# Regional Economic Outlook: EUROPE
# Strengthening the Recovery
# May 2011

## Introduction and Overview

The global recovery is gaining strength, though significant downside risks could still come into play. The April 2011 *World Economic Outlook* projects world real GDP growth of 4½ percent in 2011 and 2012, following last year's slightly stronger 5 percent pace. Emerging and developing economies are expected to expand markedly faster—at 6½ percent—than the more sluggish rate of 2½ percent projected for advanced economies. This growth setting, and the accommodative monetary policies of the major central banks, revived capital flows to emerging economies. It also conspired—in concert with adverse supply shocks and concerns about political unrest in the Middle East and North Africa—to drive up commodity prices close to levels reached before the 2008–09 crisis. Key downside risks include (i) oil prices exceeding those currently predicted by futures markets; (ii) significant fiscal and financial vulnerabilities lurking behind recent benign market developments, especially in the euro area; and (iii) overheating in emerging market economies.

Against this backdrop, Europe's recovery is expected to solidify. This edition of the *Regional Economic Outlook* puts growth for all of Europe at 2.4 and 2.6 percent for 2011 and 2012, respectively, after 2.4 percent last year (Table 1). In the baseline, inflation is likely to pick up to 3.8 percent this year on the back of the economic upturn and buoyant commodity prices before easing back to 3 percent in2012. This path assumes that the large increase in food and energy prices remains temporary and does not trigger generalized inflation through second-round effects, obviating the need for sharp monetary tightening, which could hurt the recovery.

Real activity in advanced Europe is projected to expand by 1.7 and 1.9 percent this year and next, compared with 1.7 percent in 2010. The landscape should continue to be varied within advanced Europe, though private demand is expected to continue to strengthen in the core euro area and the Nordic countries, largely offsetting the impact of fiscal consolidation on growth, while remaining weak in Greece, Ireland, Portugal, and Spain, where efforts to work off large precrisis imbalances persist. The Greek and Portuguese economies are projected to be in recession this year.

Growth in emerging Europe is expected to be stronger, at 4.3 percent in 2011 and 2012, after 4.2 percent in 2010.[1] The recovery is set to broaden as domestic demand takes over as the main pillar of growth and all countries post positive growth for the first time since the 2008–09 crisis. Nonetheless, large differences in cyclical positions, capital inflows, current account balances, and inflationary pressures remain.

The recoveries in advanced and emerging Europe are likely to be mutually reinforcing as the continent benefits from the symbiotic relationship between its two parts, with advanced Europe continuing to absorb the lion's share of emerging Europe's exports. In parallel, faster-growing emerging Europe's importance as a market for advanced Europe's firms will expand. But the biggest growth potential derives from building cross-border production chains based on national comparative advantage in a diverse, yet compact, geographical area with vastly improved institutions. German firms are in the lead in this effort. Imports from emerging Europe rose to account for 12 percent of Germany's imports, compared with their 8 percent share in the rest of advanced Europe. Both shares are still small, leaving ample room for further intraregional integration.

The main risk to the outlook for Europe arises from tensions in the euro area periphery. Other global worries also pose risks, although concerns about overheating in the emerging economies of the continent are more muted than in other regions. Strong policy responses have successfully contained the sovereign debt and financial sector troubles in the euro area periphery so far, but contagion to the core euro area, and then onward to emerging Europe, remains a tangible downside risk. Negative feedback loops between concerns about the stability of government and bank balance sheets are proving difficult to break. And concerns about weak fiscal and financial sector balance sheets extend beyond the euro area periphery. In emerging Europe, public finances have also sharply deteriorated and banks are burdened by large numbers of nonperforming loans. Emerging Europe suffered disproportionately in the 2008–09 crisis, so output gaps generally remain negative—only Belarus and Turkey are growing very fast. Inflationary pressures from high commodity prices pose challenges for policymakers, especially where output gaps are closing, food and energy prices account for a large share in the consumer price index (CPI), and central banks' credibility is less firmly established.

Dealing decisively with the financial tensions in the euro area requires comprehensive and bold policy action. The stakes are high. Unrelenting reform efforts at the national level of the crisis-afflicted countries need to be the first line of defense. Restoring fiscal health, squarely addressing weak banks, and implementing structural reforms to restore competitiveness are

[1] For purposes of the *Regional Economic Outlook*, emerging Europe comprises (i) central and southeastern Europe with the exception of the Czech Republic and countries that have adopted the euro, (ii) the European Commonwealth of Independent States (CIS) countries, and (iii) Turkey.

key. Further strengthening the European Union-wide crisis management is critical to securing a successful overall outcome. The European Union (EU) decisions of this Marchare certainly welcome, but challenges now lie in their implementation.

Fiscal consolidation and bank balance sheet repair are critical to defusing downside risks. Public debt sustainability is vital to an enduring solution for the financial tensions in the euro area and to breaking negative feedback loops between sovereign and banking sector instability. Countries under market pressure have appropriately front-loaded their fiscal adjustments, which they now must see through. Other countries can afford to phase in fiscal consolidation more gradually, but a coherent and credible consolidation strategy embedded in a medium-term framework is still necessary for rebuilding fiscal buffers and quelling ever-rising public debt ratios. In emerging Europe, reducing fiscal vulnerabilities is equally important. Key fiscal indicators have deteriorated more than in other emerging economies and now often exceed prudent thresholds. Moreover, where inflation is becoming a concern, consolidation is also called for from a demand-management perspective.

Restoring confidence in the euro area's banking system is a prerequisite to turning the page on the crisis. The upcoming round of strong, broad, and transparent stress tests provides an opportunity to address remaining vulnerabilities. But to be effective, the stress tests need to be followed by credible restructuring and recapitalization programs. Efforts to strengthen the banking systems in vulnerable countries will need to accelerate, and policies to promote deeper integration of the EU financial system—including cross-border merger and acquisitions—should be part of the solution too, buttressed by further progress in strengthening pan-European institutions and governance. In emerging Europe, the main concern is mounting nonperforming loans, while capitalization appears comfortable for now. A second wave of bank consolidation and the prospective introduction of Basel III offer opportunities to strengthen the sector.

Monetary policy in the euro area can afford to remain relatively accommodative, though normalization lies ahead as economic slack gradually dissipates. Reemerging inflation risks pose an additional challenge. In emerging Europe, inflation is running above target in many countries and second-round effects are harder to stave off. Tightening cycles are already under way and fiscal policy should support them.

The euro area-wide safety net is being strengthened to address financial tensions and to avoid future crises. Commitments have been made to improving lending capacity and pricing under the European Financial Stability Facility (EFSF). Making those commitments operational by filling in the still-missing specifics is now essential. The permanent successor arrangement, the European Stability Mechanism (ESM), is taking shape, and is appropriately larger and more flexible than the original EFSF. A revamped Stability and Growth Pact (SGP) and the new Excessive Imbalances Procedure (EIP) strengthen crisis prevention.

Looking at the crises in the euro area periphery, and in emerging Europe, more broadly in the aftermath of the Lehman Brothers collapse reveals common patterns and suggests a number of policy lessons. Financial integration in the wake of euro adoption contributed to strong cross-border capital flows into government debt, interbank markets, and the nontradable sector. Government bond yields quickly converged across the euro area, banks' cross-border exposures built up, and the nontradable sector boomed. Policymakers failed to confront asset price bubbles forcefully in the relatively protected nontradable sector, further boosting its perceived profitability. After many years of ever-higher current account deficits and eroding competitiveness, financing abruptly dried up, plunging the economies into deep recessions. Large adjustment needs, high indebtedness, and negative feedback loops between banking and sovereign instability make for a protracted recovery.

Yet, financial integration does not lead inexorably to such boom and bust cycles and, in fact, can contribute to income convergence. The internationalization of banking was not adequately matched by regulatory, supervisory, and banking reforms. National authorities retained ultimate responsibility, including for any public rescues. Moreover, financial markets failed to reflect mounting vulnerabilities in risk premiums until it was too late for a soft landing.

Stepping back from financial integration would be wrong. Instead, integration should be completed and adequate supportive policies should be put in place. Obstacles to cross-border equity investments and mergers and acquisitions should be removed so that debt flows are no longer favored. Competition in the nontradable sector should be sharpened and policies should swiftly address any future asset price bubbles to avoid luring investment into relatively unproductive uses. Banking supervision, regulation, and resolution need to be elevated to the level at which banks operate in a financially integrated region.

Overcoming the crises in Europe ultimately requires restoring productivity growth in the afflicted countries—a task that goes well beyond the changes in European governance frameworks and the completion of financial integration. Labor productivity growth fell short in these countries over the past decade, despite ample access to financing from abroad. Fostering the return to a vibrant tradable sector is a multifaceted undertaking, but first results are already in hand in the Baltic countries and in Bulgaria, as well as in Ireland and Spain, where export growth is picking up sharply and competitiveness indicators are improving.

The remainder of this edition of the *Regional Economic Outlook* discusses in more detail the outlook and policy priorities for advanced Europe in Chapter 1 and for emerging Europe in Chapter 2. The role of financial integration in the buildup and resolution of imbalances within the euro area and adjacent countries is analyzed in Chapter 3. The Appendix lists current IMF arrangements with European countries.

**Table 1. European Countries: Real GDP Growth and CPI Inflation, 2009–12**
*(Percent)*

| | Real GDP Growth | | | | Average CPI Inflation | | | |
|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2009 | 2010 | 2011 | 2012 |
| Europe[1] | -4.5 | 2.4 | 2.4 | 2.6 | 2.7 | 3.0 | 3.8 | 3.0 |
| Advanced European economies[1] | -4.0 | 1.7 | 1.7 | 1.9 | 0.7 | 1.9 | 2.5 | 1.8 |
| Emerging European economies[1] | -5.9 | 4.2 | 4.3 | 4.3 | 8.5 | 6.3 | 7.3 | 6.2 |
| European Union[1] | -4.1 | 1.8 | 1.8 | 2.1 | 0.9 | 2.0 | 2.7 | 1.9 |
| Euro area | -4.1 | 1.7 | 1.6 | 1.8 | 0.3 | 1.6 | 2.3 | 1.7 |
| Austria | -3.9 | 2.0 | 2.4 | 2.3 | 0.4 | 1.7 | 2.5 | 2.0 |
| Belgium | -2.7 | 2.0 | 1.7 | 1.9 | 0.0 | 2.3 | 2.9 | 2.3 |
| Cyprus | -1.7 | 1.0 | 1.7 | 2.2 | 0.2 | 2.6 | 3.9 | 2.8 |
| Estonia | -13.9 | 3.1 | 3.3 | 3.7 | -0.1 | 2.9 | 4.7 | 2.1 |
| Finland | -8.2 | 3.1 | 3.1 | 2.5 | 1.6 | 1.7 | 3.0 | 2.1 |
| France | -2.5 | 1.5 | 1.6 | 1.8 | 0.1 | 1.7 | 2.1 | 1.7 |
| Germany | -4.7 | 3.5 | 2.5 | 2.1 | 0.2 | 1.2 | 2.2 | 1.5 |
| Greece | -2.0 | -4.5 | -3.0 | 1.1 | 1.4 | 4.7 | 2.5 | 0.5 |
| Ireland | -7.6 | -1.0 | 0.5 | 1.9 | -1.7 | -1.6 | 0.5 | 0.5 |
| Italy | -5.2 | 1.3 | 1.1 | 1.3 | 0.8 | 1.6 | 2.0 | 2.1 |
| Luxembourg | -3.7 | 3.4 | 3.0 | 3.1 | 0.4 | 2.3 | 3.5 | 1.7 |
| Malta | -3.4 | 3.6 | 2.5 | 2.2 | 1.8 | 2.0 | 3.0 | 2.6 |
| Netherlands | -3.9 | 1.7 | 1.5 | 1.5 | 1.0 | 0.9 | 2.3 | 2.2 |
| Portugal | -2.5 | 1.4 | -1.5 | -0.5 | -0.9 | 1.4 | 2.4 | 1.4 |
| Slovak Republic | -4.8 | 4.0 | 3.8 | 4.2 | 0.9 | 0.7 | 3.4 | 2.7 |
| Slovenia | -8.1 | 1.2 | 2.0 | 2.4 | 0.9 | 1.8 | 2.2 | 3.1 |
| Spain | -3.7 | -0.1 | 0.8 | 1.6 | -0.2 | 2.0 | 2.6 | 1.5 |
| Other EU advanced economies | | | | | | | | |
| Czech Republic | -4.1 | 2.3 | 1.7 | 2.9 | 1.0 | 1.5 | 2.0 | 2.0 |
| Denmark | -5.2 | 2.1 | 2.0 | 2.0 | 1.3 | 2.3 | 2.0 | 2.0 |
| Sweden | -5.3 | 5.5 | 3.8 | 3.5 | 2.0 | 1.9 | 2.0 | 2.0 |
| United Kingdom | -4.9 | 1.3 | 1.7 | 2.3 | 2.1 | 3.3 | 4.2 | 2.0 |
| EU emerging economies | | | | | | | | |
| Bulgaria | -5.5 | 0.2 | 3.0 | 3.5 | 2.5 | 3.0 | 4.8 | 3.7 |
| Hungary | -6.7 | 1.2 | 2.8 | 2.8 | 4.2 | 4.9 | 4.1 | 3.5 |
| Latvia | -18.0 | -0.3 | 3.3 | 4.0 | 3.3 | -1.2 | 3.0 | 1.7 |
| Lithuania | -14.7 | 1.3 | 4.6 | 3.8 | 4.4 | 1.2 | 3.1 | 2.9 |
| Poland | 1.7 | 3.8 | 3.8 | 3.6 | 3.5 | 2.6 | 4.1 | 2.9 |
| Romania | -7.1 | -1.3 | 1.5 | 4.4 | 5.6 | 6.1 | 6.1 | 3.4 |
| Non-EU advanced economies | | | | | | | | |
| Iceland | -6.9 | -3.5 | 2.3 | 2.9 | 12.0 | 5.4 | 2.6 | 2.6 |
| Israel | 0.8 | 4.6 | 3.8 | 3.8 | 3.3 | 2.7 | 3.0 | 2.5 |
| Norway | -1.4 | 0.4 | 2.9 | 2.5 | 2.2 | 2.4 | 1.8 | 2.2 |
| Switzerland | -1.9 | 2.6 | 2.4 | 1.8 | -0.5 | 0.7 | 0.9 | 1.0 |
| Other emerging economies | | | | | | | | |
| Albania | 3.3 | 3.5 | 3.4 | 3.6 | 2.2 | 3.6 | 4.5 | 3.5 |
| Belarus | 0.2 | 7.6 | 6.8 | 4.8 | 13.0 | 7.7 | 12.9 | 9.7 |
| Bosnia and Herzegovina | -3.1 | 0.8 | 2.2 | 4.0 | -0.4 | 2.1 | 5.0 | 2.5 |
| Croatia | -5.8 | -1.4 | 1.3 | 1.8 | 2.4 | 1.0 | 3.5 | 2.4 |
| Macedonia | -0.9 | 0.7 | 3.0 | 3.7 | -0.8 | 1.5 | 5.2 | 2.0 |
| Moldova | -6.0 | 6.9 | 4.5 | 4.8 | 0.0 | 7.4 | 7.5 | 6.3 |
| Montenegro | -5.7 | 1.1 | 2.0 | 3.5 | 3.4 | 0.5 | 3.1 | 2.0 |
| Russia | -7.8 | 4.0 | 4.8 | 4.5 | 11.7 | 6.9 | 9.3 | 8.0 |
| Serbia | -3.1 | 1.8 | 3.0 | 5.0 | 8.1 | 6.2 | 9.9 | 4.1 |
| Turkey | -4.7 | 8.2 | 4.6 | 4.5 | 6.3 | 8.6 | 5.7 | 6.0 |
| Ukraine | -14.8 | 4.2 | 4.5 | 4.9 | 15.9 | 9.4 | 9.2 | 8.3 |
| ***Memorandum*** | | | | | | | | |
| World | -0.5 | 5.0 | 4.4 | 4.5 | 2.5 | 3.7 | 4.5 | 3.4 |
| Advanced economies | -3.4 | 3.0 | 2.4 | 2.6 | 0.1 | 1.6 | 2.2 | 1.7 |
| Emerging and developing economies | 2.7 | 7.3 | 6.5 | 6.5 | 5.2 | 6.2 | 6.9 | 5.3 |
| United States | -2.6 | 2.8 | 2.8 | 2.9 | -0.3 | 1.6 | 2.2 | 1.6 |
| Japan | -6.3 | 3.9 | 1.4 | 2.1 | -1.4 | -0.7 | 0.2 | 0.2 |
| China | 9.2 | 10.3 | 9.6 | 9.5 | -0.7 | 3.3 | 5.0 | 2.5 |

Source: IMF, World Economic Outlook database.
[1] Average weighted by GDP valued at purchasing power parity.