Press Points for Chapter 2: ***Fiscal Policy in Advanced Economies: Effectiveness, Coordination, and Solvency Issues***

Spring 2009 Regional Economic Outlook: Europe

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Key Points

- **Policy actions taken to address the crisis and the economic slowdown will severely burden public finances.**

- **Given the increased integration of European economies, policy coordination is key to magnifying the effects of national fiscal expansions. As for the content of the fiscal package, in current circumstances, spending and targeted transfers are likely to be the most effective instruments.**

- **A clear commitment to long-run fiscal discipline is now more essential than ever: any short-term support packages should be cast within a credible medium-term framework and envisage a correction as the crisis abates.**

Policy actions taken to address the global crisis have been increasingly broad in scope as financial problems have spread and activity has deteriorated. Almost all advanced European economies have provided capital injections and guarantees for financial sector liabilities. Some have purchased illiquid assets from financial institutions or extended direct loans. Altogether, the immediate impact of these measures has reached 6.3 percent of 2009 GDP on average, ranging widely from 1.1 percent of GDP in Switzerland to 20.2 percent of GDP in the United Kingdom.

Headline Support for the Financial Sector and Upfront Financing Need
(As of April 15, 2009; percent of 2008 GDP)

	Capital Injection (A)	Purchase of Assets and Lending by Treasury (B)	Central Bank Support Provided with Treasury Backing (C)	Guarantees 1/ (D)	Up-front Government Financing 2/ (E)	
Austria	5.3	0.0	0.0	30.0	5.3	
Belgium	4.7	0.0	0.0	26.2	4.7	
France	1.2	1.3	0.0	16.4	1.5	3/
Germany	3.8	0.4	0.0	18.0	3.7	
Greece	2.1	3.3	0.0	6.2	5.4	
Ireland	5.3	0.0	0.0	257.0	5.3	
Italy	1.3	0.0	0.0	0.0	1.3	
Netherlands	3.4	2.8	0.0	33.7	6.2	
Norway	2.0	15.8	0.0	0.0	15.8	
Portugal	2.4	0.0	0.0	12.0	2.4	
Spain	0.0	4.6	0.0	18.3	4.6	
Sweden	2.1	5.3	0.0	47.3	5.8	4/
Switzerland	1.1	0.0	0.0	0.0	1.1	
United Kingdom	3.9	13.8	12.9	51.2	20.2	5/
Average 6/	2.5	3.7	2.1	25.0	6.3	

Source: IMF, Update on Fiscal Stimulus and Financial Sector Measures (published April 26, 2009). Available via the Internet: http://www.imf.org/external/np/fad/2009/042609.htm.
1/ Excludes deposit insurance provided by deposit insurance agencies.
2/ Includes components of (A), (B), and (C) that require up-front government outlays.
3/ Support to the country's strategic companies is recorded under (B), of which 14bn euro will be financed by a state-owned bank, not requiring upfront Treasury financing.
4/ Part of the capital injection will be undertaken by the Stabilization Fund.
5/ Cost to nationalize Northern Rock and Bradford & Bingley recorded under (B), entailing no up-front financing.
6/ PPP GDP weights.

Automatic stabilizers and discretionary measures will help to cushion the downturn, while contributing to widening fiscal deficits. Automatic stabilizers in European advanced economies are expected to lead to a 3.3 percent of GDP increase in fiscal deficits, in average, in 2009. On top of that, there might be a further negative impact on revenues because of the ongoing reversal in house and equity prices, which is not fully reflected in the conventional estimates of cyclical balances. Most countries have also adopted fiscal stimulus plans, amounting to, on average, 1 and 0.8 percent of GDP in 2009 and 2010, respectively.

Advanced European Economies: Estimated Cost of Discretionary Measures, 2008–10 1/
(Percent of GDP, relative to 2007 baseline)

	2008	2009	2010
Austria	0.3	1.5	1.7
Belgium	0.0	0.8	0.4
Cyprus	0.3	1.7	0.0
Denmark	0.0	0.0	0.0
Finland	0.0	1.7	0.5
France	0.0	0.7	0.8
Germany	0.0	1.6	2.0
Greece	0.0	0.1	0.0
Ireland	0.0	0.0	0.0
Italy	0.0	0.2	0.1
Luxemburg	0.0	3.7	3.6
Malta	0.0	0.6	0.4
Netherlands	0.0	0.8	0.7
Norway	0.0	1.8	1.8
Portugal	0.3	1.0	0.0
Spain	1.9	2.3	0.3
Switzerland	0.0	0.7	0.0
United Kingdom	0.2	1.4	-0.1
Average 2/	0.4	1.0	0.8

Source: IMF staff estimates.
1/ Figures reflect the budgetary cost of crisis-related discretionary measures in each year compared with 2007, based on measures announced through early March 2009. They do not include (i) "below-the-line" operations that involve acquisition of assets, (ii) discretionary measures that were already planned for, (iii) automatic stabilizers. Some figures reflect staff's preliminary analysis.
2/ PPP-GDP weighted.

With active fiscal policy firmly back on the agenda, it is important to address questions of its effectiveness and coordination. 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 area-wide 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 and targeted transfers will have the largest multipliers. General tax cuts or subsidies, either for consumers or firms, will be less effective.

Effective fiscal policies will need to take into account the sustainability of public finances. In most countries, government debt will rise sharply as a share of GDP over the next year, reflecting support for the financial sector, fiscal stimulus packages, and revenue losses caused by the economic downturn and declining asset prices. The debt-to-GDP ratio is expected to increase, on average, by 9.4 percentage points—the largest jump since the early 1980s. This deterioration exacerbates existing long-run fiscal challenges related to population aging, thereby raising concerns about fiscal solvency. Financial markets have responded to these developments by requiring higher sovereign default risk premiums for most countries, and differentiating across sovereign issuers much more than before.

To improve the trade-off between the needed fiscal expansion and the risk of a loss of market confidence, governments should supplement their support packages with a clear and credible strategy to ensure fiscal solvency and improve confidence. Specifically, countries need to focus on reversible fiscal measures, formulate a plausible medium-term strategy, strengthen their fiscal frameworks at the national level, and give more weight to the medium-term framework tied to the Stability and Growth Pact.

Press Points for Chapter 3: ***European Emerging Market in Crisis: Impact and Recovery***

Spring 2009 Regional Economic Outlook: Europe

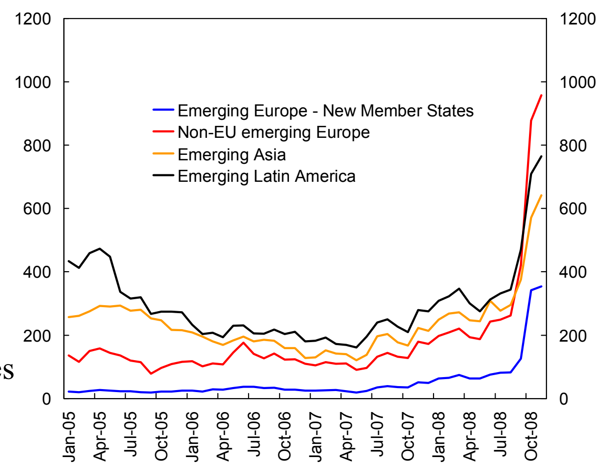
Prepared by Martin Čihák and Srobona Mitra

Key Points

- **The "halo" effect from EU membership has disappeared and financial markets have increased the scrutiny of vulnerable economies.**
- **Bank recapitalizations are unavoidable if a credit crunch is to be prevented; this needs to be accompanied by strengthening the supervisory, regulatory, and macroprudential framework.**
- **Sound macroeconomic policies are at a premium and strengthening policy-making institutions to support them and anchor expectations about euro-entry is crucial.**

A short period of apparent resilience to the global financial turmoil has rapidly given way to a deep crisis in several European emerging markets (see the first figure)**.** What initially seemed to be a turbulence limited to advanced countries spilled into emerging markets forcefully after the fall of Lehman Brothers in September 2008. The region now faces two kinds of stress: retrenchment of crossborder loans to the private sector and lower demand for exports to advanced countries. This chapter looks at why some countries were hit more than others and at policies for sustainable recovery.

Emerging Market Sovereign Bond Spreads 1/
(Basis points)

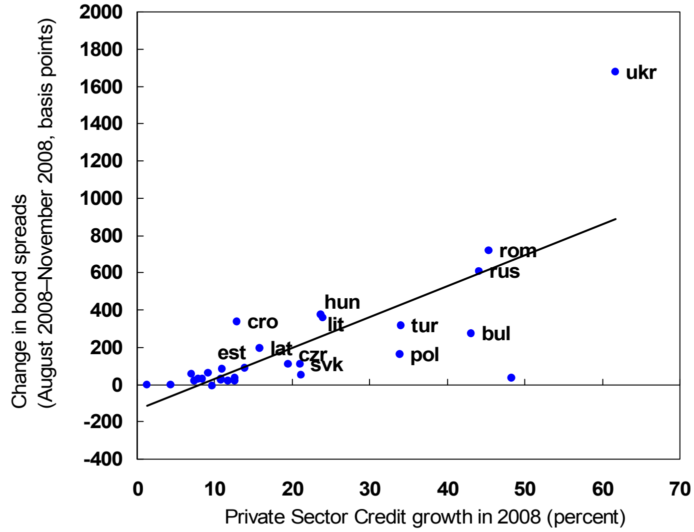


Sources: Bloomberg L.P.; and IMF staff calculations.
1/ Spreads in euros for New Member States and non-EU emerging Europe, in U.S. dollars for all others.

Financial markets are now focusing less on group effects and penalizing much more vulnerabilities in individual countries. An important fact emerging from the analysis in this chapter is that countries with lower inflation and lower current account deficits have so far been hit much less by the crisis. Countries that depended on bank-related capital inflows in recent years to finance higher credit growth were hit more (see the second figure). For emerging market countries that became EU members, adherence to EU rules and institutions has helped to mitigate the impact of the crisis, although it has not shielded them completely. Also, the so called "EU halo effect"—or the phenomenon of lower bond spreads for New Member States in spite of rising vulnerabilities in some countries—has disappeared, while cross-country differences have increased.

As a consequence, the policies leading the way out of the crisis will differ across, countries—but as a group emerging Europe depends on the path taken by advanced economies. Not all countries were hit alike, and these differences will have to be reflected in the policy response. For instance, commodity exporters are having to adjust policies rapidly to deal with large adverse terms of trade shocks, and countries where recent macroeconomic policies have been insufficiently prudent, leading to large fiscal or current account deficits or high public debt, a substantial fiscal tightening is unavoidable. At the same time, the recovery depends upon external conditions becoming more favorable, which in turn hinges on a quick resolution of the crisis in advanced economies.

Credit Growth and Crisis Impact in Europe 1/



1/ Advanced European countries not labeled.
Sources: European Bank for Reconstruction and Development; IMF, *International Financial Statistics*; Bloomberg L.P.; and IMF staff calculations.

The banking sector, which played a central role in the run-up to the crisis, is also likely to have an important part in determining the speed of recovery. Banks' provisioning policies have been procyclical, creating a need for recapitalization to prevent a wide scale credit crunch. Moreover, households—traditionally relatively debt-free—have become dependent on bank credit for their spending. This suggests that lending cuts could adversely affect households' spending abilities and prolong the recovery from the crisis.

The immediate steps involve public and private capital injections in banks to support confidence in the banking sectors and to restore lending to healthy levels. Such recapitalization would be wasteful without the strengthening of the supervisory and regulatory framework, including stronger cooperation between the home and host authorities of cross-border banks and implementing forward-looking policies that build bank reserves in good times for use during bad times. More generally, countries need to strengthen their macroprudential policies—regulations that make banks hold more capital when engaging in risky lending or when funding themselves with short term loans from foreigners—to manage bank-related capital inflows. These inflows have helped incomes in the region converge towards advanced European countries, but have often left a trail of unsustainable and unmanageable demand booms.

Sound macroeconomic policies carry an increased premium. Governments need to rebuild confidence by strengthening policy making institutions to lessen doubts about long-term fiscal sustainability that could slow down the recovery process. High financing costs currently restrain fiscal stimulus in most of the region and further fiscal tightening could be required in some countries to regain confidence in policies. Strengthening policy institutions could go a long way to control financing costs and help fix expectations on euro-entry dates. Clarification of the roadmap to the euro could alleviate concerns about the adverse impact of exchange rate depreciation on private sector balance sheets, given their widespread borrowing in foreign currency in most of emerging Europe.