IMF Regional Economic Outlook: Europe – Navigating Stormy Waters

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On October 10, 2011, the IMF's Regional Economic Outlook (REO) for Europe was presented at the OeNB. *Céline Allard,* Deputy Division Chief of the Euro Area and EU Policies Division at the IMF, outlined the report's main findings on the advanced economies in Europe, while *Lone Christiansen* from the IMF's European Department focused on the future outlook and major policy issues for the emerging European economies. *Bas Bakker,* Division Chief of Emerging Europe and Regional of the IMF's European Department, went on to analyze the economic and financial linkages between Eastern and Western Europe. In the ensuing discussion, journalists, OeNB economists and experts from various economic institutions and commercial banks raised additional topics and exchanged their views.

The presentation of the REO was chaired by *Franz Nauschnigg,* Head of the OeNB's European Affairs and International Financial Organizations Division. In his opening remarks, Nauschnigg claimed that the "stormy waters" had been calmed by the joint anti-crisis intervention of the IMF and the EU. He also pointed out that the EU's and the IMF's financial support packages, the "Vienna Initiative" and the continued exposure of parent banks in Eastern Europe have been successful in stabilizing the financial markets and have thus helped reduce CDS and interest rate spreads. This reduction in interest rate spreads, for example, helped Austrian taxpayers save EUR 2 billion by reducing interest payments over the lifespan of loans taken out in 2009 and 2010.

Outlook for Europe – Major Challenges Ahead

Since the beginning of 2011, the world economy has been hit by a number of unfavorable shocks such as the earthquake and tsunami in Japan and the deepening financial strains in euro area financial markets. Hence, a slowdown in economic activity is now evident: The IMF projects worldwide growth to come to 4% in 2011 and 2012, which is about half a percentage point lower than projected in spring 2011. As regards Europe, the REO projects growth to slow down from 2.4% in 2010 to 2.3% in 2011 and to 1.8% in 2012. Growth in the advanced European economies is forecast to slow down from 1.7% in 2010 to 1.6% in 2011 and 1.3% in 2012, while the emerging European economies are projected to grow by 4.4% in 2011 (as in 2010) and by 3.4% in 2012.

In *advanced Europe*[1], tensions have moved from the euro area periphery to some core economies. After having experienced divergent recoveries in previous years, this region now faces a synchronized slowdown. Capital buffers in banks remain thin, and external imbalances still persist. In addition, various global and domestic factors further cloud the economic outlook. Financial markets continue to be under pressure, and downside risks remain acute. As regards the policies to be taken by advanced Europe in order to reverse the slide, the IMF recommends to pursue fiscal consolidation, maintain an accommodative monetary stance and strengthen banks' capital buffers. Confidence in the banking sector has to be restored in order to bring investors back. Crisis management in the euro area should go beyond its current scope in order to secure success, and a far more

[1] *Advanced Europe refers to the euro area countries plus the Czech Republic, Denmark, Sweden, the United Kingdom, Norway, Switzerland, Iceland and Israel.*

important role should be given to EU-wide regulatory, supervisory and decision-making bodies.

Emerging Europe[2] is now caught in the downward trend observed for the advanced countries: Growth is projected to remain at 4.4% in 2011 and then to decline to 3.4% in 2012 due to the current global economic slowdown. Growth differentials, which had been large in 2009 and 2010, will diminish, due to both a pickup in the Baltic countries and Southeastern Europe and a slowdown of domestic demand growth in those countries which had expanded fastest, such as Turkey and the European CIS countries. The successful integration of emerging Europe has led to increasing spillovers between advanced and emerging Europe. But downward risks dominate: An escalation of the crisis would affect emerging Europe via trade and financial linkages. Production chains have become highly integrated across borders, and Western European banks have come to dominate emerging Europe's banking systems. Fiscal vulnerabilities are still high in many countries, and the crisis has left the region with large stocks of nonperforming loans (NPLs): In most countries, NPL ratios amount to above 10% of total loans. Policy action to be taken in emerging Europe should focus on reducing vulnerabilities by rebuilding fiscal buffers and cleaning up NPLs.

Bakker went on to present an in-depth analysis of the *economic and financial linkages* between Eastern and Western Europe. He stated that there were linkages through various channels, such as trade, cross-border production chains, FDI and the co-movement of spreads. Western European imports from and exports to CESEE have increased rapidly, making CESEE now a more important export market for Western Europe than Asia. Production chains have become deeply integrated, in particular those of Germany or Austria with Central Europe. Financial linkages have increased, too, with Western European banks dominating in most CESEE countries. Austrian and Greek banks have a particularly large exposure to CESEE. In addition, financial and trade linkages have become more interdependent – shocks in capital flows going one way are soon followed by trade shocks going the other way. In addition, financial and trade linkages are reinforced by FDI, which comes mostly from Western Europe.

Austria's trade integration with both Western Europe and CESEE has deepened: Austrian exports benefited from growth in CESEE during the period from 2003 to 2008, with export growth coming to 7.2% (instead of 4.9% without exports to CESEE), but the Austrian economy suffered severely during 2009. Furthermore, financial spillovers from Western banks are substantial as financing from Western banks fueled credit and domestic demand booms in CESEE and boosted imports from Western Europe. In view of all these spillovers, policymakers need to switch to (fiscal policy or macroprudential) tools that are still effective in interlinked economies and provide for more coordination with home supervisors. In addition, if cross-border linkages amplify business cycles, policymakers must be prepared to use their tools more aggressively.

In addition, Bakker presented an analysis of *long-term growth differentials* within Europe. He pointed out that the past decade had seen large differences in per capita GDP growth rates in Europe. To a large extent, these differences reflected

[2] *Emerging Europe refers to Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Latvia, Lithuania, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Turkey and Ukraine.*

the ongoing convergence process, but macro-policies and barriers to growth had an important influence as well. Domestic demand boom-busts hurt long-term growth, whereas low public debt and low corporate tax rates boost long-term growth. Labor market flexibility helps, as it fosters employment and labor market participation. Lessons from the Netherlands and Sweden have shown that it is possible to escape low-growth traps: Both countries took measures to correct macroeconomic imbalances and implement structural reforms. Hence, the lessons to be drawn for current poor performers would be: Reforms work, but they take time. They should be comprehensive and address both macroeconomic imbalances and structural rigidities. Moreover, reforms are not only helpful for boosting the catching-up process of poorer countries within Europe, but also for extending the European technology frontier and reducing the productivity and innovation gap between Europe and the U.S.A.

The question and answer session at the end of the presentation was dominated by questions on Erste Bank's profit warning. Both Bakker and Nauschnigg gave reassuring messages concerning Austrian banks' exposure in CESEE.