IMF Regional Economic Outlook for Europe: Fostering Sustainability

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Europe was different – this was one of the main conclusions of a lecture on the IMF's "Regional Economic Outlook: Europe"[1] held at the OeNB on May 17, 2010, by Johan Mathisen, Senior Economist of the European Department of the IMF and one of the report's authors. Mathisen's presentation was followed by a lively discussion, in which economists from the OeNB and experts from various economic institutions and commercial banks as well as journalists took part.

The lecture was chaired by the Head of the OeNB's European Affairs and International Financial Organizations Division, Franz Nauschnigg. In his opening remarks, Nauschnigg pointed out that in the course of the financial crisis, the IMF had become a systemically important institution for Central, Eastern and Southeastern European (CESEE) countries by providing timely and adequate liquidity and hence stabilizing the region. He further elaborated on the IMF's latest financial arrangements, i.e. the provision of EUR 30 billion to Greece and of approximately EUR 250 billion under the European Stabilization Mechanism (ESM).[2]

Recovery in Low Gear

Mathisen stated that in Europe, recovery had returned but was still much weaker than in other parts of the world. Europe has benefited from large capital inflows and experienced a deeper recession. Tightly integrated economies and the dependence of Europe's largest countries on exports had made the region particularly vulnerable to the collapse in global trade. Growth is uneven, and within the emerging market economies, the heterogeneity is even more pronounced. Lending conditions are still very tight, and unemployment is high and still rising.[3]

The risk situation meanwhile had become clearer, Mathisen continued. The failure to address sovereign concerns represents a major downside risk. Mathisen furthermore noted that the risk picture had changed favorably following the launch of the Greek austerity program.

The challenges to be addressed include getting public finances back on a sustainable track, reforming the financial system and improving the efficiency of labor and product markets. Moreover, emerging Europe is facing the additional challenge of attracting and managing healthy capital flows to restore economic growth. Many countries in CESEE had suffered from excessive inflows prior to the crisis, which had been associated with booming credit markets and overheated growth.

Managing Capital Flows

Mathisen said that there were two main sources of capital flows, i.e. cross-border loans in banks and corporations on the one hand and foreign direct investment (FDI) on the other hand. The key policy questions are how to ensure a healthy level of foreign investment into emerging Europe, how to prevent excessive capital

[1] *The Regional Economic Outlook can be downloaded at http://www.imf.org/external/pubs/ft/reo/2010/EUR/eng/ereo0510.htm.*

[2] *The Regional Economic Outlook was drawn up in April 2010 and hence does not reflect the IMF's latest financial arrangements.*

[3] *The growth projections for advanced European economies amount to 1% for 2010 and to 1.5% for 2011, while for emerging European economies, they are around 3.3% for 2010 and 3.4% for 2011.*

flows and how to improve the stability of an increasingly internationally integrated financial sector.

He further analyzed that there were different drivers for different capital flows: While FDI is determined by convergence factors such as structural and growth factors, cross-border loans are more closely related to exchange rate policies as well as to monetary and fiscal policies. Mathisen stated that inflows sometimes exceeded the healthy levels required by convergence, reflecting, for example, unsustainable asset and credit booms.

Policy Implications

When analyzing the exchange rate policy effects in more detail, it was found that stable exchange rates generally attracted more inflows, Mathisen explained. Countries without pegged exchange rates experienced a surge in bank-related inflows in times of slower appreciation, while countries with pegged exchange rates witnessed more bank-related inflows as the nominal exchange rate appreciated.

As regards fiscal policy, better fiscal balances generally seemed to attract more inflows, with the exception of countries with a pegged exchange rate, where higher deficits led to higher capital inflows.

Policies Matter

In conclusion, Mathisen pointed out that policies mattered: Flexible exchange rates often helped avoid excessive inflows and the unsustainable booms they fuelled. Fiscal policy mattered, in particular under managed or fixed exchange rate regimes. And some macroprudential tools and capital controls influenced inflows at least temporarily; macroprudential policies altered the composition of inflows, as prudential tools temporarily slowed inflows and changed their composition. As a result, capital controls proved partly successful in restricting portfolio debt inflows.

In the discussion following the presentation, Mathisen clarified that the IMF did not generally recommend moving towards a flexible exchange rate and underlined once more that the IMF supported sustainable polices, especially when it comes to fiscal policy: A sustainable recovery requires sustainable policies. Given the magnitude of the required fiscal retrenchment and the risk of slowing the recovery, the stabilization of public debt in the short run is neither feasible nor desirable. Instead, governments should seek to consolidate their budgets over the medium term.

Moreover, Mathisen underlined that without the IMF's financial rescue packages in Europe and CESEE, there would have been a sudden stop in capital flows.[4]

When asked about the issue of foreign currency loans, Mathisen stated that the IMF – in pursuing its mission of promoting financial stability – did not recommend such credit but acknowledged that this assessment should be based on a country-by-country basis.

[4] *As regards Europe, the IMF has signed financial arrangements totaling EUR 93 billion with ten countries (this sum includes a Flexible Credit Line (FCL) for Poland amounting to EUR 15 billion, which is to be treated as precautionary, as well as the latest Stand-By Arrangement for Greece in the amount of EUR 30 billion).*