

Executive Summary

Economic activity continued to expand in the first half of 2018, albeit at a slower-than-expected pace, mainly in advanced Europe. Domestic demand, supported by stronger employment and wages, remains the main engine of growth. However, the external environment has become less supportive and is expected to soften further in 2019 owing to slowing global demand, trade tensions, and higher energy prices. Tighter financial conditions in vulnerable emerging market economies and maturing business cycles are also weighing on activity. Accordingly, growth is projected to moderate from 2.8 percent in 2017 to 2.3 percent in 2018 and 1.9 percent in 2019. That said, it is expected to remain above potential in most countries in the region.

Risks to the outlook have increased. In the short term, escalating trade tensions and a sharp tightening in global financial conditions could undermine investment and weigh on growth. In the medium term, risks stem from delayed fiscal adjustment and structural reforms, demographic challenges, rising inequality, and declining trust in mainstream policies. Also, a “no-deal” Brexit would lead to high trade and non-trade barriers between the United Kingdom and the rest of the European Union with negative consequences for growth.

Policymakers should seize the opportunity offered by continued above-potential growth to implement structural reforms and rebuild room for fiscal policy. Countries with significant vulnerabilities should seek to reduce high levels of public debt and rebuild fiscal buffers to ensure they have policy space to cope with future shocks. In contrast, countries with ample fiscal space and stronger-than-warranted external positions should raise public investment to lift the potential of their economies and promote external rebalancing.

Monetary policy priorities differ across countries. In emerging Europe, where inflation pressure is generally building, central banks should gradually normalize monetary policy in a well-communicated manner to ensure a smooth adjustment. In advanced European economies, where underlying inflation pressures are generally subdued, monetary policy should remain supportive to ensure durable increases in inflation toward targets. Structural and financial sector reform priorities remain unchanged from those discussed in previous *Regional Economic Outlook* reports for Europe.

Well-targeted macroprudential policies can be useful in addressing specific financial stability risks. As discussed in Chapter 2, such policies have mainly aimed at building financial resilience, containing house price increases and credit growth. The analysis suggests that borrower-side measures, supported by lender-side measures, helped reduce the share of riskier mortgages, thereby contributing to improved financial resilience. Evidence is more mixed when it comes to the ability of macroprudential policies to contain house price and overall credit growth in the context of monetary policy that remains accommodative.