Executive Summary

Europe's strengthening and broadening recovery . . .

. . . is contributing significantly to global growth.

The European recovery is strengthening and broadening appreciably. Real GDP growth is projected at 2.4 percent in 2017, up from 1.7 percent in 2016, before easing to 2.1 percent in 2018. These are large upward revisions—0.5 and 0.2 percentage point for 2017 and 2018, respectively—relative to the April *World Economic Outlook*. The European recovery is spilling over to the rest of the world, contributing significantly to global growth. In a few advanced and many emerging economies, unemployment rates have returned to precrisis levels. Most emerging market European economies are now seeing robust wage growth. In many parts of Europe, however, wage growth is sluggish despite falling unemployment.

Risks are more balanced now, but tilted to the downside in the medium term.

Risks appear more balanced over the near term, but are still tilted to the downside over the medium term. The recovery may be stronger than projected in the short run. But the sustainability of the rebound remains in question. Over the longer term, adverse demographic trends and subdued productivity are likely to hold back growth. The outlook is also subject to several important domestic and external downside risks.

Policymakers should take advantage of the recovery.

Reduce fiscal deficits where debt is high and support long-term growth where fiscal positions are strong.

Keep monetary policy accommodative in most countries.

Policymakers should take advantage of the improved prospects to rebuild fiscal buffers and enhance the economy's capacity to grow and absorb shocks. Many advanced and market emerging economies need to reduce still-elevated fiscal deficits in a growth-friendly way. This task is particularly important for those with high public debt, as interest rates will likely rise over time. For countries with stronger fiscal positions, available space should be used to lift growth potential and support structural reforms. For now, monetary policy can stay accommodative in most of Europe, given subdued inflation pressures. But where wages have accelerated, central banks should be ready to gradually withdraw stimulus to keep inflation expectations firmly anchored.

Structural policies need to reinvigorate convergence, which has slowed since the crisis, and increase growth potential. Priorities differ across countries.

Advance structural reforms to raise productivity and deal with crisis legacies.

For many advanced economies, faster progress on structural reforms is needed to raise productivity growth, for example, by making product markets more competitive and improving labor markets as well as education and training. Regarding crisis legacies, cleaning up the balance sheets of weak banks remains a priority.

More needs to be done to strengthen the European Union, notably the resilience of the euro area to shocks. This requires completing the banking and capital markets unions and building a euro area fiscal capacity to provide a macroeconomic stabilization mechanism. In parallel, action is needed to resolve banking sector legacies and strictly implement the common fiscal rules.

In emerging market economies, the business environment should be further improved. After a period of rapid catch-up, countries in the region have generally seen a significant slowdown in convergence with their more advanced peers in Europe. To reaccelerate convergence, the focus should be on the next generation of reforms, especially reforms of institutions and governance.

Institutions and governance are key for productivity and inclusive growth.

Institutions are key for growth, and the legal framework is a critical institution and a vital element of the business environment. Strong institutions are conducive to a level playing field that promotes competition, help retain and attract skilled people, and ensure that growth is inclusive and sustainable. Based on the experience of Central, Eastern, and Southeastern Europe in the past 25 years, Chapter 2 offers some insights on how countries could improve the effectiveness of their judiciary. Much progress was achieved, but setbacks also happened. A more equal distribution of resources and opportunities, stronger state capacity, and greater transparency resulted in more independent, impartial, and efficient justice systems. The European Union and the Council of Europe helped catalyze reforms, but their durability depended more on domestic factors. Moving forward, reforms should focus on strong competition policies, lower trade and entry barriers, and redistributive fiscal policies that expand opportunities. Public officials need to be selected and promoted strictly on merit. Besides guaranteeing freedom of information, transparency can be enhanced by providing information on government performance, the use of public resources, financial interests, and ownership structures.

Improving resource distribution, state capacity, and transparency fosters more effective justice systems.

Reducing high NPLs via supervisory action, enhanced bankruptcy and insolvency regimes, and speeding up court procedures will help boost credit and growth in the Western Balkans.

Chapter 3 discusses the specific banking challenges facing the Western Balkan economies. In many ways, banks in this region are still reeling from the effects of a boom and bust credit cycle. This legacy is constraining credit growth at a time when it is most needed. In most countries in the region, credit-to-GDP ratios are still below their potential and show little sign of improvement. Policymakers should act on several fronts. Nonperforming loans can be reduced and profitability increased through asset quality reviews and supervisory action plans. Funding bases can be enhanced through better communication with parent banks and home supervisors and by diversifying funding sources. Addressing weak bankruptcy and insolvency regimes, improving cadastral systems, and speeding up slow court procedures should help ease the structural impediments to credit growth.