Regional Economic Outlook: EUROPE
Navigating Stormy Waters
October 2011

Introduction and Overview

Following a barrage of unfavorable shocks in the first half of 2011, global economic activity has weakened and has become more uneven. A devastating earthquake and tsunami in Japan disrupted global manufacturing; the Arab spring drove up oil prices; financial strains in euro area financial and sovereign debt markets deepened; growth in the U.S. decelerated sharply; and the standoff about raising the ceiling on U.S. government debt sapped confidence in policy making. Against this backdrop, projections for global growth have been revised downward, especially for advanced economies. The October 2011 *World Economic Outlook* projects real GDP growth worldwide at 4.0 percent for 2011and 2012—about ½ percentage point lower than projected in the April 2011 edition.

In Europe, the recovery lost steam in the second quarter, after a surprisingly strong first quarter, with growth in many countries coming to a near stand-still. The deceleration was partly the result of global shocks, which affected mostly those countries in Europe that had benefited so far from the strong global recovery. Yet it was also the result of the escalation of the euro area crisis, which is having a more wide-spread effect on domestic demand, as the confidence shock spreads beyond the periphery to core countries' consumers, bankers, and investors.

This edition of the *Regional Economic Outlook* hence projects growth for all of Europe to slow down from 2.4 percent in 2010 to 2.3 percent in 2011, and further to 1.8 percent in 2012 (Table 1). Inflation is likely to decline from 4.2 percent in 2011 to 3.1 percent in 2012, amid remaining economic slack and commodity prices that retreat from their peaks in early 2011.

Real economic activity in advanced Europe is projected to expand by 1.6 percent in 2011 and 1.3 percent in 2012. In the wake of the global crisis in 2008/09, advanced European economies recovered at different speeds. Some economies experienced tepid growth, hindered by high private indebtedness, a burst in asset prices, weak credit owing to banks' funding difficulties and private-sector deleveraging, and lost competitiveness. Meanwhile, many others—such as Germany or Sweden—free from major imbalances, took advantage of their strong initial competitiveness positions to ride the global recovery wave in 2010, barely affected by the turmoil in the euro area periphery. This tiering is now fading, and the most recent indicators point to a general convergence toward low growth. Countries under market pressure will continue to suffer from deeper fiscal austerity measures, sharper private-sector balance sheet deleveraging, and more severe structural unemployment, with Portugal and Greece expected to remain in recession until mid-2012 and early 2013, respectively. In Italy

and Spain, higher interest costs on the sovereign debt, front-loaded fiscal adjustment, and increased tensions surrounding banks will constitute additional drags on already soft activity. Meanwhile, weaker global growth momentum will weigh on northern euro area countries, slowing the closing of their output gaps and the improvement of their labor markets. Germany, for instance, will see its growth pace halved from 2.7 percent in 2011 to 1.3 percent in 2012.

Growth in emerging Europe is projected to remain unchanged from last year—at 4.4 percent in 2011—and then to decline to 3.4 percent in 2012, as rebounds run their course and the global slowdown makes itself felt. Growth differentials within emerging Europe, which had been large in 2009 and 2010, are set to diminish. This reflects both a pickup in the Baltic countries and southeastern Europe—regions that had been most severely affected by the global crisis of 2008/09—and a slowdown of domestic demand growth in countries that hitherto expanded the fastest, such as Turkey and the European CIS countries. Nonetheless, significant differences remain in countries' cyclical positions—output gaps in Poland and Turkey are closed or positive, while activity of many other countries has yet to return to precrisis levels.

Given persistent tensions in euro area sovereign markets and global weaknesses, downside risks remain particularly acute. Renewed concerns about policy slippages in program countries or lack of commitment to continued support of program countries at the euro area level could amplify the shockwaves seen during the 2011 summer throughout the euro area with adverse repercussions regionally and globally. Although substantial amounts of capital were raised ahead of this summer's stress tests, capital buffers remain low in a significant number of euro area financial institutions, which reduces their ability to cope with shocks. Funding could dry up, jeopardizing the functioning of the financial system, at a time when banks and sovereigns are facing major rollover requirements. Compounding the intra-euro area stresses, a further setback in global growth would also generate negative spillovers.

With growth momentum waning and financial tensions rising, policy adjustments are called for. The withdrawal of monetary support, or monetary tightening in the cyclically more advanced economies, will need to be paused or even reversed in cases where downside risks to inflation and growth persist. While the deteriorated state of public finances, and renewed market concerns over sovereign debt, leave no option but to strengthen fiscal positions, the slowdown in growth is calling for caution. Where pressures are most severe, the consolidation should continue to be front-loaded—intensifying market pressures is hardly an option. In other countries, where medium-term fiscal consolidation plans are credible or have been front-loaded, there may be room to allow automatic stabilizers to work fully to deal with growth surprises.

Crisis management in the euro area needs to go beyond its current approach to secure success. Euro area leaders need to spell out and recommit to a common vision of how the

euro area is expected to function in the future. This is essential to anchor market expectations and dispel the prevailing uncertainty. Overall, a definite strengthening of fiscal and economic governance of the monetary union is needed. While strengthening national budgetary rules, countries will need to cede some control over their fiscal position to a central euro area body. Increased ex-ante fiscal risk sharing is likely to be necessary together with a common approach and backstop to the financial system of the euro area.

A number of actions to deal with the crisis should be undertaken urgently. Implementation of the July 21 EU summit decisions should be accelerated. More comprehensive actions toward restructuring and front-loaded strengthening of banks' capital buffers are also needed, as uncertainties surrounding bank balance sheets continue to rattle investors. Ideally, capital should be raised through private solutions including cross-border consolidations. In the absence of these measures, supervisors will have to make the case either for injecting public funds into weak banks—which will be difficult in an environment of fiscal consolidation—or closing them down. Ending the intertwining of sovereign and bank balance sheets stresses ultimately requires a European Resolution Authority, backed by a common deposit guarantee and resolution fund.

An escalation of the strains in euro area debt markets also poses risks for emerging Europe, considering its tight economic and financial linkages with advanced Europe together with fragilities stemming from the 2008/09 crisis. Policy makers will need to make headway with repairing public finances, including through strengthening fiscal frameworks to underwrite lasting fiscal discipline. Addressing high ratios of non-performing bank loans is another priority to improve conditions for new lending and reduce economic drag from overextended borrowers more generally.

Raising growth rates in slow growing countries would help address many of Europe's pressing problems, not least lingering concerns about the longer-term sustainability of public finances. In the past decade, growth rates in GDP per capita have differed markedly among European countries, from zero in Italy and Portugal to more than 4 percent in the best performers. To a large extent, growth differentials reflect convergence. However, a number of countries have grown less than their potential because of poor macroeconomic policies and barriers to growth. Heavily regulated goods and labor markets and inadequate institutions and macroeconomic policies have kept some countries less flexible, less competitive, and less integrated into the global economy than their better-performing peers, and this explains much of their inferior growth performance. Escaping low-growth traps is not easy, but the experience of the Netherlands and Sweden in the 1980s and 1990s demonstrates that it can be done. Reforms should be comprehensive, addressing both macroeconomic imbalances and structural problems, not only because both matter but also because reforms can be mutually reinforcing. Implementing reforms takes time and the rewards become visible only with some delay, but the long-term impact can be substantial.

The successful integration of emerging Europe has led to increasing spillovers between advanced and emerging Europe. Emerging Europe is now one of the most dynamic markets for advanced Europe's exports; production chains have become highly integrated across borders; and western European banks have come to dominate emerging Europe's banking systems. The growing interaction has benefited both regions, but it has also meant that shocks in one region increasingly affect the other, with spillovers progressively traveling both ways. Financial and trade spillovers interact, as shocks to financial flows from west to east are soon felt in trade flows. Spillovers may complicate economic policy making, but such challenges should not detract from the fundamental benefits of economic and financial integration.

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. Growth differentials in Europe are analyzed in Chapter 3, and linkages between advanced and emerging Europe are discussed in Chapter 4. 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]	-4.6	2.4	2.3	1.8	2.7	3.0	4.2	3.1
Advanced European economies[1]	-4.1	1.7	1.6	1.3	0.7	1.9	2.8	1.7
Emerging European economies[1]	-6.0	4.4	4.4	3.4	8.5	6.3	7.9	6.8
European Union[1]	-4.2	1.8	1.7	1.4	0.9	2.0	3.0	1.8
Euro area	-4.3	1.8	1.6	1.1	0.3	1.6	2.5	1.5
Austria	-3.9	2.1	3.3	1.6	0.4	1.7	3.2	2.2
Belgium	-2.7	2.1	2.4	1.5	0.0	2.3	3.2	2.0
Cyprus	-1.7	1.0	0.0	1.0	0.2	2.6	4.0	2.4
Estonia	-13.9	3.1	6.5	4.0	-0.1	2.9	5.1	3.5
Finland	-8.2	3.6	3.5	2.2	1.6	1.7	3.1	2.0
France	-2.6	1.4	1.7	1.4	0.1	1.7	2.1	1.4
Germany	-5.1	3.6	2.7	1.3	0.2	1.2	2.2	1.3
Greece	-2.3	-4.4	-5.0	-2.0	1.3	4.7	2.9	1.0
Ireland	-7.0	-0.4	0.4	1.5	-1.7	-1.6	1.1	0.6
Italy	-5.2	1.3	0.6	0.3	0.8	1.6	2.6	1.6
Luxembourg	-3.6	3.5	3.6	2.7	0.4	2.3	3.6	1.4
Malta	-3.3	3.1	2.4	2.2	1.8	2.0	2.6	2.3
Netherlands	-3.5	1.6	1.6	1.3	1.0	0.9	2.5	2.0
Portugal	-2.5	1.3	-2.2	-1.8	-0.9	1.4	3.4	2.1
Slovak Republic	-4.8	4.0	3.3	3.3	0.9	0.7	3.6	1.8
Slovenia	-8.1	1.2	1.9	2.0	0.9	1.8	1.8	2.1
Spain	-3.7	-0.1	0.8	1.1	-0.2	2.0	2.9	1.5
Other EU advanced economies								
Czech Republic	-4.1	2.3	2.0	1.8	1.0	1.5	1.8	2.0
Denmark	-5.2	1.7	1.5	1.5	1.3	2.3	3.2	2.4
Sweden	-5.3	5.7	4.4	3.8	2.0	1.9	3.0	2.5
United Kingdom	-4.9	1.4	1.1	1.6	2.1	3.3	4.5	2.4
EU emerging economies								
Bulgaria	-5.5	0.2	2.5	3.0	2.5	3.0	3.8	2.9
Hungary	-6.7	1.2	1.8	1.7	4.2	4.9	3.7	3.0
Latvia	-18.0	-0.3	4.0	3.0	3.3	-1.2	4.2	2.3
Lithuania	-14.7	1.3	6.0	3.4	4.2	1.2	4.2	2.6
Poland	1.6	3.8	3.8	3.0	3.5	2.6	4.0	2.8
Romania	-7.1	-1.3	1.5	3.5	5.6	6.1	6.4	4.3
Non-EU advanced economies								
Iceland	-6.9	-3.5	2.5	2.5	12.0	5.4	4.2	4.5
Israel	0.8	4.8	4.8	3.6	3.3	2.7	3.4	1.6
Norway	-1.7	0.3	1.7	2.5	2.2	2.4	1.7	2.2
Switzerland	-1.9	2.7	2.1	1.4	-0.5	0.7	0.7	0.9
Other emerging economies								
Albania	3.3	3.5	2.5	3.5	2.2	3.6	3.9	3.5
Belarus	0.2	7.6	5.0	1.2	13.0	7.7	41.0	35.5
Bosnia and Herzegovina	-2.9	0.7	2.2	3.0	-0.4	2.1	4.0	2.5
Croatia	-6.0	-1.2	0.8	1.8	2.4	1.0	3.2	2.4
Macedonia	-0.9	1.8	3.0	3.7	-0.8	1.5	4.4	2.0
Moldova	-6.0	6.9	7.0	4.5	0.0	7.4	7.9	7.8
Montenegro	-5.7	1.1	2.0	3.5	3.4	0.5	3.1	2.0
Russia	-7.8	4.0	4.3	4.1	11.7	6.9	8.9	7.3
Serbia	-3.5	1.0	2.0	3.0	8.1	6.2	11.3	4.3
Turkey	-4.8	8.9	6.6	2.2	6.3	8.6	6.0	6.9
Ukraine	-14.8	4.2	4.7	4.8	15.9	9.4	9.3	9.1
Memorandum								
World	-0.7	5.1	4.0	4.0	2.5	3.7	5.0	3.7
Advanced economies	-3.7	3.1	1.6	1.9	0.1	1.6	2.6	1.4
Emerging and developing economies	2.8	7.3	6.4	6.1	5.2	6.1	7.5	5.9
United States	-3.5	3.0	1.5	1.8	-0.3	1.6	3.0	1.2
Japan	-6.3	4.0	-0.5	2.3	-1.4	-0.7	-0.4	-0.5
China	9.2	10.3	9.5	9.0	-0.7	3.3	5.5	3.3

Source: IMF, *World Economic Outlook*.

[1] Average weighted by GDP valued at purchasing power parity.