Regional Economic Outlook: EUROPE
Fostering Sustainability
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Executive Summary

A moderate and uneven recovery is taking shape across Europe, supported by the rebound in global trade and policy stimulus. Europe's performance remains weak compared with the recoveries underway in other parts of the world; these differences largely reflect the legacy of the economic and financial crisis, which affected Europe more than other regions. The varying speed of recovery in advanced Europe, where many southern European economies continue to struggle, is closely linked to the degree of overheating and credit expansion going into the crisis. The even more varied speed of recovery in the economies of emerging Europe reflects country-specific vulnerabilities, external financing difficulties, and variations in their reliance on export demand. Inflationary pressures are subdued in advanced economies; but in emerging Europe, with its greater differences in exchange rate regimes and economic structures, the picture is again more mixed.

Unprecedented and often synchronized policy actions helped prevent a financial and economic meltdown and continue to support the upswing. Fiscal policy protected aggregate demand and private consumption from the full impact of the shock through discretionary stimulus and automatic stabilizers. An array of emergency monetary and financial measures averted a cascade of bank failures and contained systemic financial risk. In the most vulnerable and hard hit countries in emerging Europe, coordinated assistance from the IMF, the European Union (EU), and other multilateral institutions eased the inevitable adjustment to considerably tighter constraints on external financing. Large and front-loaded official financing measures allowed for more gradual corrections in the current account and smoother policy adjustments than would have been possible otherwise.

Growth is expected to pick up during 2010–11, but the traditional drivers of the recovery are likely to be weaker than usual. In the near term, growth will continue to benefit from exports, fiscal support (including from lagged stimulus measures such as infrastructure investment), and an upswing in inventories. Improvements in investor and consumer confidence should raise domestic demand. However, with unemployment expected to increase, and with lingering difficulties in the banking sector likely to restrain credit supply, consumption and investment will remain lackluster.

Risks to the overall outlook appear broadly balanced. On the downside, market concerns about sovereign liquidity and solvency in Greece, if unchecked, could turn into a larger sovereign debt crisis, potentially leading to some contagion. Another downside risk is a commodity price shock that could lead central banks to raise interest rates sooner than expected. On the upside, growth could be significantly higher if the continued dynamism of activity in the United States and in Asian and Latin American emerging economies boosts trade. In emerging Europe, a decrease in investors' risk appetite could discourage further monetary easing, while further deleveraging and persistently tight credit conditions could continue to depress domestic demand.

Although supportive macroeconomic policies are still needed to secure a self-sustaining recovery, the costs and limits of many crisis interventions are of growing concern. Such concerns are most prominent on the fiscal side, but they exist as well for monetary and financial policies. Aiming to stabilize public debt in the short run is neither feasible nor desirable, given the risk of a relapse into recession and the magnitude of the required fiscal retrenchment. However, sustainability indicators are flashing warning signs about the public debt in most countries, and sizable consolidation efforts are needed in the medium term. Although the required adjustments are not necessarily unprecedented, they often exceed current fiscal adjustment plans. For countries with already low fiscal credibility, more immediate consolidation is a must. In the monetary and financial areas, the onset of exit from crisis support reflects preestablished sunset clauses and normalized market conditions, which reduce the attractiveness of many emergency facilities. However, the persistence of blanket crisis measures in the financial sector still allows some banks to postpone restructuring and thereby prolongs underlying fragilities. Blanket guarantees and liquidity support must be gradually replaced by specific interventions in individual institutions.

Spillovers across policy areas and countries require the coordination and sequencing of the exit from crisis policies—particularly in the EU and the euro area. Without a coordinated approach, the withdrawal of enhanced deposit guarantees will trigger opportunistic capital flows in the EU's tightly integrated markets. Across policy areas, eliminating remaining banking sector problems will help normalize credit conditions, enhance the effectiveness of monetary policy, and aid the fiscal exit. The need for coordination is particularly great in the euro area, where cross-border and cross-policy spillovers are intertwined. Here, existing frameworks like the Excessive Deficit Procedure and the Stability and Growth Pact can be helpful, for example by serving as common anchors to medium-term plans for adjustment and exit in line with the principles endorsed by the G-20. However, the Greek crisis is a powerful reminder of long-standing gaps in the area's fiscal architecture. Filling those gaps will require a substantial strengthening of fiscal discipline in good times and the introduction of procedures to manage.

For emerging Europe, the key policy challenge will be attracting and harnessing healthy capital inflows to restore economic growth (Chapter 2). After a long period of relatively large and seemingly unstoppable inflows, the region saw capital inflows decelerate as the crisis took hold. The differential impact of the crisis across countries reflected variations in the factors that attracted excessive foreign capital before the crisis. In general, the countries hit the most had precrisis inflows that were the most in excess of what can be explained by structural factors, such as the degree of income convergence or the size and structure of their economies. Their economies often had features that tended to create the illusion of fiscal space—heavily managed exchange rates, booming credit markets, and overheated growth. As policymakers became increasingly worried about vulnerabilities associated with the surge of flows, they often resorted to prudential policies that were somewhat effective in moderating the size and composition of those flows.

These precrisis trends provide a number of important policy lessons. For countries that are already seeing a resumption of inflows, responsive macroeconomic policies will be critical to stemming an excessive surge. For countries with pegged exchange rates, the best response to inflows in excess of those driven by structural factors is to tighten fiscal policies. For countries without pegged exchange rates, the most effective response could be to let the currency appreciate. A freely floating exchange rate is also helpful in preventing excessive inflows and the accumulation of financial fragilities.

These macroeconomic policies should be accompanied by improvements in the financial stability of the increasingly integrated financial system in the region. Prudential tools such as capital requirements on foreign borrowing help to lower excessive inflows and related risks in banks. Higher risk weights on loans to certain sectors help build buffers in the banking system and prevent overheating of certain sectors. To sustain the resilience of the financial system, these tools need supportive macroeconomic policies and effective cross-border financial supervision.

Where capital inflows conducive to income convergence have yet to resume, policymakers will need to reorient the sources of economic growth toward the tradables sector. While this transformation would take place in the private sector, it will require support from policies to restore a balance between the nontradables and tradables sectors, improve intersectoral labor mobility, reduce skill mismatches, and address country-specific infrastructure bottlenecks.