IMF Outlook for Europe: Securing Recovery

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On October 6, 2009, *Helge Berger*, Deputy Division Chief of the EU Policies and Regional Studies Division of the IMF's European Department, presented the IMF's "Regional Economic Outlook: Europe" at a seminar hosted by the OeNB. Berger's presentation was followed by a lively and inspiring exchange of views between economists from the OeNB and experts from various commercial banks and economic institutions.

Peter Mooslechner, Head of the OeNB's Economic Analysis and Research Department, and *Franz Nauschnigg*, Head of the OeNB's European Affairs and International Financial Organizations Division, provided the opening remarks to the seminar.

A Moderate Recovery

Recent data show that the current recession in Europe, after gathering pace through early 2009, appears to have ended at mid-2009. Berger suggested that the ebbing of the economic contraction could be attributed to external demand on the one hand and effective monetary and fiscal policies on the other: Interest rate cuts, unconventional monetary policy measures and rapidly increasing fiscal deficits helped put a floor under falling economic activity. He also pointed out that countries particularly hard hit by the crisis, such as the U.K., Spain and Ireland, would need much longer to recover.

An array of financial sector interventions succeeded in stabilizing markets, although their implementation and coordination was complicated at first by the unprecedented nature of the crisis. Hence, according to Berger, the recovery taking place is moderate. Also, it is likely to be slow and fragile: An increasing amount of bankruptcies, rising unemployment and scarcity of credit will weigh on economic activity. Thus, financial problems persist and the potential output is weakened.

Berger went on to stress that policymakers should focus their attention on repairing the financial system and supporting demand in order to secure a strong and sustained recovery: They should adopt a more proactive approach to assessing the balance sheet risks faced by banks and take action to recapitalize and restructure viable institutions. At the same time, monetary and fiscal policy should prepare an exit strategy from the extraordinary measures put in place during the crisis.

In order to achieve higher long-term growth, a new supervisory and regulatory environment and structural reforms should be defined. These regulatory reforms should also set the stage for the post-crisis financial industry. Berger pointed out that the introduction and implementation of stress tests represented a huge success in macroprudential regulation.

Fiscal Policy to Focus on Sustainability

In order to sustain the upswing, Berger recommended to implement stimulus measures and to let automatic stabilizers work. Nevertheless, as soon as the recovery takes hold, exit strategies should be pursued and consolidation should be

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reached. The contingent costs of the crisis represent a risk and are adding to pressures from an aging population. According to Berger, the costs of Europe's rapidly aging population already exceed the costs of the crisis.

Central Banks to Exercise Caution in Monetary Policymaking

As regards monetary policy, Berger warned that the additional policy options should remain in place for only as long as they are needed, as interventions come at a cost. Central banks should thus plan to implement an exit strategy as soon as the recovery has taken hold. However, the unwinding of the unconventional monetary measures requires careful judgment with respect to pace and timing. Berger then focused on the output gap and stated that uncertainty regarding the output-gap can drive a wedge between central banks and public expectations. He stressed that it was important to clearly communicate the commitment to price stability and to adjust to new information accordingly in order to anchor expectations.

Emerging Europe: The"EU Halo Effect" Is Gone

On the subject of emerging Europe, Berger's assessment was that the situation is different now: Post-crisis emerging Europe, as an integrated region, faces a more volatile environment and higher risk premiums. The perception of investors has changed; they now clearly differentiate between countries, dismissing the EU "halo effect" for this region. Policies should focus on ensuring banking stability and steadying fiscal policy around a sustainable path.

Structural Change Critical to Sustain Long-Term Growth

Finally, Berger underlined that higher longer-term growth through structural change would support the recovery, smooth the exit from unconventional monetary policy and help emerging markets adjust to lower capital inflows in the aftermath of the crisis. Hence, policymakers should pursue opportunities to reform labor and product markets and try to rejuvenate the Lisbon Agenda. In this context, Berger emphasized that labor hoarding was a massive phenomenon in Europe, including the U.K.

In the ensuing discussion, *Doris Ritzberger-Grünwald*, Head of the OeNB's Foreign Research Division, pointed out that labor hoarding could also be perceived as positive, as it represents the pillar of private consumption, whereas *Franz Nauschnigg*, Head of the OeNB's European Affairs and International Financial Organizations Division, posed the question of whether labor hoarding might contribute to potential output. Berger concluded that labor hoarding per se could not be condemned and recommended structural change as a means of promoting long-term growth in Europe.