Regional Economic Outlook: EUROPE
Securing Recovery
October 2009

Executive Summary

The current European recession, one of the deepest and longest on record, is showing signs of bottoming out. After gathering pace through early 2009, the contraction appears to have ended at mid-2009, helped by rebounding confidence and a tentative pickup in global trade. Headline inflation remains low, reflecting developments in commodity prices and weak demand, especially investment. In most emerging economies, economic activity and inflation have followed similar paths, but with more heterogeneity. Especially in countries that have experienced steep declines in capital inflows, the downturn is easing more slowly.

Although policy frameworks in Europe typically take a medium-term approach, policymakers adapted and moved steadily to address many of the policy and coordination challenges posed by the crisis. Interest rate cuts, unconventional monetary measures, and rapidly accumulating fiscal deficits helped put a floor under falling economic activity. And an array of financial sector interventions succeeded in dissipating systemic hazards and lifting risk appetite and asset prices, even though their implementation and coordination was complicated at first by the unprecedented nature of the crisis and the lack of established European processes for dealing with it.

The recovery is likely to be slow and fragile. Because of the ongoing rebalancing of global demand, Europe cannot count on exports alone to drive the recovery. At the same time, the drag from rising unemployment and scarcity of credit as banks continue to deleverage their balance sheets will weigh on economic activity. The risks around this baseline are broadly balanced. On the upside, the pickup in global trade could prove stronger and longer lasting than currently anticipated. On the downside, bad loans tied to the recession could further aggravate tensions in the financial sector. Moreover, overhangs of foreign currency-denominated debt in emerging Europe create vulnerabilities that could resonate across the continent through the highly integrated banking system and tight trade links. Another risk is tied to consumption, which could suffer if employment adjusted only slowly to the cycle, raising the prospect of a jobless recovery, with possibly negative repercussions for confidence, consumption, and investment.

Beyond the short run, the recovery is likely to be hampered by the impact of the crisis on potential output and Europe's well-known structural rigidities. Europe's medium-term growth outlook has been weakened by the drop in investment that followed the crisis, threats of increasing structural unemployment, and the end of financial sector, real estate, and construction booms in a number of countries (Chapter 2). While the exact impact of the crisis is hard to pin down and some of the developments affecting potential output are bound to correct themselves, others tie into long-standing European issues, such as high levels of employment protection and unrealized growth opportunities in the market for services, particularly in advanced economies.

Against this background, policymakers should focus their attention on securing a durable and strong recovery. In the near term, they should adopt a more resolute and proactive approach to assessing the balance sheet risks faced by banks, and take action to recapitalize or restructure viable institutions and resolve others. In addition, the welcome overhaul of the European Union's (EU) financial stability arrangements should be implemented swiftly to guarantee the effective coordination of financial supervision across borders, including that between emerging and advanced economies, and to guide the implementation of macroprudential regulation to guard against future financial sector risks. Fundamental progress on comprehensive cross-border crisis management is still needed, including the creation of tools for early intervention and cost-sharing rules.

At the same time, monetary and fiscal policy need to move carefully to sustain the upswing while preparing to disengage from the extraordinary measures put in place during the crisis. Although the fragility of the recovery requires fiscal policy to follow through with planned stimuli and letting automatic stabilizers work, sustainability concerns demand a strong consolidation effort—also because of the looming fiscal costs of Europe's rapidly aging population. Monetary policy will need to remain supportive for the time being and keep all options open. In the advanced economies, there might still be additional room for maneuver through a more forceful signal of the intent to keep interest rates low and the extension of nonstandard measures. But these policies are not without costs and raise the possibility of market dislocations, moral hazard, and accumulation of risks on the much-increased balance sheets of the central banks. Central banks should thus plan to exit as soon as the recovery takes hold.

Potential growth is tightly linked to all elements of the European policy agenda. Moving fast to repair the damage the crisis has caused to potential output will make for a more dynamic and robust recovery, which, among other things, will strengthen fiscal sustainability and ease exit problems. In the advanced economies, policymakers should pursue opportunities to reform labor and product markets and make every effort to rejuvenate the Lisbon Agenda. In most emerging economies, structural flexibility that allows a shift of resources and labor to the production of tradable goods and services will be important for ensuring further progress in catching up with income levels in the advanced economies, especially if capital flows to the emerging European economies remained subdued.

The uncertainty surrounding the size of the drop in potential output due to the crisis is considerable, and policymakers will need to take it into account (Chapter 3). Central banks must clearly communicate their views on the path of potential output and its implications for price stability to anchor inflation expectations and limit the costs of policy mistakes. Given the impact of the crisis on public finances, fiscal policy should err on the side of caution and start the necessary consolidation as soon as the state of the cycle allows.

The effects of the crisis are also likely to linger with respect to macroeconomic volatility in many emerging markets (Chapter 4). Financial markets have developed a keen eye for external and internal vulnerabilities. In particular, fiscal sustainability concerns, stemming partly from worries about the extent of problems in the financial sector, have triggered a decompression of interest rate spreads and have increased exchange rate volatility over and above the effects of the global shocks hitting the region. In the short run, policies to stabilize the financial sector and deal with foreign debt overhangs will be helpful. But to address the more lasting volatility shifts, policymakers will profit particularly from introducing frameworks that steady fiscal policy around a sustainable path and improve financial stability arrangements. Steps in this direction would also support growth through lowering perceived investor risk and interest rates.