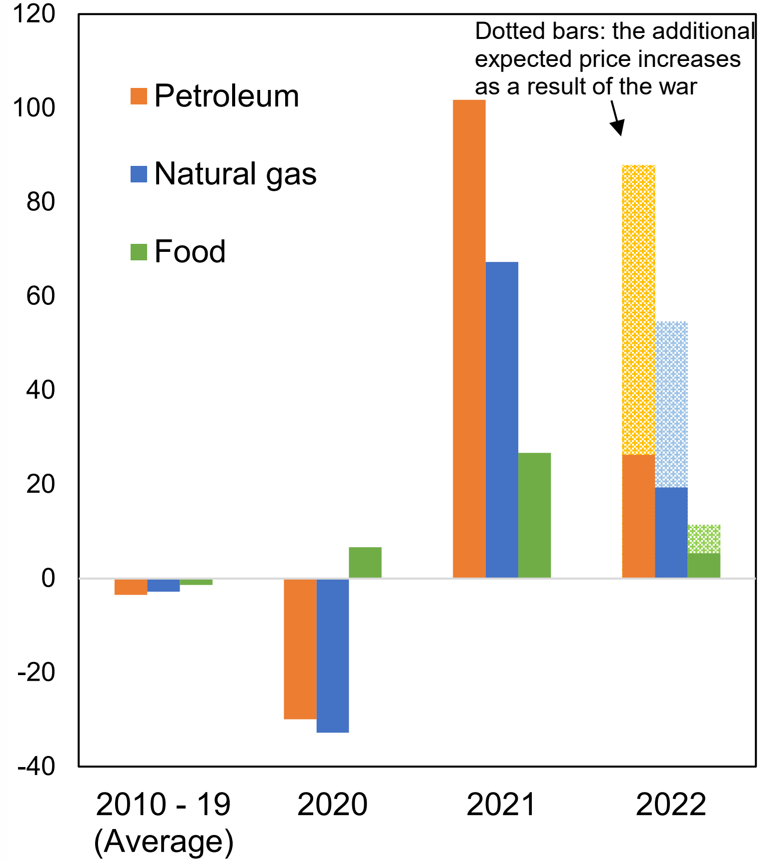
European Department

The war in Ukraine has triggered massive refugee flows, large commodity price hikes, and heightened uncertainty

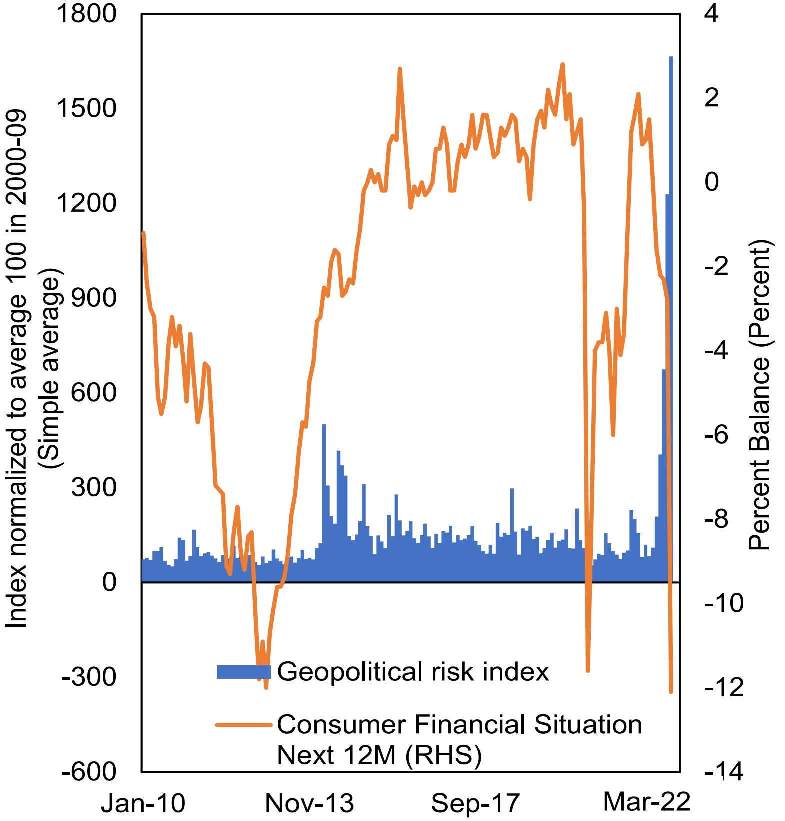
Refugees Flows in Europe
(as of April 11, 2022; in millions)



Commodity Prices
(Annual change, percent)



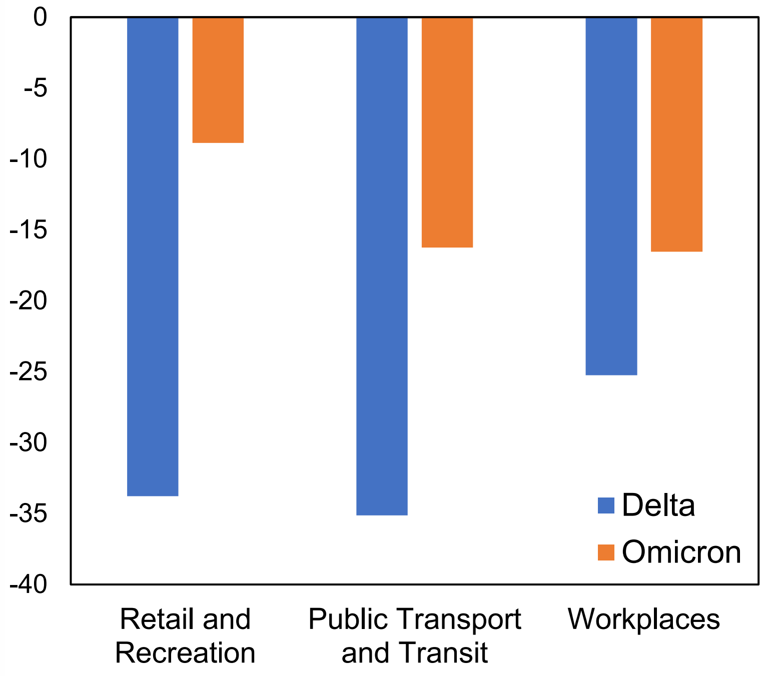
Europe: Geopolitical Risk Index and Consumer Confidence



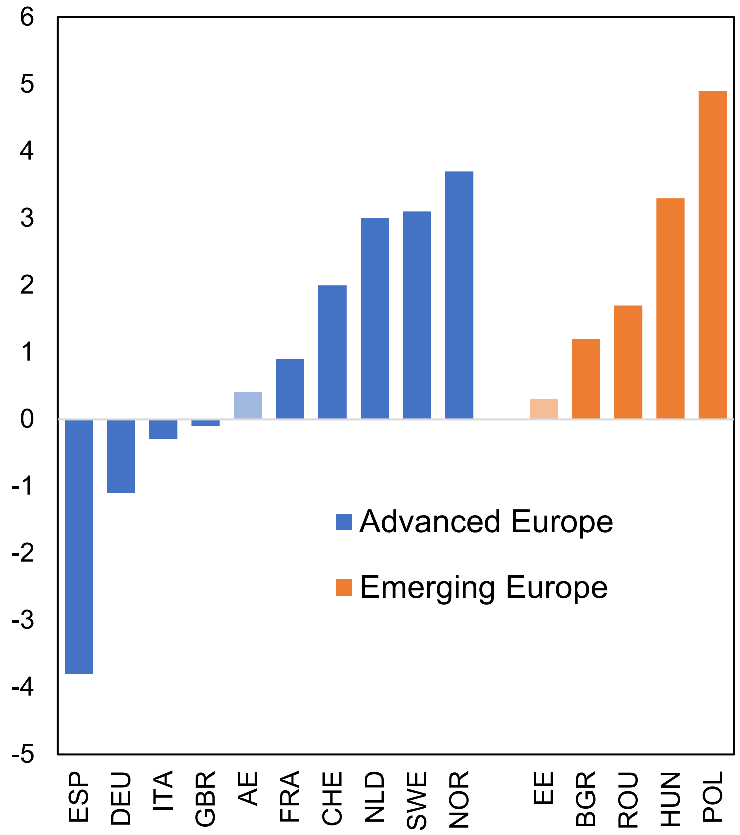
Sources: Eurostat; UNHCR; IMF, *World Economic Outlook;* Haver Analytics; Caldara, Dario and Matteo Iacoviello (2021), "Measuring Geopolitical Risk," working paper, Board of Governors of the Federal Reserve System; and IMF staff calculations.
Notes: In the left figure, the yellow columns represent Ukrainian refugees into Europe, regardless of their status (either asylum seekers or not). In the right figure, the geopolitical risk index encompasses 17 European countries, and the consumer confidence index corresponds to the Euro Area.

Until the war the pandemic was in retreat, the economic recovery was on track, labor markets were tightening, …

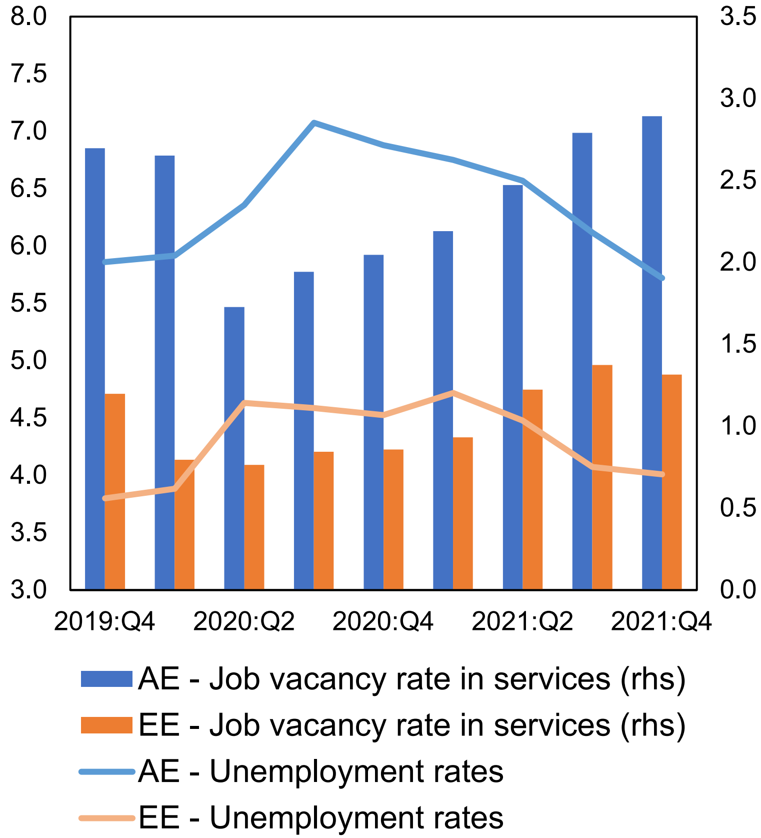
Google Mobility Indicators During Covid Cases Spikes
(Percent deviation from baseline)



GDP for Select Countries
(Gaps relative to pre-crisis levels)



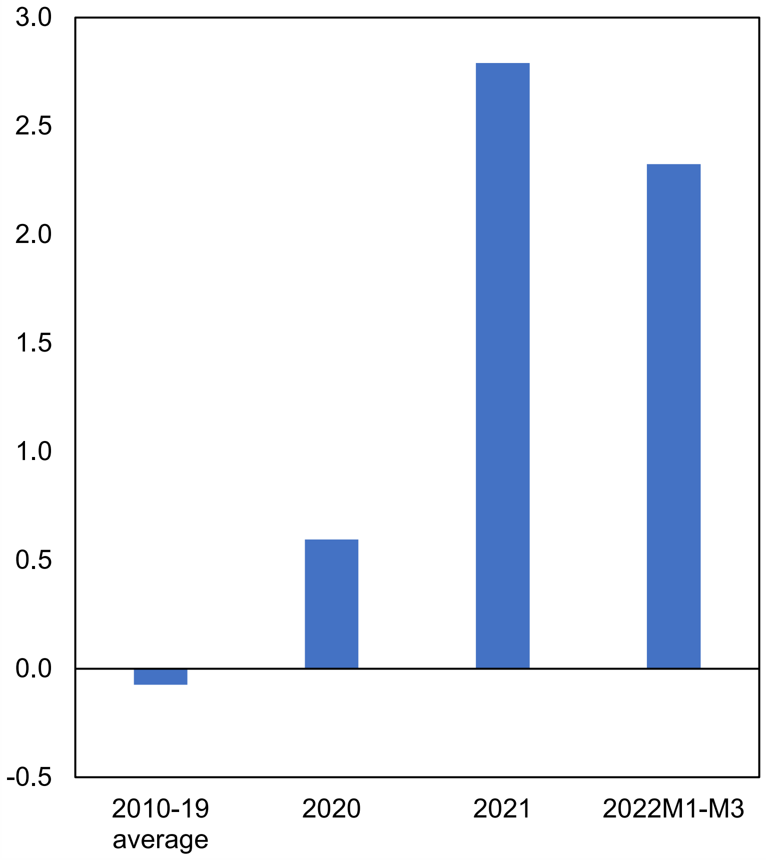
Job Vacancy and Unemployment Rates
(Percent)



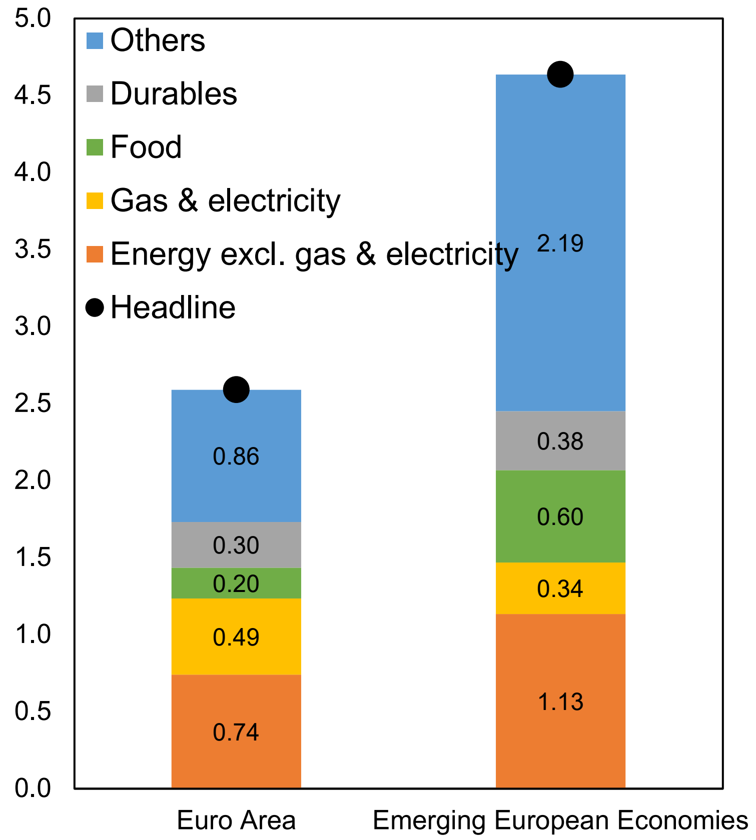
Sources: Google Mobility Report; IMF *World Economic Outlook;* European Commission; Statistical Office of European Communities; Haver Analytics; and IMF staff calculations.
Notes: In the left panel, Delta and Omicron variant spikes are measured from October 2020 to February 2021, and from October 2021 until now, respectively; such periods were determined by case spikes above 200 people per 100k people. AE stands for Advanced European Economies, and EE stands for Emerging European Economies. In the middle panel, AE and EE are PPP-GDP weighted average of the group. EE countries exclude Belarus, Russia, Turkey, and Ukraine. In the right chart, AE includes Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Ireland, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Norway, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, United Kingdom. EE includes Bulgaria, Croatia, Hungary, North Macedonia, Poland, and Romania.

... supply bottlenecks had worsened, and inflation was running high with growing risks of 'second-round' effects

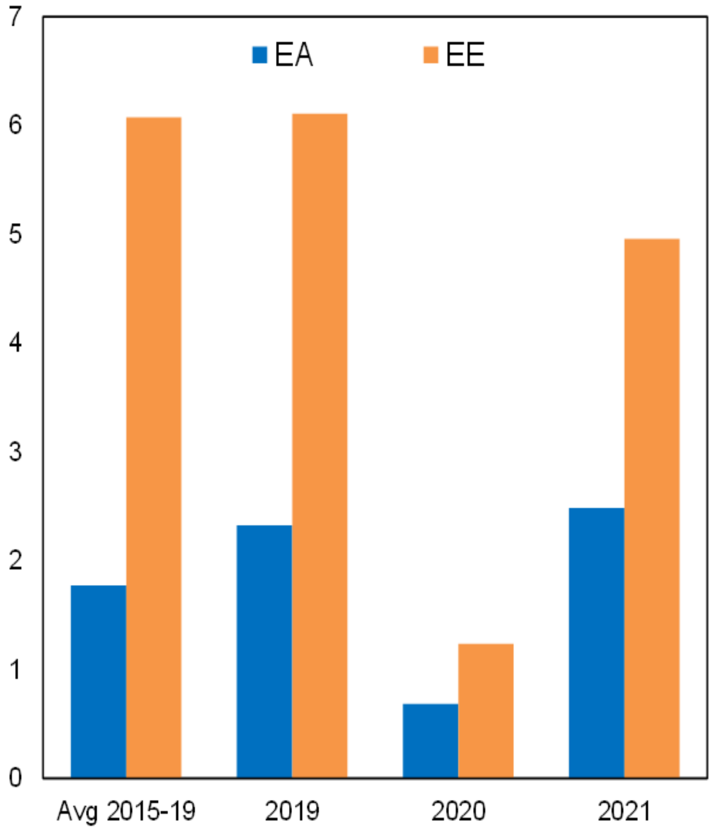
Euro Area: Suppliers Delivery Times
(Normalized; positive denotes increase)



Europe: Inflation Decomposition, 2021
(Percent change, year over year, average of period)



Europe: Nominal Compensation per employee
(Bil. LC, Percent change)



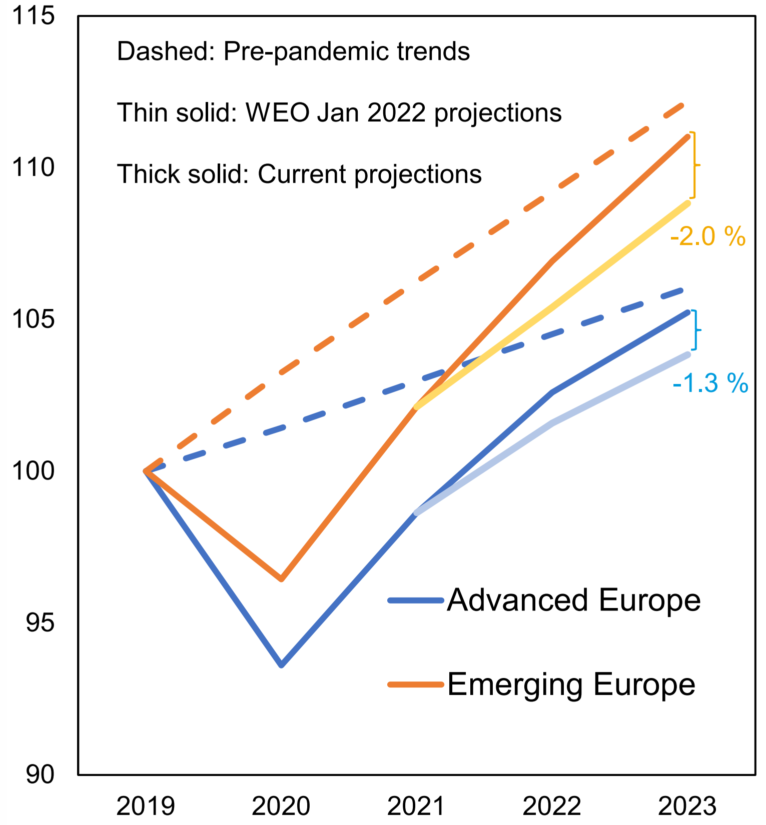
Sources: European Commission; Statistical Office of European Communities; Haver Analytics; IMF, *World Economic Outlook*; and IMF staff calculations.
Notes: In the left panel, delivery times are normalized such that the mean value is 0 and the standard deviation is 1. In the middle panel, inflation for Emerging European Economies includes Bulgaria, Croatia, Hungary, North Macedonia, Poland, Romania, and Serbia. In the right panel, Emerging Economies includes Bulgaria, Croatia, Hungary and Romania. Compensation per employee is calculated as compensation of employees in the whole economy divided by the number of employees in all domestic industries, where available, full-time equivalents are used.

The war will set back the recovery…

WEO Projections: Real GDP Growth
(Year-on-year percent change)

Year	2020	2021	2022		
WEO vintages		Prel.	Apr. 2022	Diff. since Jan. 2022	Diff. since Oct. 2021
Europe	-4.9	5.9	1.6	-2.3	-2.5
Advanced Europe	-6.4	5.6	3.0	-1.0	-1.4
Euro area	-6.4	5.3	2.8	-1.1	-1.5
Emerging Europe	-1.8	6.7	-1.7	-5.1	-5.3
Emerging Europe excl. Belarus, Russia, Turkey, and Ukraine	-3.5	6.3	3.2	-1.5	-1.7

Europe: Real GDP Trends
(Index; 2019 = 100)



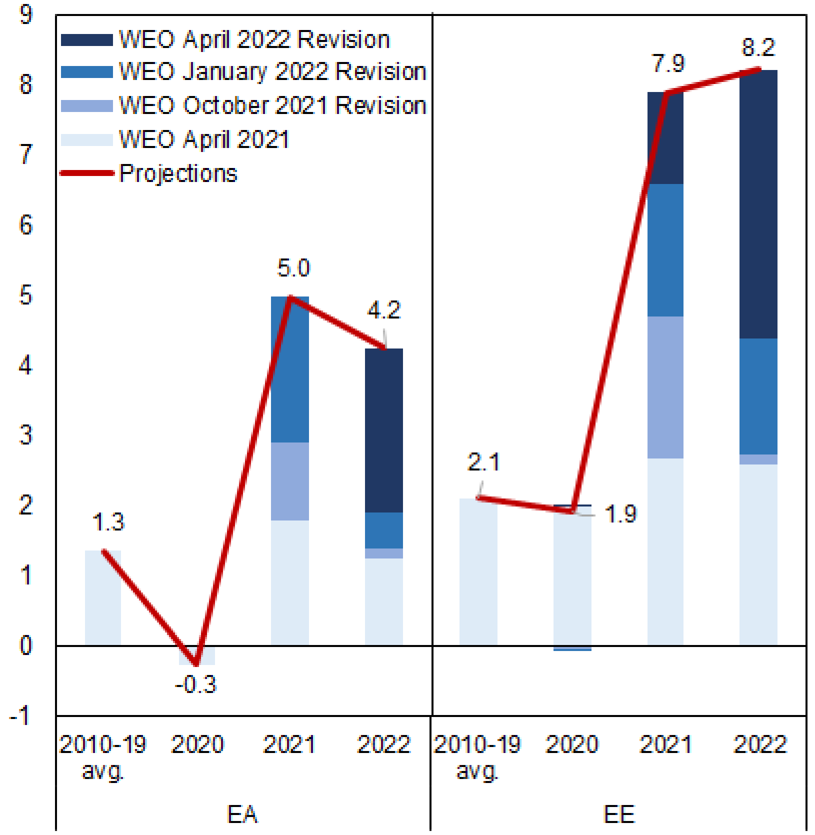
Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
Notes: In the right chart, pre-pandemic trends are forecasts from the January 2020 WEO, Advanced Europe and Emerging Europe are PPP GDP weighted average, and Emerging Europe excludes Belarus, Russia, Turkey and Ukraine.

… and lead to higher and more persistent inflation

WEO Projections: CPI Inflation
(Percent, average of the year)

Year	2020	2021	2022		
WEO vintages		Prel.	Apr. 2022	Diff. since Jan. 2022	Diff. since Oct. 2021
Europe	2.0	4.8	12.4	6.3	8.9
Advanced Europe	0.4	2.5	5.5	2.2	3.7
Euro area	0.3	2.6	5.3	2.2	3.6
Emerging Europe	5.4	9.7	28.7	16.5	21.4
Emerging Europe excl. Belarus, Russia, Turkey, and Ukraine	2.7	4.7	9.1	3.4	6.0

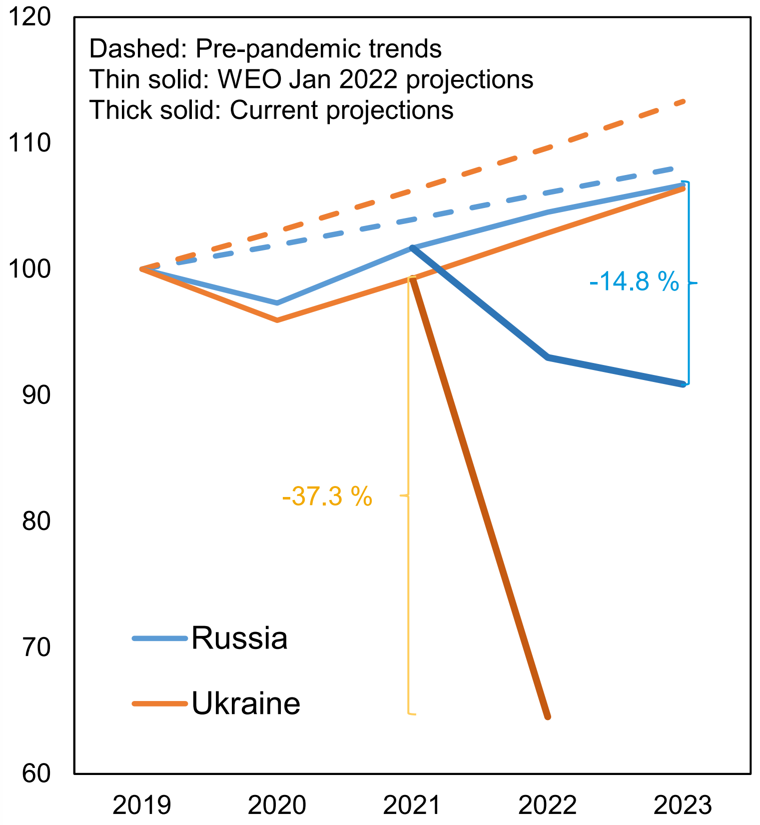
Europe: Inflation Projection
(Percent, end of period)



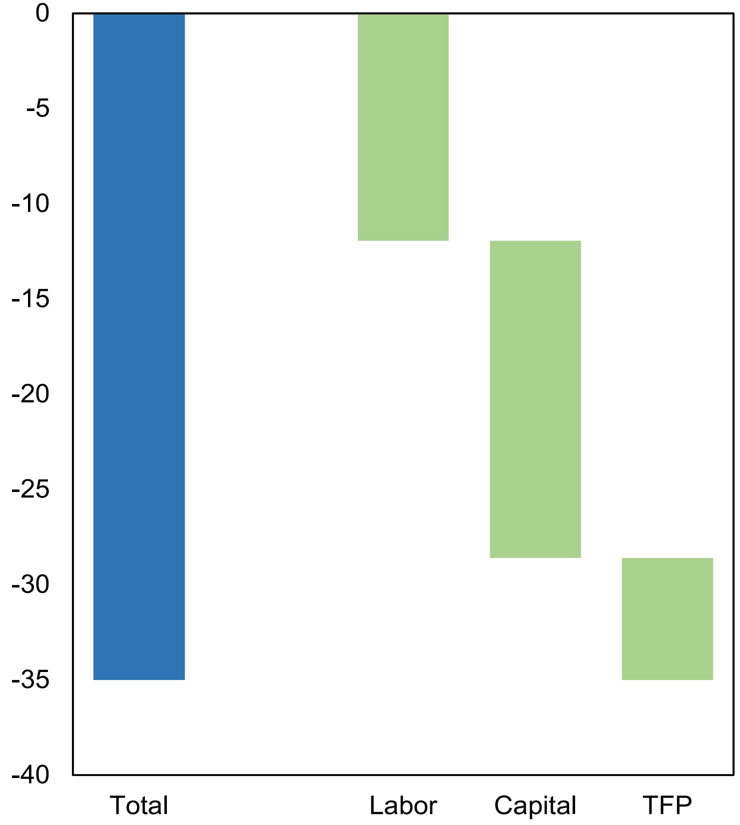
Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
Notes: In the right chart, Emerging Europe (EE) excludes Belarus, Russia, Turkey and Ukraine.

The sharpest contractions are projected in Russia and Ukraine

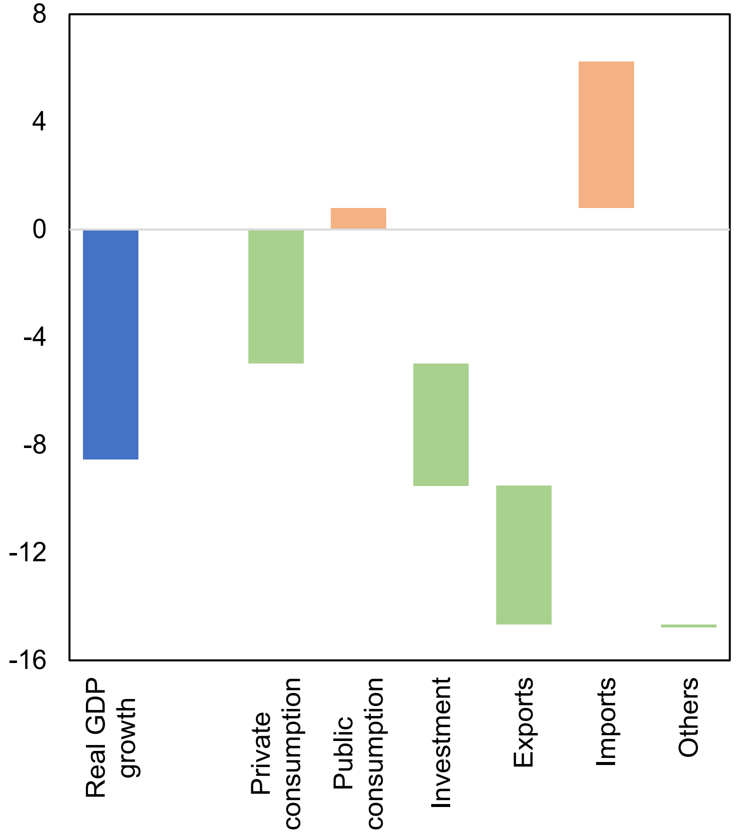
Conflict Countries: Real GDP Trends
(Index; 2019 = 100)



Ukraine: 2022 Real GDP Contraction
(percent)

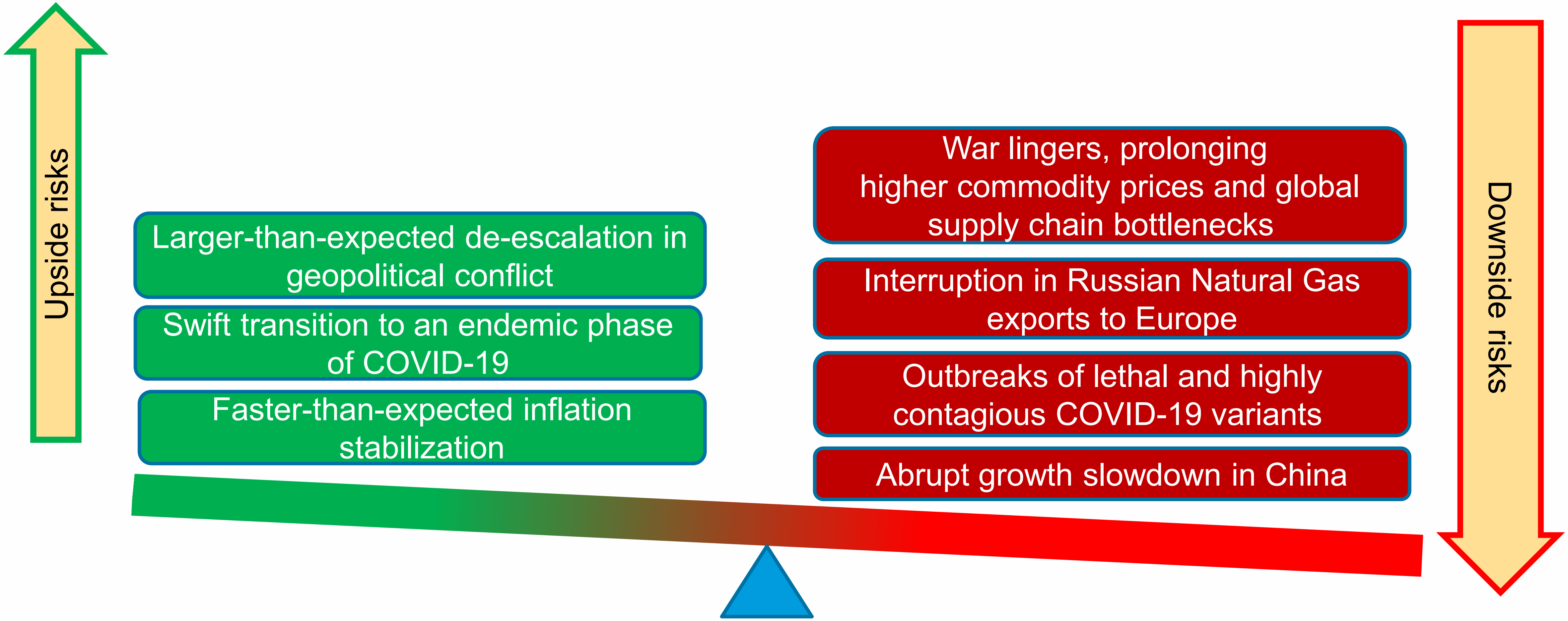


Russia: 2022 Real GDP Growth Decomposition
(percent)



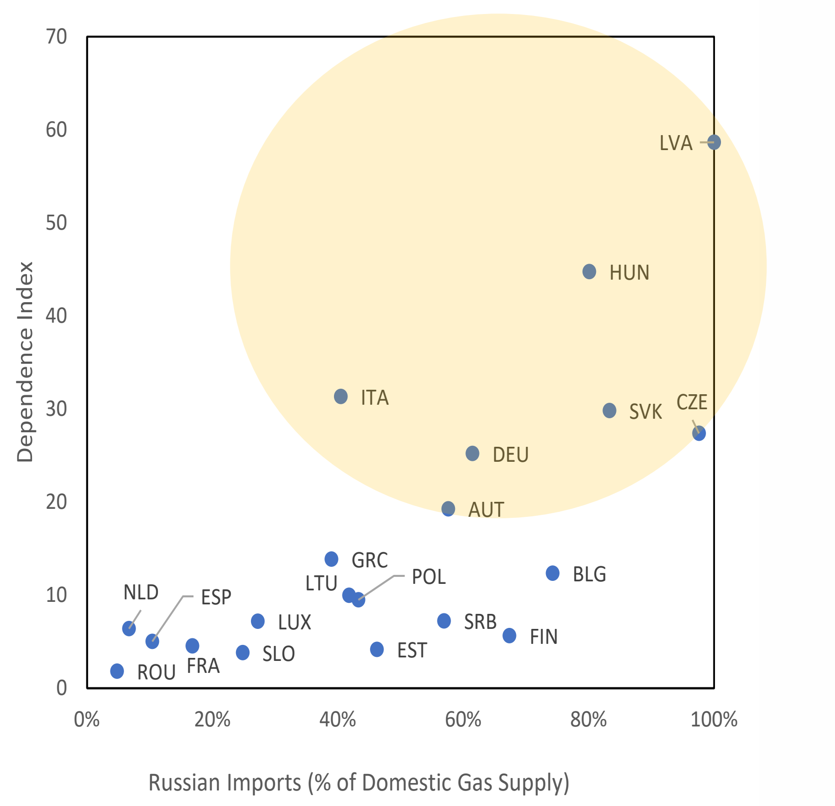
Sources: Haver Analytics, IMF *World Economic Outlook*, and IMF staff calculations.
Notes: In the left chart, pre-pandemic trends are forecasts from the January 2020 WEO.

The balance of risks is clearly to the downside, on war-related uncertainty and an incomplete exit from the pandemic

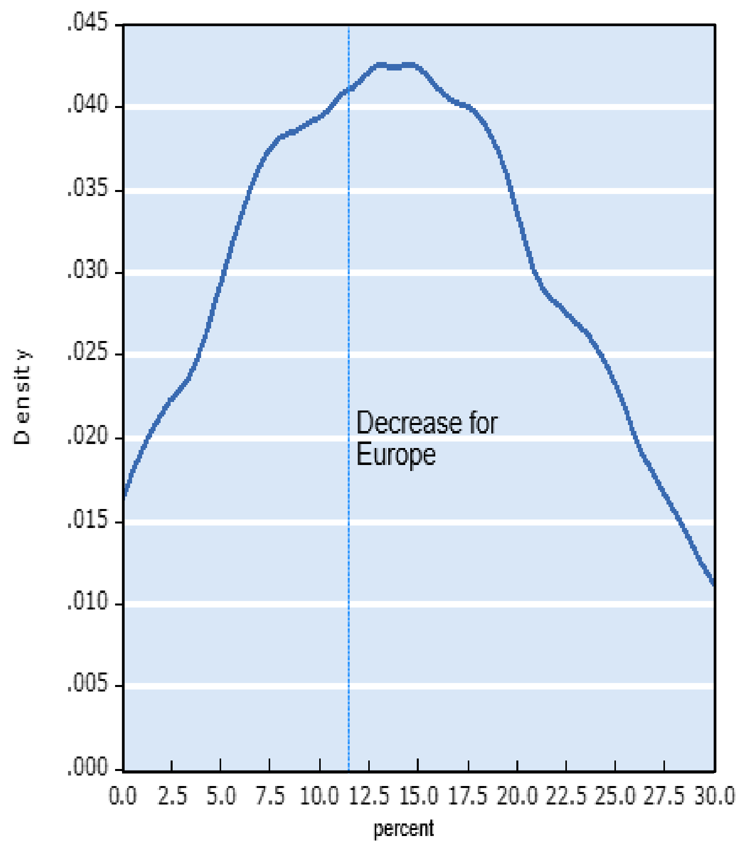


A full interruption of Russian natural gas exports to Europe is a serious downside risk for activity and upside risk for inflation

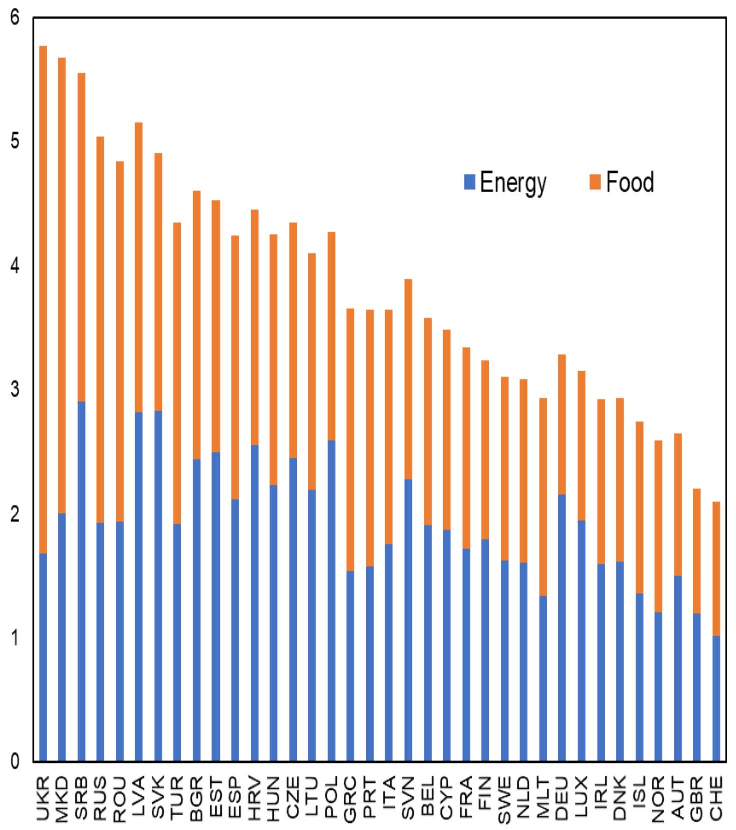
Europe: Gas Intensity and Dependence
(Select countries)



Europe: Gas Supply Shortfall
(Kernel density. Select countries, in percent)



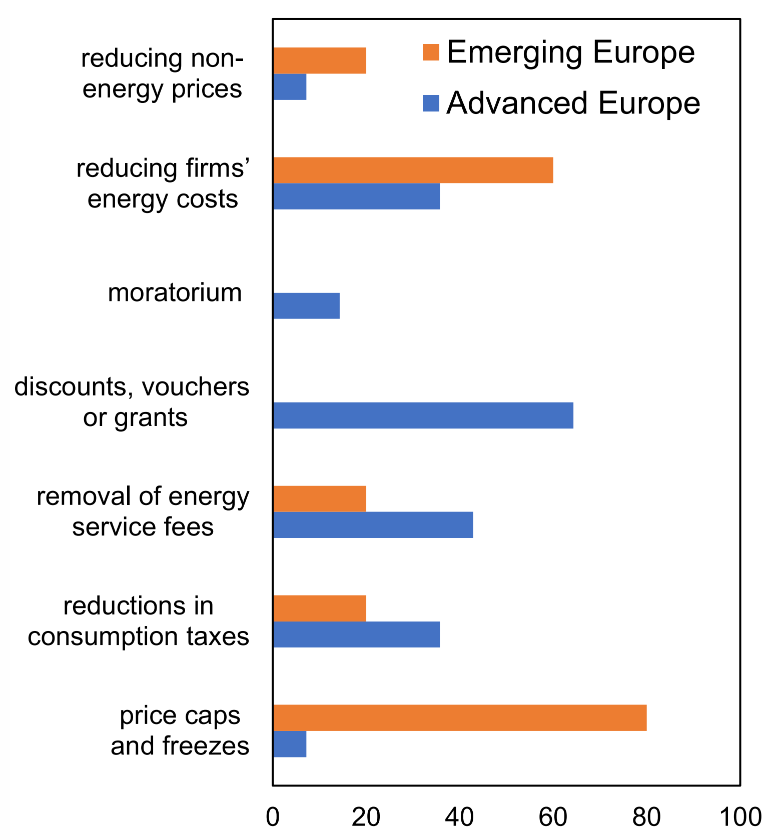
Impact on Inflation of Further Increases in Food and Energy prices
(Percentage points)



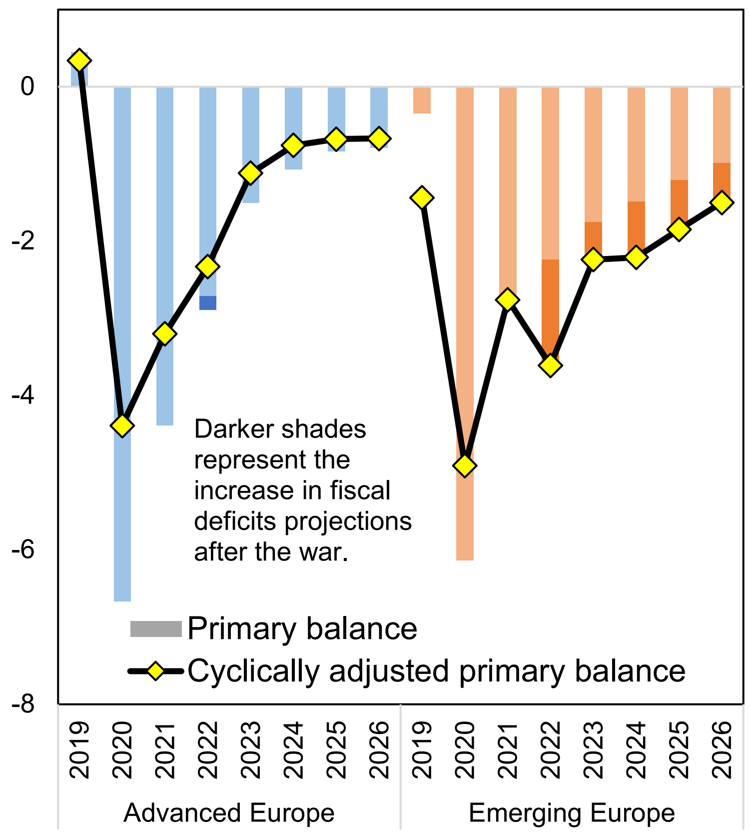
Sources: Eurostat, *World Economic Outlook Database* and IMF staff calculations.
Notes: The left panel shows the distribution of gas supply contraction in case of a Russian gas shut-off for select 18 European countries; the middle panel shows the distribution of assessed output losses for select 18 European countries in case of a Russian gas shut-off; the right panel shows the CPI sensitivity to a combined 20 percent increase on energy prices and a 10 percent increase in food prices; energy includes electricity, gas, solid fuels and liquid fuels, and heat energy under the housing category, and fuels and lubricants under the transport category.

Automatic stabilizers and temporary programs should mitigate the impact of the war shock, but with plans to anchor public debt

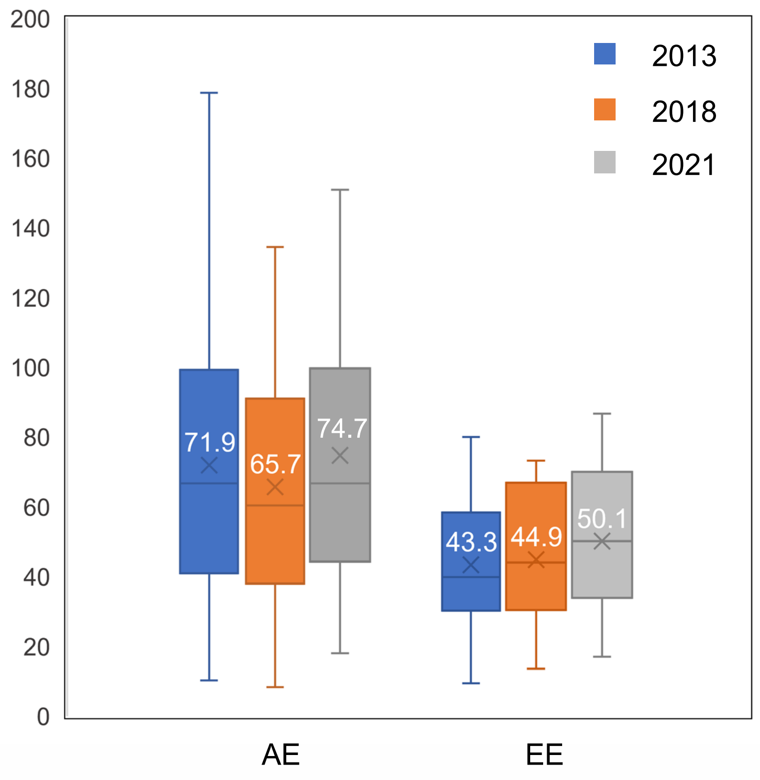
Europe: Energy Measures
(Percent of total countries in the group)



General Government Fiscal Balance
(PPP-GDP weighted average, percent of GDP)



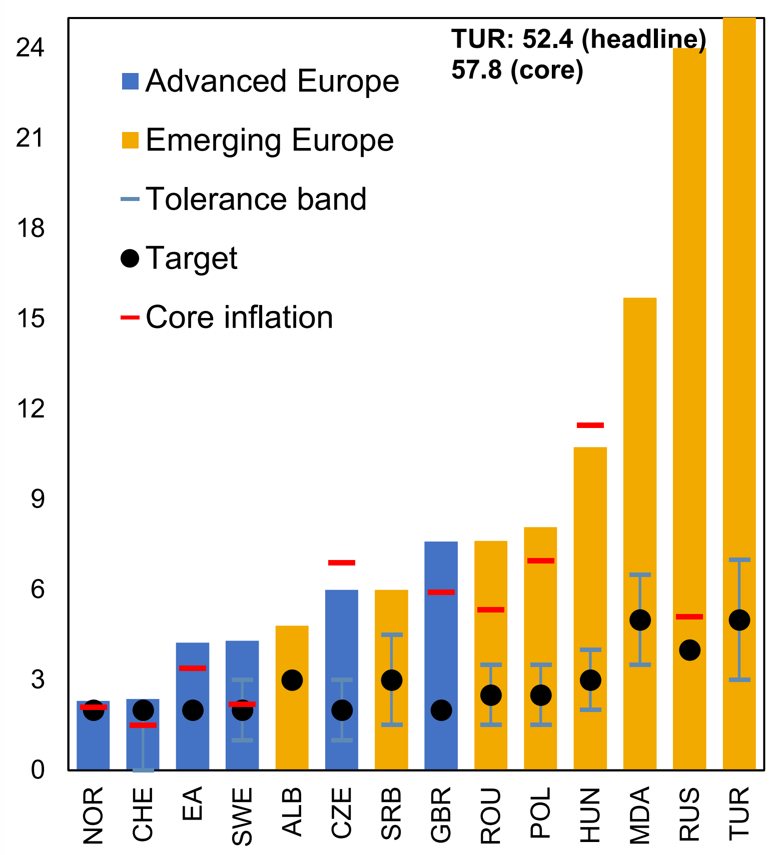
Europe: Public Debt-to-GDP Ratios
(Interquartile range, percent of GDP)



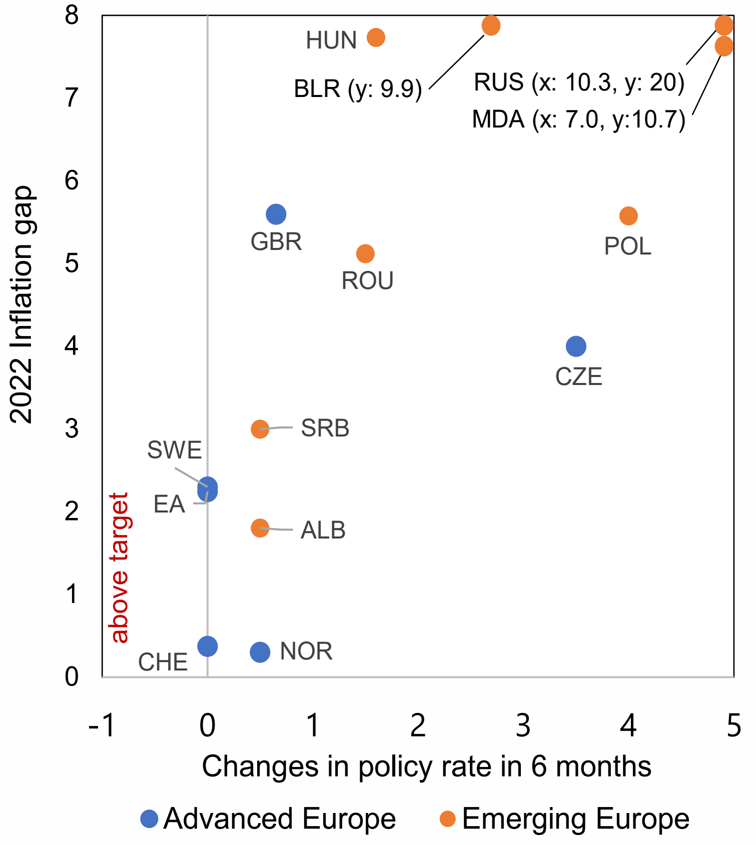
Source: Haver Analytics; IMF *World Economic Outlook;* and IMF staff calculations.
Notes: The left chart includes Belgium, Cyprus, Estonia, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Netherlands, Slovenia, Spain and United Kingdom for Advanced Europe; and Bosnia and Herzegovina, Bulgaria, Hungary, Poland and Serbia for Emerging Europe. The energy measures are not exhaustive. The middle panel excludes Belarus, Russia, Turkey, and Ukraine for Emerging Europe. Cyclically adjusted balance is in percent of potential GDP. In the right chart, the numbers inside the box and whiskers plots indicate average values.

Policy rate hikes should signal commitment to targets in Emerging Europe. The ECB can proceed more gradually

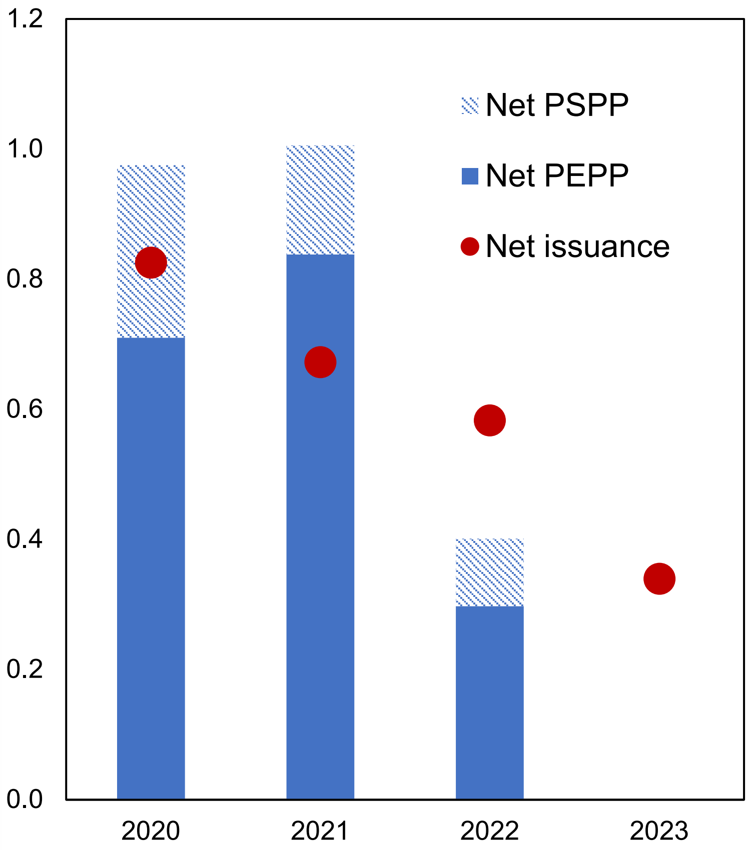
Select Countries and Euro Area: Projected 2022 Inflation and Target Range
(Percent)



Inflation Gaps and Policy Rates
(Percentage points)



Euro Area: Net Issuance vs. ECB Net Purchases
(EUR trillion)



Source: European Central Bank, national central banks, Haver Analytics, IMF *World Economic Outlook,* and IMF staff calculations.
Note: In the middle panel, the inflation gap refers to the difference between the inflation target (or its midpoint) and WEO inflation forecast for end-2022. Policy rate changes refer to the difference between the nominal policy rate in place in mid-April 2022 and that prevailing in mid-October 2021. In the right panel, PEPP stands for Pandemic Emergency Purchase Program and PSPP stands for Public Sector Purchase Program; it is assumed that 1.85 trillion euros under PEPP will be completed by March 2022, evenly distributed over the remaining months. APPs will continue at 20 billion euros per month, 75% of which will be used for public sector securities.

Structural policies should focus on addressing both old and new transitional and long-term challenges

Transitional Challenges

- Provide Humanitarian Relief and refugee integration as needed
- Mitigate Energy Supply Downside Risks
- Foster Factor Reallocation

Policies

- Provide temporary protection and labor, education and health rights
- Refill storage tanks; allow price signals to operate; prepare contingency plans
- Active and passive Labor Policies, Education Policies
- Market regulations and bankruptcy and solvency framework

Long-term challenges

- Boost productivity
- Promote Energy Security
- Facilitate move to a digital green economy
- Enhance human capital and Infrastructure
- Strengthen governance

Policies

- Product market reforms
- Improve energy networks, increase energy efficiency and diversify supply
- Labor market reforms
- Actionable long-term climate and digital strategies; infrastructure investment
- Enhancement of institutions

Key Messages

- **Context:** The war in Ukraine is a humanitarian catastrophe and is casting a pall on the European economy. Europe has reacted quickly to provide support to refugees from the war, but more will likely be needed.

- **Outlook:** Very high uncertainty, sanctions and commodity price hikes, and pandemic-related fragilities will set back the post-crisis recovery and add to inflation pressures. Some countries project technical recessions in 2022, and downside risks are prevalent.

- **Macroeconomic Policy Mix:** The war-induced supply shock calls for fiscal policy to become more accommodative to mitigate the war's negative impact, while monetary policy should stay the course to guard against inflation:

  - As the recovery weakens or stalls, ***fiscal policy*** should allow automatic fiscal stabilizers to operate and provide humanitarian relief to refugees and temporary support to cushion the impact of higher commodity prices on vulnerable households and firms.

  - ***Monetary policy*** should maintain a flexible normalization course at a pace commensurate with economic activity and inflation expectations, mindful of the risk that a faster withdrawal of monetary stimulus may be needed.

- **Structural Policies** should address new challenges, including the integration of refugees. Mitigation of energy security risks is an opportunity to accelerate the green transition, while continuing to mend lingering pandemic-related scars, ease factor reallocation, and promote new growth engines.

Thank you