Regional Economic Outlook: EUROPE
Building confidence
October 2010

Introduction and Overview

Europe is recovering from its deepest recession in the postwar period. Following a 4.6 percent contraction in 2009, GDP is projected to increase by 2.3 percent in 2010 and 2.2 percent in 2011 (Table 1). With the exception of Greece and Portugal, growth in all countries will be positive next year—a stark difference from 2009, when only Albania, Belarus, Israel, and Poland saw positive growth.

The recovery in Europe has been boosted by the resurgence of the world economy. Global GDP growth is approaching precrisis growth rates (4.8 percent in 2010 and 4.2 in 2011), and European exports are benefiting. Export growth is especially strong in countries that export capital goods, which had earlier seen a very steep drop in external demand. Germany grew at an annualized rate of 9 percent in the second quarter, driving a resurgence of exports from its main suppliers—including in emerging Europe.

Advanced Europe is projected to grow by 1.7 percent in 2010 and 1.6 percent in 2011 (Chapter 1). The eruption of sovereign troubles in early 2010 threatened confidence and shook a still weak financial system. Yet, as the euro weakened and global stock markets tumbled, policy actions helped contain the problem and the recovery endured. Despite recent strength, however, the upswing in advanced Europe is projected to remain weak by historical standards and also compared with other advanced economies. In part, these growth differentials are due to the lingering impact of the crisis and the accelerating fiscal adjustment in 2011. But they also reflect well-known structural rigidities in the labor, product, and services markets that will limit the euro area's potential growth now that the inventory cycle has run its course.

Although the outlook has brightened, significant risks remain. The surprisingly strong growth in the first half of 2010 could continue longer than expected and provide an additional short-term thrust to the recovery by boosting private demand. Activity in the United States or emerging Asia might still exceed expectations and keep exports up. At the same time, however, global growth could very well turn out to be weaker than predicted, with a tail risk of a double-dip recession. Renewed volatility in European financial and sovereign markets is also a possibility.

Table 1. European Countries: Real GDP Growth and CPI Inflation, 2007–11

(Percent)

	Real GDP Growth					Average CPI Inflation				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Europe[1]	4.0	1.4	-4.6	2.3	2.2	3.6	5.7	2.7	2.9	2.8
Advanced European economies[1]	3.0	0.5	-4.0	1.7	1.6	2.1	3.4	0.7	1.8	1.7
Emerging European economies[1]	7.0	4.1	-6.0	3.9	3.8	7.8	12.0	8.5	6.1	6.1
European Union[1]	3.2	0.8	-4.1	1.7	1.7	2.4	3.7	0.9	1.9	1.8
Euro area	2.9	0.5	-4.1	1.7	1.5	2.1	3.3	0.3	1.6	1.5
Austria	3.7	2.2	-3.9	1.6	1.6	2.2	3.2	0.4	1.5	1.7
Belgium	2.8	0.8	-2.7	1.6	1.7	1.8	4.5	0.0	2.0	1.9
Cyprus	5.1	3.6	-1.7	0.4	1.8	2.2	4.4	0.2	2.2	2.3
Finland	5.3	0.9	-8.0	2.4	2.0	1.6	3.9	1.6	1.4	1.8
France	2.3	0.1	-2.5	1.6	1.6	1.6	3.2	0.1	1.6	1.6
Germany	2.7	1.0	-4.7	3.3	2.0	2.3	2.8	0.2	1.3	1.4
Greece	4.5	2.0	-2.0	-4.0	-2.6	3.0	4.2	1.4	4.6	2.2
Ireland	5.6	-3.5	-7.6	-0.3	2.3	2.9	3.1	-1.7	-1.6	-0.5
Italy	1.5	-1.3	-5.0	1.0	1.0	2.0	3.5	0.8	1.6	1.7
Luxembourg	6.5	0.0	-4.1	3.0	3.1	2.3	3.4	0.4	2.3	1.9
Malta	3.7	2.6	-2.1	1.7	1.7	0.7	4.7	1.8	1.9	2.1
Netherlands	3.9	1.9	-3.9	1.8	1.7	1.6	2.2	1.0	1.3	1.1
Portugal	2.4	0.0	-2.6	1.1	0.0	2.4	2.7	-0.9	0.9	1.2
Slovak Republic	10.6	6.2	-4.7	4.1	4.3	1.9	3.9	0.9	0.7	1.9
Slovenia	6.8	3.5	-7.8	0.8	2.4	3.6	5.7	0.9	1.5	2.3
Spain	3.6	0.9	-3.7	-0.3	0.7	2.8	4.1	-0.2	1.5	1.1
Other EU advanced economies										
Czech Republic	6.1	2.5	-4.1	2.0	2.2	2.9	6.3	1.0	1.6	2.0
Denmark	1.7	-0.9	-4.7	2.0	2.3	1.7	3.4	1.3	2.0	2.0
Sweden	3.3	-0.4	-5.1	4.4	2.6	1.7	3.3	2.0	1.8	1.9
United Kingdom	2.7	-0.1	-4.9	1.7	2.0	2.3	3.6	2.1	3.1	2.5
EU emerging economies[1]	6.0	4.4	-3.0	1.6	2.9	4.6	6.5	3.9	3.2	3.1
Bulgaria	6.2	6.0	-5.0	0.0	2.0	7.6	12.0	2.5	2.2	2.9
Estonia	6.9	-5.1	-13.9	1.8	3.5	6.6	10.4	-0.1	2.5	2.0
Hungary	1.0	0.6	-6.3	0.6	2.0	7.9	6.1	4.2	4.7	3.3
Latvia	10.0	-4.2	-18.0	-1.0	3.3	10.1	15.3	3.3	-1.4	0.9
Lithuania	9.8	2.8	-14.8	1.3	3.1	5.8	11.1	4.2	1.0	1.3
Poland	6.8	5.0	1.7	3.4	3.7	2.5	4.2	3.5	2.4	2.7
Romania	6.3	7.3	-7.1	-1.9	1.5	4.8	7.8	5.6	5.9	5.2
Non-EU advanced economies										
Iceland	6.0	1.0	-6.8	-3.0	3.0	5.0	12.4	12.0	5.9	3.5
Israel	5.3	4.2	0.8	4.2	3.8	0.5	4.6	3.3	2.3	2.8
Norway	2.7	0.8	-1.4	0.6	1.8	0.7	3.8	2.2	2.5	1.4
Switzerland	3.6	1.9	-1.9	2.9	1.7	0.7	2.4	-0.5	0.7	0.5
Other emerging economies										
Albania	5.9	7.7	3.3	2.6	3.2	2.9	3.4	2.2	3.4	2.9
Belarus	8.6	10.2	0.2	7.2	6.2	8.4	14.8	13.0	7.3	10.8
Bosnia and Herzegovina	6.1	5.7	-3.1	0.5	3.0	1.5	7.4	-0.4	2.4	2.5
Croatia	5.5	2.4	-5.8	-1.5	1.6	2.9	6.1	2.4	1.9	2.8
Kosovo	4.0	5.4	4.0	4.6	5.9	4.4	9.4	-2.4	1.7	3.2
Macedonia	6.1	5.0	-0.8	1.2	3.0	2.3	8.3	-0.8	1.9	3.0
Moldova	3.0	7.8	-6.5	3.2	3.5	12.4	12.7	0.0	7.4	6.0
Montenegro	10.7	6.9	-5.7	-1.8	4.5	4.2	8.5	3.4	0.6	1.0
Russia	8.5	5.2	-7.9	4.0	4.3	9.0	14.1	11.7	6.6	7.4
Serbia	6.9	5.5	-3.0	1.5	3.0	6.5	12.4	8.1	4.6	4.4
Turkey	4.7	0.7	-4.7	7.8	3.6	8.8	10.4	6.3	8.7	5.7
Ukraine	7.9	2.1	-15.1	3.7	4.5	12.8	25.2	15.9	9.8	10.8

Source: IMF, World Economic Outlook database.

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

In view of these risks, it will be crucial to get policies right. Fiscal consolidation, while inevitable, should be undertaken in a way that minimizes the negative impact on growth; monetary policy must steer carefully between the need to normalize policies on the one hand and the necessity to mitigate sovereign market volatility and ensure bank liquidity on the other; and the recent checkup of European banks must be followed by rapid action to eliminate remaining weaknesses in balance sheets while continuing to safeguard lending capacity. In addition, if the confidence of financial markets, consumers, and investors is to be stabilized beyond the short term, the governance of the European Union (EU) and the euro area will need to be fundamentally improved.

Emerging Europe is also recovering, growing by 3.9 percent in 2010 and 3.8 percent in 2011 (Chapter 2). Emerging Europe had been hit hard by the global crisis, as it was affected not only through lower exports, but also through a sharp drop in capital inflows, which brought an end to the domestic demand boom that many countries had experienced in the precrisis years. The region is now recovering on the back of resurgent exports, but domestic demand remains subdued, particularly in countries where the deflation of precrisis asset and credit booms has been most severe.

The outlook in emerging Europe will depend crucially on developments in Western Europe. Renewed turmoil in Western Europe could affect emerging Europe not only through trade channels; it could also hurt capital flows to the region and domestic credit growth, which would further weaken domestic demand.

Policymakers in emerging Europe face the difficult challenge of dealing with the legacies of the crisis while not hurting the recovery. Headline fiscal deficits rose sharply during the crisis, and have remained high in 2010. To a large extent, these deficits are structural: although headline deficits were low in most countries before the crisis, a temporary boom in revenues masked the underlying deterioration that resulted from the rapid growth of public expenditure. Credit growth has been weak since the onset of the crisis. This is the result of lower capital transfers from advanced Europe, increasing nonperforming loans (NPLs)—which necessitate an increase in provisioning—and weak demand. With demand for credit now recovering, public policies could reduce supply side constraints on credit growth by reducing uncertainty about macroeconomic policy. Credible fiscal consolidation plans could help preempt sovereign debt concerns, which would be particularly damaging in countries where banks have substantial exposure to sovereigns. Beyond the short term, the region will need to find new growth engines, as the growth model of the boom years—driven by capital inflows, rapid credit growth, and domestic demand booms—will need to shift toward greater reliance on the tradable sector as an engine of growth.

Although the crisis in emerging Europe has been deep, the banking and currency crises that many had initially feared have largely been avoided—the result of strong domestic policy responses, rapid and large-scale financing packages of international institutions, and

the continued support of Western banks (Chapter 3). The boom-bust cycle provides important lessons in crisis prevention. Although the crisis in emerging Europe was triggered by external factors (the recession in advanced Europe and the sudden stop in capital inflows), domestic imbalances and vulnerabilities played a key role. Indeed, countries that have largely managed to avoid the capital-inflows-driven credit and domestic demand booms have had a much less severe recession.