Regional Economic Outlook: EUROPE
Addressing the Crisis
May 2009

Executive Summary

Following a collapse in confidence and global demand, Europe has entered a deep recession. Further amplification of the downturn through adverse feedback effects between the financial system and the real economy is a key risk. Inflation has fallen sharply against the background of a broad-based and rapid decline in consumption, investment, and exports. The downturn is being felt across Europe's advanced and emerging economies, owing to similarities in their exposure to global financial and real shocks, and strong regional trade and financial integration. Country-specific factors matter too, however, with some countries facing more extreme financing difficulties implementing adjustment programs supported by the IMF and other sources, including the European Union (EU).

Even assuming more forceful policy actions, the downturn is likely to last until early 2010, and the subsequent recovery is expected to be gradual. Restoring confidence, adjusting to a lower level of wealth, and reducing leverage in the financial sector will take time. And with a globally synchronized downturn, the scope for Europe to benefit from an export-led recovery is limited. Following the jarring global repricing of risk and the diminishing of risk appetite, the cost of capital will remain high for some time, and several emerging economies are facing a sudden retrenchment of capital inflows. With the reversal of commodity prices and the widening of the output gap, deflationary pressures have increased, but inflation expectations so far remain anchored in positive territory. Economies adjusting under fixed exchange rate regimes are particularly likely to see their price levels decline, while nominal exchange rate depreciations elsewhere could lessen downward pressure on inflation.

Building on ongoing progress, further policy action, especially in the financial sector, is required to restore market trust and confidence in all countries. In addition to continued liquidity provision, credible loss recognition must be undertaken, taking fully into account prospective losses from the economic downturn. Viable institutions need to be recapitalized, with public support as needed, while others should be resolved. Equally important is the ring-fencing of impaired assets in order to reduce uncertainty.

With the downturn likely to be protracted, macroeconomic policies will need to continue to support demand, while keeping an eye on the medium and longer run. Further room to reduce interest rates should be exploited swiftly, and additional unconventional easing will have to be considered, with appropriate safeguards to limit market distortions, ensure reversibility, and preserve the integrity of central banks. Fiscal policies to soften the downturn should continue into 2010, with an emphasis on effectiveness and sustainability. The pursuit of growth-enhancing structural reforms to tackle the aging-related increases in public costs looming on the horizon will be particularly important.

For Europe, addressing the current economic and financial crisis coherently and comprehensively across advanced and emerging economies provides an opportunity to emerge from the crisis with stronger policy institutions and substantial progress made toward its goals of integration and convergence. The benefits of coordination are particularly large in the financial area and in mitigating regional downside risks. Agreeing on basic methodologies to determine capital needs and the approach to deal with impaired assets will avoid distortions and policy arbitrage, and minimize collective costs. Similarly, full home-host coordination on loss recognition and recapitalization of cross-border banks is an important element in this approach. Potential debt-servicing difficulties and disruptive exchange rate movements should be preempted with the involvement of EU institutions, and of the IMF where needed, by extending currency swap lines for emerging markets and clarifying the road maps for euro adoption.

Beyond the immediate crisis, improving the EU's financial stability framework will be essential. Implementing the recommendations of the de Larosière report deserves strong support. Nonetheless, reforms will eventually need to go further to ensure a cross-sectoral integration of supervisory arrangements and establish an effective framework for cross-border crisis management and resolution.

With active fiscal policy firmly back on the agenda, it is important to address questions of its effectiveness and coordination (Chapter 2). Especially in a tightly integrated region under a common currency such as the euro area, the benefits of fiscal expansion spill across borders while costs—namely increasing debt levels and potentially higher financing expenditure—amass locally. This creates significant room for a coordinated fiscal expansion, as a simultaneous areawide stimulus would yield much stronger growth effects than a stimulus in just one country. As for the content of the fiscal package, in current circumstances, spending on infrastructure and targeted transfers are likely to have the largest multipliers. General tax cuts or subsidies, either for consumers or firms, are likely to be less effective.

Effective fiscal policies will need to take into account the sustainability of public finances. While global developments have played a role in the recent increase in euro area sovereign interest rate differentials, country-specific factors—in particular rapidly rising projected debt levels, as well as concerns about the solvency of national banking systems and their budgetary consequences—have increasingly become important. One implication is that the impact of expansionary fiscal action will be larger in countries with lower public debt and relatively healthy banking sectors; this adds to the call to tailor fiscal action to the fiscal room available. Another implication is that, to maintain fiscal space, countries need to focus on reversible fiscal measures, formulate a plausible medium-term strategy, strengthen their fiscal frameworks at the national level, and make full use of the medium-term framework tied to the Stability and Growth Pact (SGP) where applicable.

Some of these concerns also feature in emerging market economies, although with substantial variation within the region (Chapter 3). In emerging Europe, too, the crisis has put a premium on sound policies at the country level. A large part of the differences in the way the crisis affected individual countries can be explained by diverging macroeconomic performance and external vulnerabilities, such as current account deficits. At the same time, the apparent ability of new EU member countries to attract cheaper funding because of their EU membership, the so-called EU halo effect, has disappeared. Gone as well is the notion that bank-based financing of external capital needs will guarantee stable capital inflows during a crisis. With western European parent banks in need of government support themselves, markets are taking a less sanguine view of extensive foreign ownership in the financial sector. Increasingly, recapitalization of banks is becoming a regional issue, merely underscoring the advantages of a coordinated European approach.

The banking sector could also hold a key to the speed of the recovery in emerging Europe. Measures to support credit, for instance through bank recapitalizations, can hold off a tightening of credit conditions, support consumption, and prevent recessions from becoming overly protracted in some countries. This mechanism is emphasized in recent IMF-supported programs, which have provided funds especially for meeting bank recapitalization needs. To reduce the procyclical volatility of bank profits and lending in the future, prudential rules on provisioning need to be strengthened once the crisis has dissipated. The need for enhanced cross-border coordination among home and host central banks, supervisors, and governments should also be on the policy agenda.