IMF Regional Economic Outlook: Europe – Building Confidence

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The IMF's recent Regional Economic Outlook (REO) for Europe was presented at the Oesterreichische Nationalbank (OeNB) on October 20, 2010. First, *Ajai Chopra,* Acting Director of the IMF's European Department outlined the main findings of this report[1]. Second, *Helge Berger,* Deputy Division Chief of the Euro Area and EU Policies Division of the IMF's European Department, focused on the outlook and policy issues for advanced European economies. Third, *Bas Bakker,* Division Chief of the Emerging Europe Regional Division of the IMF's European Department, presented prospects and issues for emerging European economies after the crisis. In the discussion that followed, economists from the OeNB and experts from various economic institutions and commercial banks exchanged their views.

The presentation was chaired by *Franz Nauschnigg,* Head of the OeNB's European Affairs and International Financial Organizations Division. In his opening remarks, Nauschnigg pointed out that the good international cooperation, especially with and between the IMF and the EU, had helped stabilize the markets in Central, Eastern and Southeastern Europe. As spreads and interest rates declined, this joint effort eventually prevented a meltdown.

After the deepest recession in the postwar period, Europe is now recovering, as was pointed out by Chopra: With the exception of Greece and Portugal, all European countries should post positive growth next year. While advanced Europe[2] is projected to expand by 1.7% in 2010 and 1.6% in 2011, emerging Europe[3] is forecast to grow by 3.9% in 2010 and 3.8% in 2011.

In his presentation on advanced European economies, Berger stated that, despite recent strength, the outlook remains moderate and uneven. This is mainly due to well-known structural rigidities in the labor, product and services markets, which will limit the euro area's growth potential. In addition, significant risks remain, with downside risks having even increased.

In view of these risks, it will be crucial to get the policies right: Monetary policy should remain supportive and must steer carefully between the need to normalize policies on the one hand, and to ensure bank liquidity on the other. Fiscal consolidation is inevitable, but should be undertaken in a way that minimizes the negative impact on growth. As regards the fiscal governance discussion, structural reforms are needed in order to support growth and reduce trade imbalances.

Furthermore, in order to sustain the upswing, the remaining banking weaknesses should be dealt with and the gaps in the "European House" should be closed in order to build confidence. As regards European supervision and macroprudential policies, significant progress has been achieved. Their cooperative implementation remains the crucial next step.

As regards emerging Europe, Bakker pointed out that the projected expansion of 3.9% in 2010 is mainly led by exports, while domestic demand remains subdued. The recovery is uneven across regions, with CIS countries and Turkey experiencing

[1] *See www.imf.org/external/pubs/ft/reo/2010/eur/eng/ereo1010.htm for the full report.*

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

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

the strongest growth, and countries that had deep recessions the weakest growth. However, the near-term outlook is benign: all countries will grow in 2011. There are some upside risks, but there are significant downside risks for emerging Europe, which would be particularly harmful if they materialized. Hence, there is a strong need for suitable policies to sustain the recovery and minimize risks: Substantial fiscal consolidation is needed over the next five years, as fiscal positions have weakened. Although fiscal consolidation may hurt growth in the short term, market concerns about weak public finances could be even more damaging. In addition, private sector credit growth, which has been weak since the onset of the crisis, has to be revived in order to support the recovery. In this context, it seems very important to repair bank balance sheets, which will help alleviate supply constraints.

Bakker then elaborated on the question of why the slump in emerging Europe was so deep: The seeds for the crisis were planted in the five years leading up to the crisis by buoyant growth in domestic demand, which was led by credit booms, an overheating of the economy and the buildup of large imbalances and vulnerabilities. The credit booms, which were financed by large capital flows from Western European banks, fueled a domestic demand boom. But he also emphasized that it was not just private demand that grew rapidly, as buoyant fiscal revenues were likewise used to increase public expenditure. As a consequence, asset prices and inflation surged and vulnerabilities increased sharply. The crisis was triggered by the global financial turmoil in the aftermath of Lehman Brothers' collapse, which led to a sudden stop of capital inflows and to the collapse of global trade flows.

However, a meltdown was avoided with the help of decisive domestic policy, large-scale international financial support and the presence of Western European banks that did not reduce their exposure in the region during the crisis. In addition, countercyclical policy in Western Europe, such as policy rate cuts, liquidity provision from the Eurosystem and accommodating fiscal policy, contributed further to avoiding a final breakdown of the region. However, some countries were more affected than others: Countries that had the largest imbalances and the strongest credit booms have seen the deepest recessions, whereas countries that managed to avoid excesses have seen much shallower recessions or avoided them altogether.

Among the lessons to be learnt from the crisis are the insights that credit booms can be costly and that they are especially hard to stop under fixed exchange rate regimes. There is a strong need for a more active fiscal policy, as larger surpluses in boom years can be used to lean against overheating and to build buffers for countercyclical policies during a downturn.