World Economic and Financial Surveys

Regional Economic Outlook

Europe

Strengthening the Recovery

MAY 11

INTERNATIONAL MONETARY FUND

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Cataloging-in-Publication Data

Regional economic outlook. Europe. – Washington, D.C. :
International Monetary Fund, 2007-

v. ; cm. – (World economic and financial surveys, 0258-7440)

Twice a year.
Began with Nov. 07 issue.
Some issues have also thematic titles.

1. Economic forecasting – Europe – Periodicals. 2. Europe – Economic conditions – 1945 – Periodicals. I. Title: Europe. II. International Monetary Fund. III. Series: World economic and financial surveys.

HC241.A1 R445

ISBN-13 978-1-61635-063-5

Please send orders to:
International Monetary Fund
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Introduction and Overview

The global recovery is gaining strength, though significant downside risks could still come into play. The April 2011 *World Economic Outlook* projects world real GDP growth of 4½ percent in 2011 and 2012, following last year's slightly stronger 5 percent pace. Emerging and developing economies are expected to expand markedly faster—at 6½ percent—than the more sluggish rate of 2½ percent projected for advanced economies. This growth setting, and the accommodative monetary policies of the major central banks, revived capital flows to emerging economies. It also conspired—in concert with adverse supply shocks and concerns about political unrest in the Middle East and North Africa—to drive up commodity prices close to levels reached before the 2008–09 crisis. Key downside risks include (i) oil prices exceeding those currently predicted by futures markets; (ii) significant fiscal and financial vulnerabilities lurking behind recent benign market developments, especially in the euro area; and (iii) overheating in emerging market economies.

Against this backdrop, Europe's recovery is expected to solidify. This edition of the *Regional Economic Outlook* puts growth for all of Europe at 2.4 and 2.6 percent for 2011 and 2012, respectively, after 2.4 percent last year (Table 1). In the baseline, inflation is likely to pick up to 3.8 percent this year on the back of the economic upturn and buoyant commodity prices before easing back to 3 percent in 2012. This path assumes that the large increase in food and energy prices remains temporary and does not trigger generalized inflation through second-round effects, obviating the need for sharp monetary tightening, which could hurt the recovery.

Real activity in advanced Europe is projected to expand by 1.7 and 1.9 percent this year and next, compared with 1.7 percent in 2010. The landscape should continue to be varied within advanced Europe, though private demand is expected to continue to strengthen in the core euro area and the Nordic countries, largely offsetting the impact of fiscal consolidation on growth, while remaining weak in Greece, Ireland, Portugal, and Spain, where efforts to work off large precrisis imbalances persist. The Greek and Portuguese economies are projected to be in recession this year.

Growth in emerging Europe is expected to be stronger, at 4.3 percent in 2011 and 2012, after 4.2 percent in 2010.[1] The recovery is set to broaden as domestic demand takes over as the main pillar of growth and all countries post positive growth for the first time since the 2008–09 crisis. Nonetheless, large differences in cyclical positions, capital inflows, current account balances, and inflationary pressures remain.

The recoveries in advanced and emerging Europe are likely to be mutually reinforcing as the continent benefits from the symbiotic relationship between its two parts, with advanced Europe continuing to absorb the lion's share of emerging Europe's exports. In parallel, faster-growing emerging Europe's importance as a market for advanced Europe's firms will expand. But the biggest growth potential derives from building cross-border production chains based on national comparative advantage in a diverse, yet compact, geographical area with vastly improved institutions. German firms are in the lead in this effort. Imports from emerging Europe rose to account for 12 percent of Germany's imports, compared with their 8 percent share in the rest of advanced Europe. Both shares are still small, leaving ample room for further intraregional integration.

The main risk to the outlook for Europe arises from tensions in the euro area periphery. Other global worries also pose risks, although concerns about overheating in the emerging economies of the continent are more muted than in other regions.

[1] For purposes of the *Regional Economic Outlook*, emerging Europe comprises (i) central and southeastern Europe with the exception of the Czech Republic and countries that have adopted the euro, (ii) the European Commonwealth of Independent States (CIS) countries, and (iii) Turkey.

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]	-4.5	2.4	2.4	2.6	2.7	3.0	3.8	3.0
Advanced European economies[1]	-4.0	1.7	1.7	1.9	0.7	1.9	2.5	1.8
Emerging European economies[1]	-5.9	4.2	4.3	4.3	8.5	6.3	7.3	6.2
European Union[1]	-4.1	1.8	1.8	2.1	0.9	2.0	2.7	1.9
Euro area	-4.1	1.7	1.6	1.8	0.3	1.6	2.3	1.7
Austria	-3.9	2.0	2.4	2.3	0.4	1.7	2.5	2.0
Belgium	-2.7	2.0	1.7	1.9	0.0	2.3	2.9	2.3
Cyprus	-1.7	1.0	1.7	2.2	0.2	2.6	3.9	2.8
Estonia	-13.9	3.1	3.3	3.7	-0.1	2.9	4.7	2.1
Finland	-8.2	3.1	3.1	2.5	1.6	1.7	3.0	2.1
France	-2.5	1.5	1.6	1.8	0.1	1.7	2.1	1.7
Germany	-4.7	3.5	2.5	2.1	0.2	1.2	2.2	1.5
Greece	-2.0	-4.5	-3.0	1.1	1.4	4.7	2.5	0.5
Ireland	-7.6	-1.0	0.5	1.9	-1.7	-1.6	0.5	0.5
Italy	-5.2	1.3	1.1	1.3	0.8	1.6	2.0	2.1
Luxembourg	-3.7	3.4	3.0	3.1	0.4	2.3	3.5	1.7
Malta	-3.4	3.6	2.5	2.2	1.8	2.0	3.0	2.6
Netherlands	-3.9	1.7	1.5	1.5	1.0	0.9	2.3	2.2
Portugal	-2.5	1.4	-1.5	-0.5	-0.9	1.4	2.4	1.4
Slovak Republic	-4.8	4.0	3.8	4.2	0.9	0.7	3.4	2.7
Slovenia	-8.1	1.2	2.0	2.4	0.9	1.8	2.2	3.1
Spain	-3.7	-0.1	0.8	1.6	-0.2	2.0	2.6	1.5
Other EU advanced economies								
Czech Republic	-4.1	2.3	1.7	2.9	1.0	1.5	2.0	2.0
Denmark	-5.2	2.1	2.0	2.0	1.3	2.3	2.0	2.0
Sweden	-5.3	5.5	3.8	3.5	2.0	1.9	2.0	2.0
United Kingdom	-4.9	1.3	1.7	2.3	2.1	3.3	4.2	2.0
EU emerging economies								
Bulgaria	-5.5	0.2	3.0	3.5	2.5	3.0	4.8	3.7
Hungary	-6.7	1.2	2.8	2.8	4.2	4.9	4.1	3.5
Latvia	-18.0	-0.3	3.3	4.0	3.3	-1.2	3.0	1.7
Lithuania	-14.7	1.3	4.6	3.8	4.4	1.2	3.1	2.9
Poland	1.7	3.8	3.8	3.6	3.5	2.6	4.1	2.9
Romania	-7.1	-1.3	1.5	4.4	5.6	6.1	6.1	3.4
Non-EU advanced economies								
Iceland	-6.9	-3.5	2.3	2.9	12.0	5.4	2.6	2.6
Israel	0.8	4.6	3.8	3.8	3.3	2.7	3.0	2.5
Norway	-1.4	0.4	2.9	2.5	2.2	2.4	1.8	2.2
Switzerland	-1.9	2.6	2.4	1.8	-0.5	0.7	0.9	1.0
Other emerging economies								
Albania	3.3	3.5	3.4	3.6	2.2	3.6	4.5	3.5
Belarus	0.2	7.6	6.8	4.8	13.0	7.7	12.9	9.7
Bosnia and Herzegovina	-3.1	0.8	2.2	4.0	-0.4	2.1	5.0	2.5
Croatia	-5.8	-1.4	1.3	1.8	2.4	1.0	3.5	2.4
Macedonia	-0.9	0.7	3.0	3.7	-0.8	1.5	5.2	2.0
Moldova	-6.0	6.9	4.5	4.8	0.0	7.4	7.5	6.3
Montenegro	-5.7	1.1	2.0	3.5	3.4	0.5	3.1	2.0
Russia	-7.8	4.0	4.8	4.5	11.7	6.9	9.3	8.0
Serbia	-3.1	1.8	3.0	5.0	8.1	6.2	9.9	4.1
Turkey	-4.7	8.2	4.6	4.5	6.3	8.6	5.7	6.0
Ukraine	-14.8	4.2	4.5	4.9	15.9	9.4	9.2	8.3
Memorandum								
World	-0.5	5.0	4.4	4.5	2.5	3.7	4.5	3.4
Advanced economies	-3.4	3.0	2.4	2.6	0.1	1.6	2.2	1.7
Emerging and developing economies	2.7	7.3	6.5	6.5	5.2	6.2	6.9	5.3
United States	-2.6	2.8	2.8	2.9	-0.3	1.6	2.2	1.6
Japan	-6.3	3.9	1.4	2.1	-1.4	-0.7	0.2	0.2
China	9.2	10.3	9.6	9.5	-0.7	3.3	5.0	2.5

Source: IMF, *World Economic Outlook.*

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

Strong policy responses have successfully contained the sovereign debt and financial sector troubles in the euro area periphery so far, but contagion to the core euro area, and then onward to emerging Europe, remains a tangible downside risk. Negative feedback loops between concerns about the stability of government and bank balance sheets are proving difficult to break. And concerns about weak fiscal and financial sector balance sheets extend beyond the euro area periphery. In emerging Europe, public finances have also sharply deteriorated and banks are burdened by large numbers of nonperforming loans. Emerging Europe suffered disproportionately in the 2008–09 crisis, so output gaps generally remain negative—only Belarus and Turkey are growing very fast. Inflationary pressures from high commodity prices pose challenges for policymakers, especially where output gaps are closing, food and energy prices account for a large share in the consumer price index (CPI), and central banks' credibility is less firmly established.

Dealing decisively with the financial tensions in the euro area requires comprehensive and bold policy action. The stakes are high. Unrelenting reform efforts at the national level of the crisis-afflicted countries need to be the first line of defense. Restoring fiscal health, squarely addressing weak banks, and implementing structural reforms to restore competitiveness are key. Further strengthening the European Union-wide crisis management framework is critical to securing a successful overall outcome. The European Union (EU) decisions of this March are certainly welcome, but challenges now lie in their implementation.

Restoring confidence in the euro area's banking system is a prerequisite to turning the page on the crisis. The upcoming round of strong, broad, and transparent stress tests provides an opportunity to address remaining vulnerabilities. But to be effective, the stress tests need to be followed by credible restructuring and recapitalization programs. Efforts to strengthen the banking systems in vulnerable countries will need to accelerate, and policies to promote deeper integration of the EU financial system—including cross-border merger and acquisitions—should be part of the solution too, buttressed by further progress in strengthening pan-European institutions and governance. In emerging Europe, the main concern is mounting nonperforming loans, while capitalization appears comfortable for now. A second wave of bank consolidation and the prospective introduction of Basel III offer opportunities to strengthen the sector.

Fiscal consolidation and bank balance sheet repair are critical to defusing downside risks. Public debt sustainability is vital to an enduring solution for the financial tensions in the euro area and to breaking negative feedback loops between sovereign and banking sector instability. Countries under market pressure have appropriately front-loaded their fiscal adjustments, which they now must see through. Other countries can afford to phase in fiscal consolidation more gradually, but a coherent and credible consolidation strategy embedded in a medium-term framework is still necessary for rebuilding fiscal buffers and quelling ever-rising public debt ratios. In emerging Europe, reducing fiscal vulnerabilities is equally important. Key fiscal indicators have deteriorated more than in other emerging economies and now often exceed prudent thresholds. Moreover, where inflation is becoming a concern, consolidation is also called for from a demand-management perspective.

Monetary policy in the euro area can afford to remain relatively accommodative, though normalization lies ahead as economic slack gradually dissipates. Reemerging inflation risks pose an additional challenge. In emerging Europe, inflation is running above target in many countries and second-round effects are harder to stave off. Tightening cycles are already under way and fiscal policy should support them.

The euro area-wide safety net is being strengthened to address financial tensions and to avoid future crises. Commitments have been made to improving lending capacity and pricing under the European Financial Stability Facility (EFSF). Making those commitments operational by filling in the still-missing specifics is now essential. The permanent successor arrangement, the European

Stability Mechanism (ESM), is taking shape, and is appropriately larger and more flexible than the original EFSF. A revamped Stability and Growth Pact (SGP) and the new Excessive Imbalances Procedure (EIP) strengthen crisis prevention.

Looking at the crises in the euro area periphery, and in emerging Europe, more broadly in the aftermath of the Lehman Brothers collapse reveals common patterns and suggests a number of policy lessons. Financial integration in the wake of euro adoption contributed to strong cross-border capital flows into government debt, interbank markets, and the nontradable sector. Government bond yields quickly converged across the euro area, banks' cross-border exposures built up, and the nontradable sector boomed. Policymakers failed to confront asset price bubbles forcefully in the relatively protected nontradable sector, further boosting its perceived profitability. After many years of ever-higher current account deficits and eroding competitiveness, financing abruptly dried up, plunging the economies into deep recessions. Large adjustment needs, high indebtedness, and negative feedback loops between banking and sovereign instability make for a protracted recovery.

Yet, financial integration does not lead inexorably to such boom and bust cycles and, in fact, can contribute to income convergence. The internationalization of banking was not adequately matched by regulatory, supervisory, and banking reforms. National authorities retained ultimate responsibility, including for any public rescues. Moreover, financial markets failed to reflect mounting vulnerabilities in risk premiums until it was too late for a soft landing.

Stepping back from financial integration would be wrong. Instead, integration should be completed and adequate supportive policies should be put in place. Obstacles to cross-border equity investments and mergers and acquisitions should be removed so that debt flows are no longer favored. Competition in the nontradable sector should be sharpened and policies should swiftly address any future asset price bubbles to avoid luring investment into relatively unproductive uses. Banking supervision, regulation, and resolution need to be elevated to the level at which banks operate in a financially integrated region.

Overcoming the crises in Europe ultimately requires restoring productivity growth in the afflicted countries—a task that goes well beyond the changes in European governance frameworks and the completion of financial integration. Labor productivity growth fell short in these countries over the past decade, despite ample access to financing from abroad. Fostering the return to a vibrant tradable sector is a multifaceted undertaking, but first results are already in hand in the Baltic countries and in Bulgaria, as well as in Ireland and Spain, where export growth is picking up sharply and competitiveness indicators are improving.

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. The role of financial integration in the buildup and resolution of imbalances within the euro area and adjacent countries is analyzed in Chapter 3. The Appendix lists current IMF arrangements with European countries.

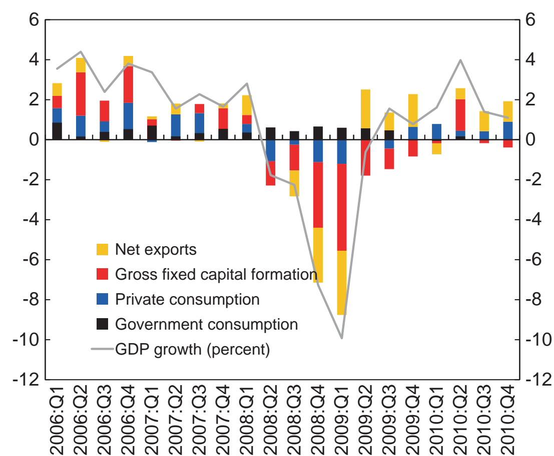
1. Advanced Europe: Tackling the Sovereign Crisis

Despite headwinds from sovereign and financial tensions, the recovery continues. But downside risks still loom large, and divergences across advanced Europe persist. To avoid a protracted period of low growth punctuated by economic, financial, and social crises, further bold measures at the national level are needed to address weak banks, credibly restore fiscal health, and bolster structural reforms. An additional strengthening of the EU-wide policy response, building on the March 24–25 decisions, will also be essential, as will stronger economic governance and an integrated financial stability framework at the EU level to prevent the buildup of macroeconomic imbalances as witnessed prior to the crisis. Meanwhile, monetary policy can remain accommodative, though normalization lies ahead as economic slack wanes and the balance of inflation risks shifts.

Figure 1.1

Euro Area: Contributions to GDP Growth, 2006:Q1–2010:Q4

(Quarter-over-quarter annualized growth rate, percentage points; seasonally adjusted)



Sources: Eurostat; and IMF staff calculations.
Note: Contributions from inventories and statistical discrepancy not shown.

Recovery Continues

Recovery Is Becoming More Self-Sustained …

Despite lingering financial tensions, growth in advanced Europe has strengthened. The initial momentum provided by fiscal stimulus, the restocking cycle, and the global upswing is gradually giving way to a more broadly based recovery in which private domestic demand is playing a larger role (Figure 1.1). And while the worst postwar recession is likely to leave lasting scars on the *level* of output, the recovery is now tracking the pattern and timing of past upturns in the euro area, with *growth* back to precrisis rates two and a half years after the failure of Lehman Brothers (Figure 1.2).

However, this general picture masks substantial divergences in growth trajectories (Figure 1.3 and Table 1 in the Introduction and Overview). The initial recovery in the core euro area and Nordic countries occurred at a more gradual pace than elsewhere in the world. But government-supported work-time reductions minimized the upsurge in unemployment (for example, in Germany and Italy) and strong social safety nets cushioned the blow to households (for instance, in France), sowing the seeds for private consumption to resume gradually as the employment outlook stabilized. In turn, the improvement in profitability prompted firms to unfreeze the investment plans put on ice during the crisis, even as banks remained reluctant to lend, while the robust recovery in global trade continued to support the more competitive economies, including Germany and Sweden, which rebounded firmly in 2010 (Box 1.1).

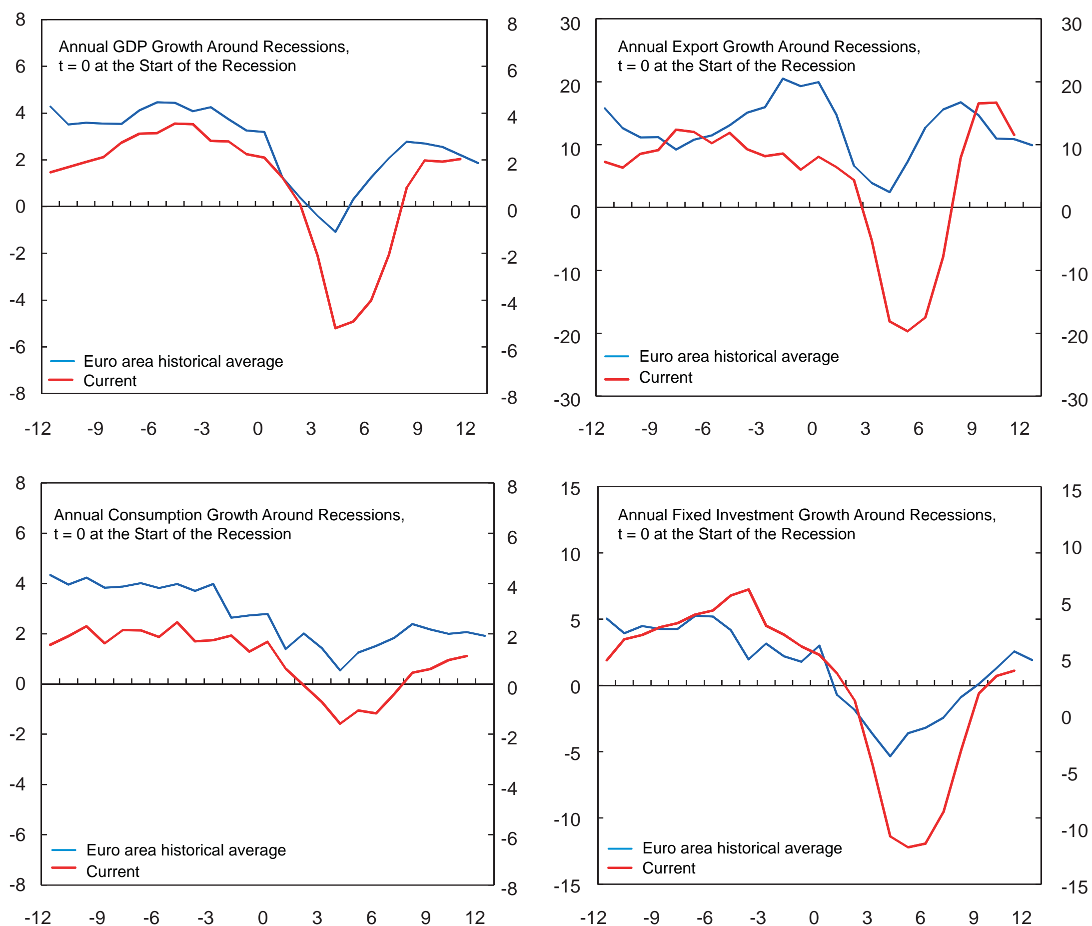
Conversely, in the most vulnerable euro area countries, the correction of precrisis imbalances has forced a major adjustment. Front-loaded fiscal tightening under intense market pressures and continuous private sector deleveraging are taking their toll on activity. As detailed in Chapter 3, a legacy of poor competitiveness and inappropriate trade specialization also hinder export growth, and current account deficits remain large, especially in Greece and Portugal (Chen, Milessi-Ferretti, and Tressel, forthcoming; and Jaumotte and Sodsriwiboon, 2010). In Ireland and Spain, the correction in credit flows following the burst

Note: The main author of this chapter is Céline Allard.

Figure 1.2

Euro Area: Current Crisis Compared with Past Episodes, 1960:Q2–2010:Q4

(Annual percentage change)



Sources: Eurostat; Organization for Economic Cooperation and Development; and IMF staff calculations.

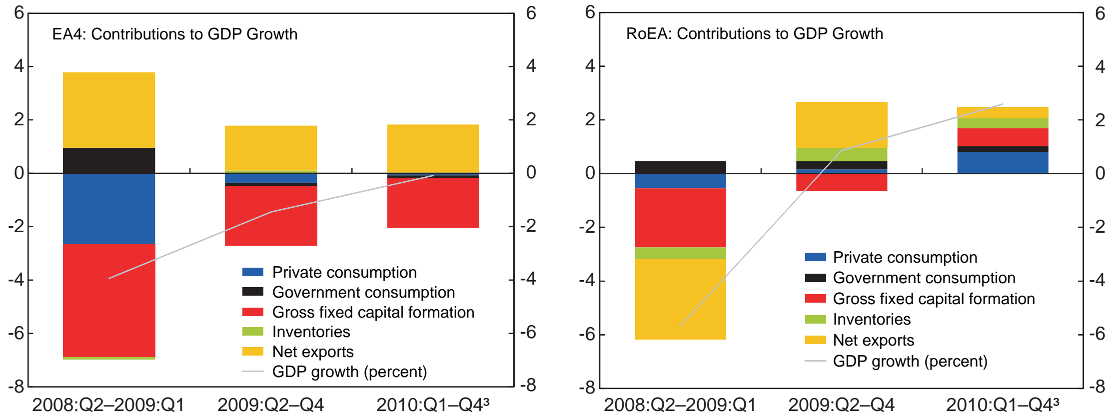
of the real estate bubble triggered extensive job loss in the construction and financial sectors. The UK economy is facing considerable short-term uncertainty, as growth turned flat in late 2010—taking out temporary weather-related effects—and fiscal consolidation accelerates. However, the adjustment of its exchange rate and its accommodative monetary policy stance should help mitigate the contractionary effect of its sizable up-front fiscal adjustment.

Unemployment responses to the crisis have varied extensively across countries (Figure 1.4). In most of Northern Europe, the deterioration in labor markets was generally contained compared with past recessions—despite a more severe output contraction—with firms resorting to labor hoarding. In some countries, part-time schemes further supported job retention. In Germany and Norway, for example, the unemployment rate barely inched up during the crisis. In contrast, it rose markedly in some other countries, such as Spain and Ireland, where activity in the construction sector contracted sharply following the burst of housing bubbles, leaving many low-skilled workers without jobs. Youth unemployment, in particular, increased substantially. In extreme cases like Spain, close to one young worker out of two is now out of work, raising the specter of a "lost generation." Likewise, temporary contract workers bore the greatest burden of the adjustment, and where it was not already high before the crisis, the long-term unemployment rate is creeping up.

Figure 1.3

EA4 and Rest of Euro Area (RoEA): Contributions to GDP Growth, 2008:Q2–2010:Q4[1,2]

(Cumulative quarter-over-quarter growth rate; percentage points; seasonally adjusted; weighted by real GDP)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.
[1]EA4: Greece, Ireland, Portugal, and Spain.
[2]Statistical discrepancy not shown.
[3]Data for Greece and Luxembourg are from 2010:Q1 to 2010:Q3.

Because adjustments have been concentrated in these specific populations, they are likely to be associated with losses in human capital and rising inequality, potentially threatening Europe's social cohesion and stability.

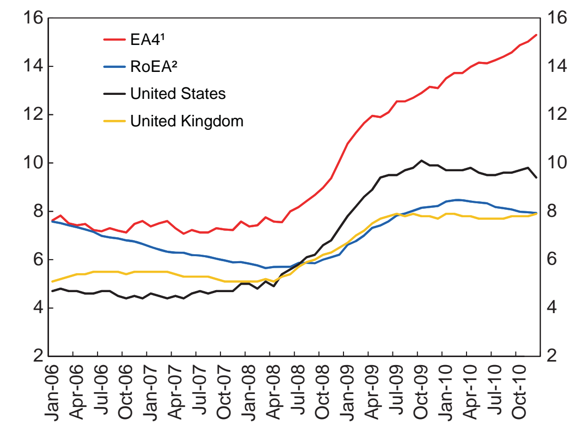
… Despite Divergent Growth and Financial Tensions

Protracted recessions in part of the euro area present challenges to growth in advanced Europe. So far, the growing traction from domestic demand has remained immune to the slump in the euro area periphery. This is not surprising, given limited trade linkages between northern Europe and the euro area periphery (Table 1.1). For example,

Figure 1.4

Selected European Countries and the United States: Unemployment Rate, January 2006–December 2010

(Percent)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.
[1]EA4: Greece, Ireland, Portugal, and Spain.
[2]Rest of Euro Area (RoEA): Excludes Greece, Ireland, Portugal, and Spain.

Table 1.1

Selected European Countries: Share of Exports by Destination, 2009

(Percent of total exports)

	Germany	France	United Kingdom	Sweden	Switzerland
EA4[1]	5.9	10.6	12.2	3.9	5.1
Central and Eastern Europe	8.8	4.8	3.5	6.0	3.5
Asia excl. Japan	7.0	4.7	5.2	6.1	5.8

Sources: IMF, *Direction of Trade Statistics*; and IMF staff calculations.
[1] Greece, Ireland, Portugal, and Spain.

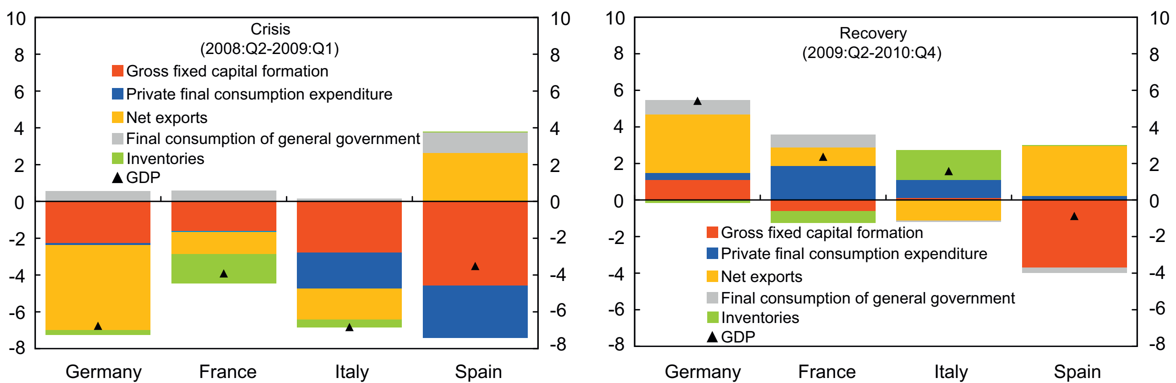
Box 1.1

Domestic Demand and Recovery in the Large Euro Area Countries

Given lingering uncertainties and market pressures, what does the future hold for domestic demand in the euro area? This box investigates the question using econometric analysis for the four largest countries of the euro area, and finds that growth divergences will continue to be underpinned by differing trajectories for domestic demand. For Germany, the worst of the crisis seems over and domestic demand is set to expand. At the other end of the spectrum, the adjustment in Spain still has a long way to go. France stands in between, as its strong social safety net tends to smooth fluctuations. Although domestic demand has recovered moderately, Italy's growth prospects remain weak against the backdrop of trend losses in competitiveness.

While private domestic demand is beginning to play a larger role in the euro area recovery, there are important differences across the four largest economies (first figure). Consumption is recovering in France and Italy, while it remains fairly sluggish in Germany and is barely growing in Spain (on a cumulative quarter-over-quarter basis since 2009:Q2). Investment is on the rebound in Germany, but it remains sluggish in Italy and lagging in France, and it continues to plunge in Spain. This box will elaborate on these dynamics and offer some implications for the recovery looking ahead, drawing on behavioral equations for consumption and investment estimated for each of the four large euro area countries.

Large Euro Area Countries: Cumulative Quarter-over-Quarter Growth and Contributions
(Percentage points)



Sources: Eurostat; and IMF staff calculations.

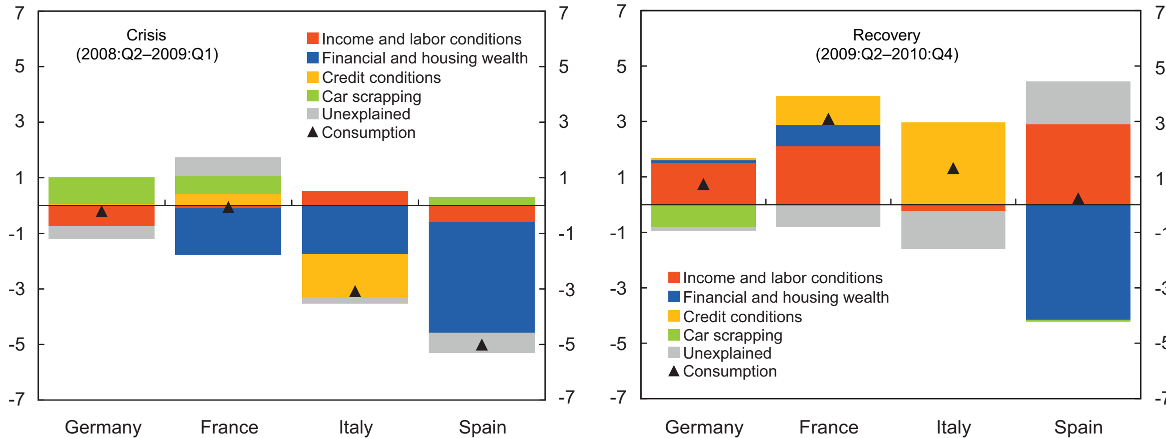
Consumption

Improving income and labor market conditions are supportive, while stabilization in credit markets is a boon in Italy and France, although negative wealth effects remain a drag in Spain (second figure).

The divergent income dynamics that supported consumption in Spain but not in Germany during the crisis are now reversing (third figure). In Spain, despite skyrocketing unemployment, overall real disposable income was resilient during the crisis, reflecting increased transfers and postponed tax payments. In Germany, despite good employment performance during the crisis, a drop in self-employed earnings and capital income drove real disposable income down marginally. However, disposable income is picking up in Germany and is poised to support consumption in the coming quarters, while ongoing labor market adjustment and fiscal withdrawal in Spain may weaken consumption.

Note: The main author of this box is Irina Tytell.

Cumulative Quarter-over-Quarter Consumption Growth and Dynamic Contributions
(Percentage points)

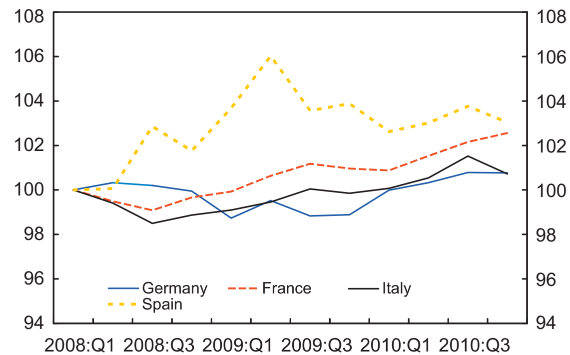


Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Wealth effects continue to restrain consumption in Spain, while they have turned supportive elsewhere. Wealth effects exerted a strong drag on consumption during the downturn in all countries but Germany—where real estate prices had remained muted before the crisis. Since then, the pickup in financial wealth and housing prices has started to support consumption again in France and, to a lesser extent, in Italy. However, Spain continues to experience a significant housing market correction that will hinder consumption in the near term.

While car scrapping schemes played a stabilizing role during and beyond the recession, their withdrawal is weakening consumption. In Germany, almost all the support provided during the crisis has already been subtracted, but in Spain further negative "payback" effects are possible in the coming quarters.

Four Large Euro Area Countries: Real Disposable Income
(Index, 2008: Q1=100)



Source: IMF, World Economic Outlook database.

Investment

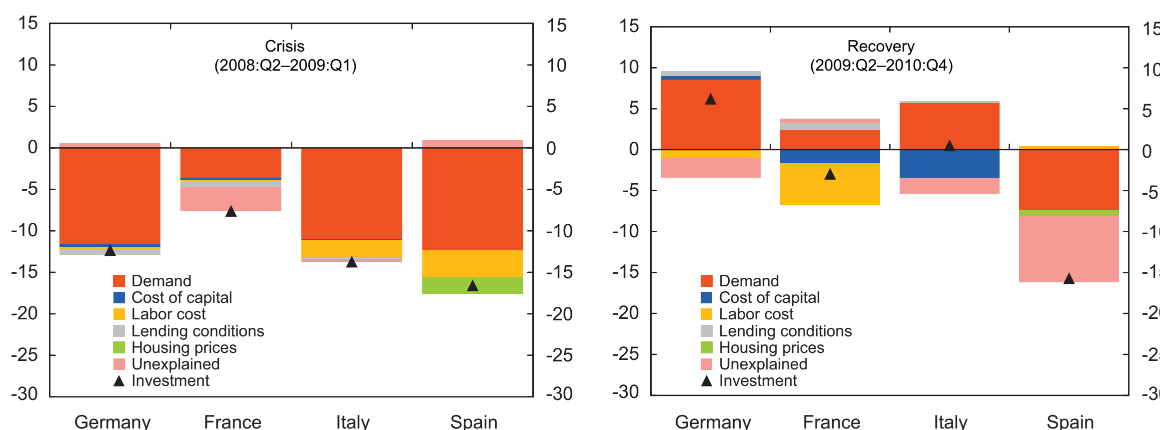
The accelerator effect has turned positive, except in Spain, but higher labor costs remain a constraint, as do higher costs of capital, except in Germany (fourth figure).

The growth accelerator will continue to support investment as the recovery strengthens, but Spain's depressed outlook will remain a constraint. The growth rebound in Germany pushed up demand for capital goods from firms to a much larger extent than in Italy and France. In Spain, a depressed outlook continues to weigh on investment decisions.

The negative effect of higher labor costs on firms' profitability will wane, while stabilizing credit supply is poised to support investment again, with Spain the exception. Reflecting in part the resilience of employment even as

Box 1.1 *(concluded)*

Large Euro Area Countries: Cumulative Quarter-over-Quarter Investment Growth and Dynamic Contributions
(Percentage points)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.

output dropped, unit labor costs rose in the wake of the crisis, but the negative profitability effects are set to fade, and firms are now better positioned to resume investment, having preserved human capital during the downturn. Gradual repair of banks' balance sheets and the stabilization in lending conditions will, to some extent, provide increasing support to investment, although Spain's ongoing housing market correction will be a curb in the near term. In addition, increasing tiering in costs of capital will remain a challenge as long as sovereign bond markets stay under pressure.

Germany, Sweden, and Switzerland sell less than 6 percent of their exports to Greece, Ireland, Portugal, and Spain combined, two to three times less than combined trade with the dynamic regions of central and eastern Europe and emerging Asia. This disconnect is somewhat less evident for the United Kingdom, given its tight trade linkages with Ireland, although the depreciation of the pound has cushioned the effects.

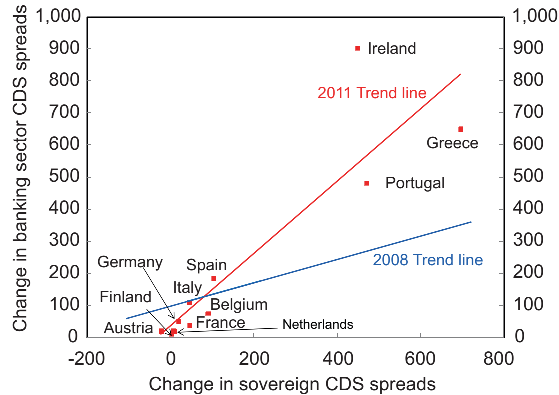
The renewed bout of financial turmoil has arguably mattered more. As the situation in the Irish banking sector deteriorated, a new wave of market turbulence erupted in November 2010. Sovereign risks intensified again in the euro area periphery countries, spilling over to more countries, including Belgium and Italy. Government bond spreads surged to substantially higher levels than those experienced during the turmoil in May 2010. These developments raised further concerns about periphery governments' ability to support still-weak banking sectors, while pressuring banks' balance sheets—which contain significant amounts of domestic sovereign bonds. This adverse feedback loop between the sovereign and the banking sectors in the periphery threatened to fundamentally disrupt funding markets (Figure 1.5). Pressures became increasingly severe in Ireland and led the authorities to embark on an adjustment program supported by the EU and the IMF (Appendix). Similarly, Portugal has now asked for external financial assistance.

Spillovers to the real economy have nonetheless remained largely confined to affected countries. The crisis-management framework put in place in the spring was activated quickly. The European Central Bank (ECB) stepped up its Securities Markets Program, which has now accumulated €76.1 billion of securities. The European safety net set up in May 2010 was tapped to fund part of the Irish program, with the European Financial Stability Facility (EFSF)

Figure 1.5

Selected Euro Area Countries: Change in Sovereign and Bank Credit Default Swap (CDS) Spreads, January 2010–March 2011[1]

(Basis points)

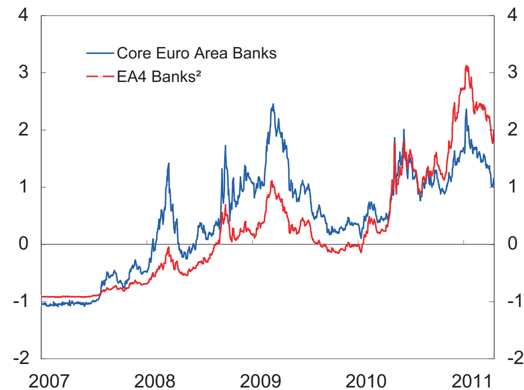


Sources: Bloomberg L.P.; Datastream; and IMF staff calculations.

[1] Trendlines indicate changes from January to December 2008 for the 2008 trend line, and changes from January 2010 to March 2011 for the 2011 trend line.

Figure 1.6

Euro Area: Banking Sector Risk Index, 2007–11[1]



Sources: Bloomberg L.P.; and IMF staff calculations.

[1] Normalized score from a principal component analysis on 5-year senior bank credit default swap spreads, estimated using daily data (Jan.1, 2005–Apr. 15, 2011).The core risk index comprises CDS spreads of 26 banks and the EA4 risk index 13 banks. The first principal component captures 84.5 percent of the common variation across core country banks and 86.1 percent across EA4 country banks.

[2] EA4: Greece, Ireland, Portugal, Spain.

successfully issuing its first supporting bond in January 2011. In addition, the ECB extended the full allotment regime of its refinancing operations until at least July 2011. These measures helped mitigate the perception of risk for core countries' banks, though without completely eliminating it (Figure 1.6). And a concomitant strengthening of national reforms allowed Spain to decouple from other periphery countries in early 2011.

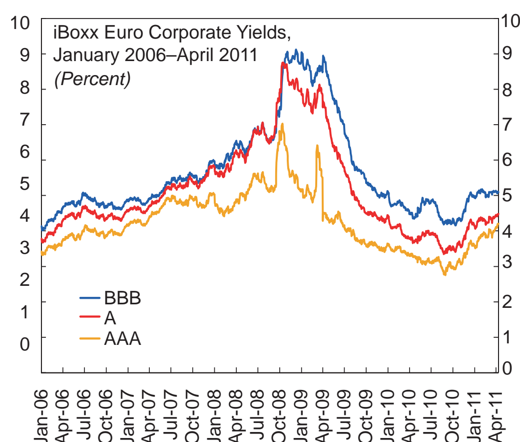
The Outlook Remains for Uneven Growth …

Growth prospects will depend critically on the way in which the remaining tensions in the euro area periphery and European financial sectors are resolved. Under the assumption of credible policies to restore confidence and address underlying weaknesses (see below), the forecast remains for a gradual and uneven expansion, with countries under market pressures continuing to lag behind the recovery in northern Europe. Real GDP is projected to expand by 1.6 percent in 2011 and 1.8 percent in 2012 in the euro area, driven by the strengthening recoveries in Germany, France, and other smaller northern euro area economies, where better employment prospects have improved households' income outlooks, despite higher commodity prices. Although fiscal consolidation is set to dampen growth somewhat, steps taken to restore the soundness of public finances will bolster confidence and help pave the way for a more solid medium-term outlook. Robust growth in emerging countries and better short-term prospects in the United States will continue to provide support to the tradable sector (Figure 1.7), but less so in the euro area periphery countries, which will suffer from deeper fiscal austerity measures, sharper private sector balance sheet deleveraging, and more severe structural unemployment. Thus, intra-euro area growth differentials will persist, with 2011 growth projected to range between –3 percent in Greece and 2½ percent or more in Austria, Finland, Germany, and Luxembourg.

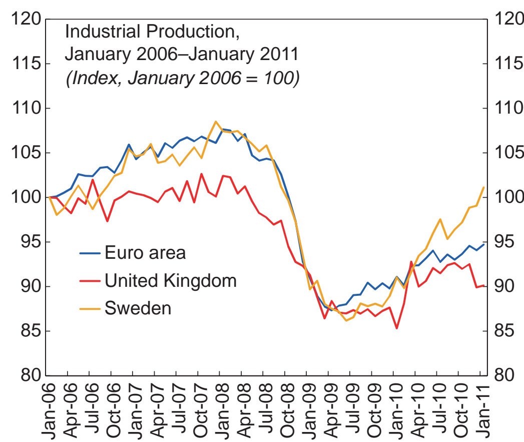
The outlook also foresees differentiated recoveries outside the euro area, although for different reasons. Despite some support from the depreciated pound and a rapid unfreezing of past investment decisions, stronger headwinds from a front-loaded fiscal strategy and higher household debt levels will restrain growth somewhat in the

Figure 1.7

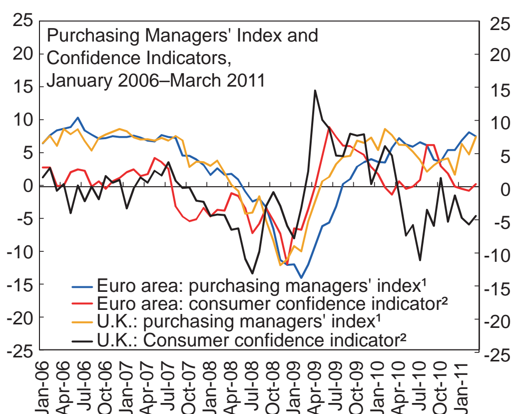
Selected European Countries: Key Short-Term Indicators



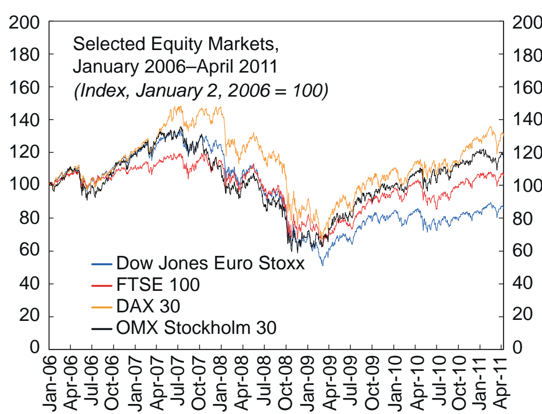
Source: Datastream.



Sources: Eurostat; Haver Analytics; and IMF staff calculations.



Sources: Eurostat; European Commission Business and Consumer Surveys; Haver Analytics; and IMF staff calculations.
[1]Seasonally adjusted; deviations from an index value of 50.
[2]Percentage balance; difference from the value three months earlier.

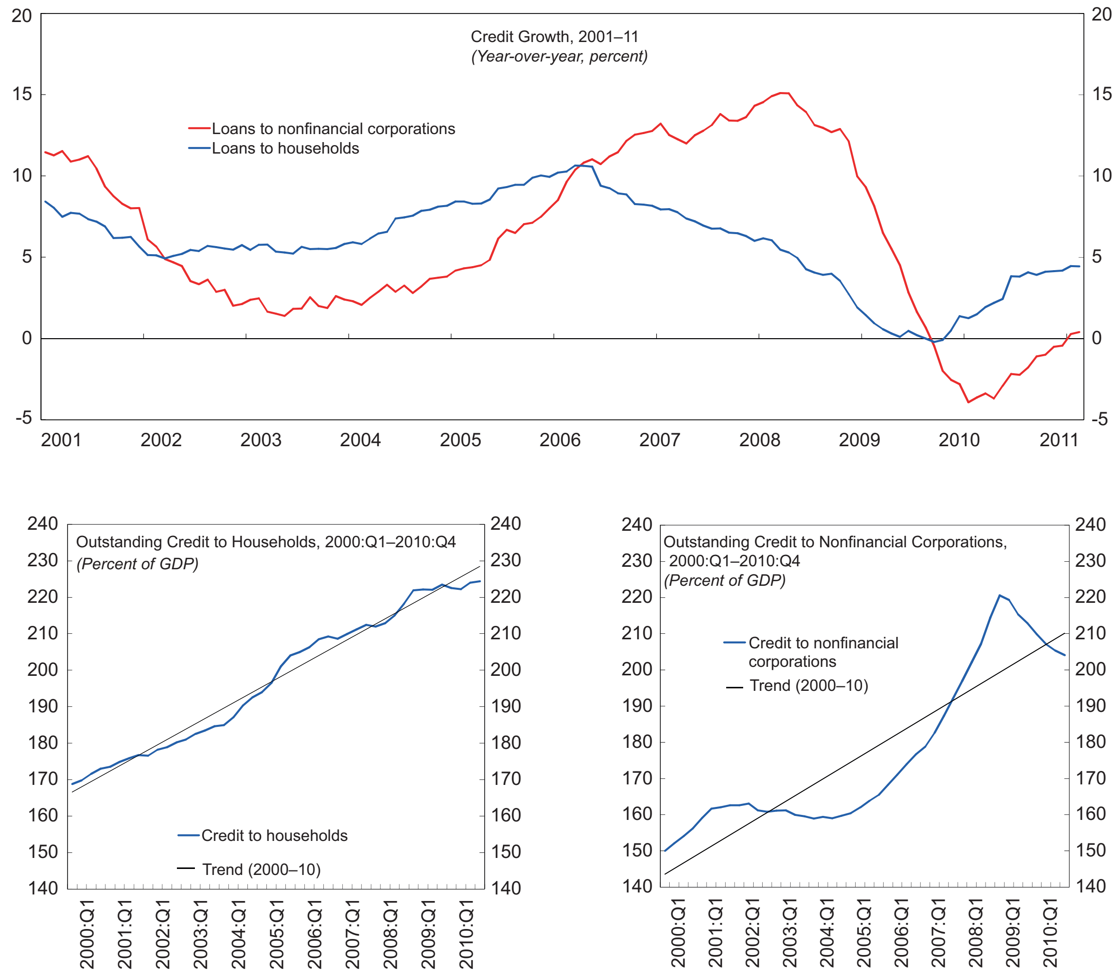


Source: Datastream.

United Kingdom, to 1.7 percent in 2011 and 2.3 percent in 2012. Switzerland, having suffered less from the global crisis and benefiting from a healthy fiscal outlook, is more advanced in the recovery cycle, although the appreciation of its currency will weigh on exports. All in all, growth can be expected to converge gradually toward potential, at 2.4 percent in 2011 and 1.8 percent in 2012. In Sweden, rapidly improving financial conditions have propelled the economy out of recession faster than elsewhere, but with growth foreseen at 3.8 percent in 2011 and 3.5 percent in 2012, the first signs of overheating, especially in the real estate sector, are emerging.

One overarching concern is whether the recovery—and investment, in particular—can proceed despite persistent weaknesses in European banking sectors. As discussed earlier (IMF, 2009), recoveries following financial crises tend to be weak, with firms' investments suffering particularly badly from sluggish credit. Although these features have definitely been at play in advanced Europe since 2008, no decisive evidence yet indicates that a true credit crunch is taking hold. Household credit has begun to recover and credit to enterprises appears to have bottomed out in the euro area, as banks managed to slow down the deleveraging process (Figure 1.8 and Box 1.2). Moreover, enterprise credit is typically a lagging indicator because firms

Figure 1.8
Euro Area: Credit Developments



Sources: European Central Bank; and IMF, World Economic Outlook database.

initially finance new investment from internal resources. Indeed, the balance sheets of large firms in the core economies are generally in good shape, allowing them to self-finance their expansion projects and, in some places, to provide funding to suppliers—thus alleviating somewhat the tighter lending standards affecting small and medium enterprises. Large firms have also continued tapping capital markets at costs that remain attractive by historical standards. Barring a shock to confidence, investment is therefore expected to continue recovering in the near term, albeit gradually. However, constraints on bank intermediation are likely to appear during the next few years, as regulatory changes in the context of Basel III and the EU's bank resolution proposals, the necessary shift away from wholesale funding, and the normalizing of monetary conditions will force banks to reprice risk. In the meantime, banks in the euro area periphery countries will also have to work through a growing share of doubtful assets.

… With Substantial Downside Risks

In that context, although the resilience of the global recovery could provide somewhat stronger-than-expected momentum to the recovery in advanced Europe, downside risks still loom large. Japan's natural disaster, geopolitical problems in the Middle

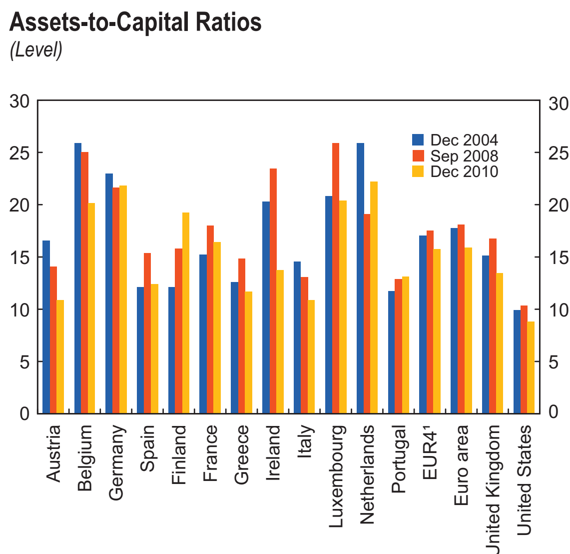
Box 1.2

Deleveraging in the Euro Area

Despite some reduction since the beginning of the crisis—mainly through higher capital—euro area banks' leverage remains high by international standards.[1] In the run-up to the crisis, euro area banks had high leverage multiples (asset to capital ratios) that allowed them to turn relatively low operating performance into high return on equity (first figure). This high leverage was achieved through heavy reliance on short-term wholesale funding, which dried up as counterparty risk concerns related to subprime and periphery debt exposures surged. Reductions in bank leverage ratios have been particularly strong in the euro area periphery (Ireland, Greece, and Spain), even though large banks in these countries were generally less leveraged than those in the core. Deleveraging also occurred in core countries, particularly in Austrian, Belgium, French, and Italian banks. The reduction was achieved mostly through an increase in capital buffers, although a decline in assets took place in the context of bank restructuring in Ireland, Belgium, and Luxembourg (second figure).

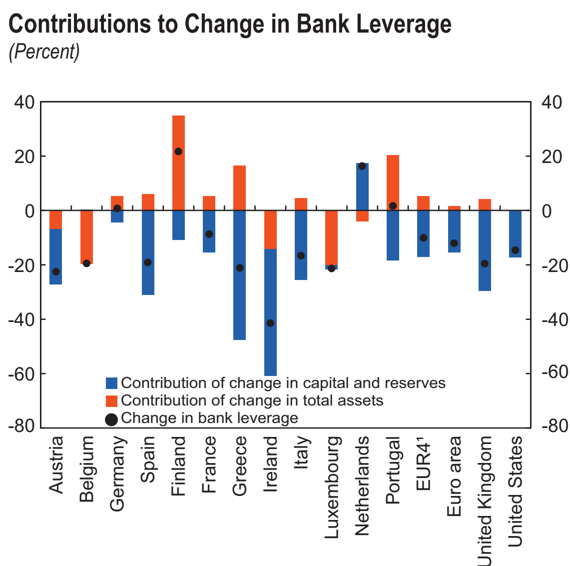
While the overall level of assets changed relatively little, two specific classes of assets—international claims and loans—contracted significantly in the wake of the crisis. International claims, which expanded steadily in the years before the crisis, contracted sharply as interbank markets froze during the global crisis, and again during the Greek crisis in May 2010 as wholesale funding markets came under stress (third figure). Among domestic claims, the bulk of the adjustment was driven by loans to nonfinancial corporations, which declined in the periphery (Ireland, Spain), but also in countries whose banks were exposed to subprime products (Germany, Belgium). Lending to households has been more resilient overall and continued to expand in the majority of countries (fourth figure).

Assets-to-Capital Ratios
(Level)



Sources: ECB Monetary and Financial Institutions (MFI) statistics; and IMF staff calculations.
[1]EUR4 is the weighted average of France, Germany, Italy, and Spain.

Contributions to Change in Bank Leverage
(Percent)



Sources: ECB Monetary and Financial Institutions (MFI) statistics; and IMF staff calculations.
[1]EUR4 is the weighted average of France, Germany, Italy, and Spain.

Note: The main authors of this box are Thierry Tressel and Nico Valckx.

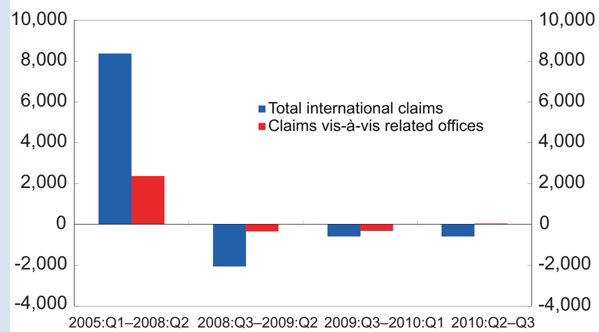
[1] Data for euro area countries and the United Kingdom are based on ECB and Bank of England statistics on monetary and financial institutions' (MFI) aggregate balance sheets, that is, the sum of the harmonized balance sheets of all the MFIs resident in the country. Data for the United States are from the U.S. Federal Deposit Insurance Corporation for all commercial banks. There may be methodological differences with other data sources that use consolidated banking (group-level) data.

Ongoing regulatory reforms to reduce banking sector vulnerabilities may reinforce deleveraging pressures. The new set of regulations known as Basel III designed by the Basel Committee on Banking Supervision (BCBS) requires higher and better quality of capital, especially for systemically important financial institutions (SIFIs). IMF analysis estimates that implementation of the Basel III rules over a three-year period could reduce European SIFIs core Tier 1 ratios by as much as 2.1 percentage points, from 9.0 to 6.9 percent (Ötker-Robe, Pazarbasioglu, and others, 2010), some of which would need to be offset by banks. This could entail in particular further deleveraging during the coming years and result in further contractions in some asset classes if retained earnings fall short or additional capital cannot be raised easily. However, because implementation is spread out over eight years—until early 2019—the impact on assets may be weaker.

In turn, deleveraging is likely to dampen future activity, although the effect appears manageable. Deleveraging affects real activity through two opposing channels. Lower bank leverage has a confidence-enhancing effect as larger capital buffers increase banking sector soundness and lead to lower risk premiums and cheaper funding, in turn supporting credit. Nonetheless, deleveraging caused by the shrinking of assets can constrain bank credit supply, and hence, activity. Estimates coordinated by the Financial Stability Board and the BCBS—in which the IMF participated—suggest, however, that the impact on aggregate output of the transition toward higher capital standards would remain modest: An increase by 1 percentage point in the capital target over an eight-year period would shave off 0.1 percent from the level of GDP (Macroeconomic Assessment Group, 2010).

Change in International Claims of Euro Area Banks

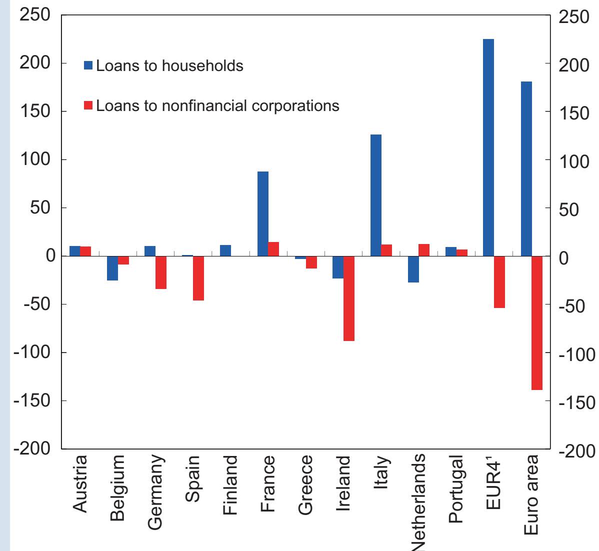
(Billions of U.S. dollars)



Source: BIS locational banking statistics by nationality.

Change in Loan Volume, September 2008–December 2010

(Billions of euros)

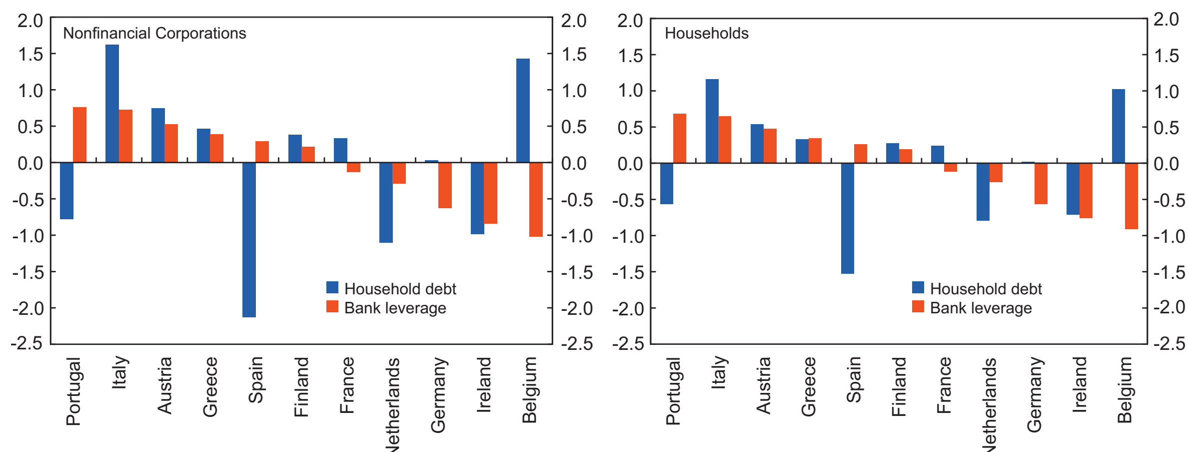


Sources: ECB Monetary and Financial Institutions (MFI) statistics; and staff calculations.
[1] France, Germany, Italy, and Spain.

Deleveraging would also negatively affect credit. A complementary econometric panel analysis shows that credit growth, both to firms and households, is negatively affected by bank leverage. The effects are relatively large for the corporate sector, with a 10 percent increase in bank leverage estimated to reduce credit growth to nonfinancial enterprises by 2¾ percent in the euro area. Because initial conditions differ, the impact varies across euro area countries (fifth figure). The analysis also points to the role of household indebtedness in dampening credit, both to households and firms, suggesting that the legacy of the crisis and necessary private sector balance sheet adjustment will weigh on lending in the near term, independently of bank deleveraging. A 10 percent increase in the household debt ratio is estimated to reduce credit growth by 3 percent in the euro area, as banks compensate for higher risks or lower return on their stock of mortgages, or on new loans, by tightening lending standards across a broader set of borrowers, while more indebted households reduce their demand for credit.

Box 1.2 *(concluded)*

Euro Area Countries: Estimated Effects of Bank and Household Leverage on Credit Growth Relative to the Euro Area Average[1]
(Percentage points)



Sources: ECB Monetary and Financial Institutions (MFI) statistics; and IMF staff calculations.
[1]The model estimates, at a quarterly frequency for a panel sample of euro area countries and for the period 2008–2010, the relationship between credit growth and the log of bank leverage and log of household debt-to-GDP ratio of the previous quarter. The chart reports the estimated impacts on credit growth of initial leverage and household debt for each country, all expressed in deviation from the euro area average.

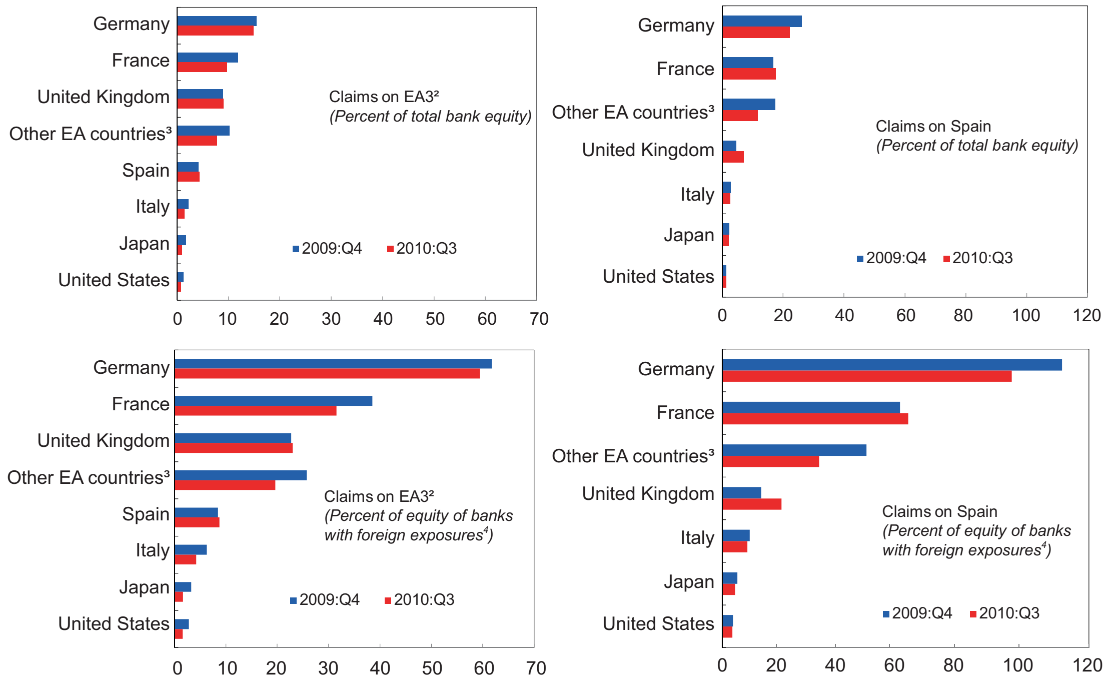
East, and disruptions to energy supplies could derail global growth, with detrimental consequences for the most export-dependent European countries, and for private consumption. Deep-rooted financial and structural problems in the most vulnerable euro area countries are likely to keep European confidence volatile, and new spells of anxiety in financial markets could emerge if, for example, the political resolve to tackle the crisis disappoints.

A major point of pressure in the immediate future stems from large rollover needs in euro area periphery countries from both the banking and the sovereign sectors. Combined bonds due in 2011 amount to 10 percent of GDP or more in Greece, Portugal, and Spain—roughly twice the 2007 amount. Rollover needs have also increased significantly in Belgium, Ireland, and the United Kingdom. More generally, crisis-related funding pressures in high-deficit countries have forced governments to assume additional risks by shifting to shorter maturities and to rely more heavily on private syndication (De Broeck and Guscina, 2011). In periphery countries, this pressure is compounded by a shrinking investor base. In addition, as explained in the April 2011 *Global Financial Stability Report* (IMF, 2011), banks' reluctance to deleverage—as they then have to book the accompanying losses—have made them increasingly eager to find alternative funding sources to reduce dependence on wholesale markets. In some countries (for example, Spain and Greece), this has triggered a competition war for retail deposits, putting unsustainable pressures on interest margins. In other countries, covered bonds issuance has picked up, but over-collateralization required even for the best rated banks means that only a limited portion of their balance sheets can be funded in this way. And reliance on ECB funding has become entrenched for a number of second-tier banks in large European countries; nearly all banks in Greece, Ireland, and Portugal; and some small and mid-sized Spanish saving banks.

With liquidity pressures remaining acute, a negative shock could rapidly spill over through the periphery and potentially beyond. Despite some reduction during the last year, cross-border exposures

Figure 1.9

Selected Advanced Countries: Claims on Domestic Banks and Public Sector[1]



Sources: Bank of England; Bankscope; BIS Consolidated Banking Statistics; IMF, *International Financial Statistics;* and IMF staff calculations.
[1]The exposures were adjusted using data from the Bank of Ireland to account for the fact that a significant portion of the claims are claims on foreign banks domiciled in Ireland.
[2]EA3: Greece, Ireland, and Portugal.
[3]Other EA countries includes Austria, Belgium, Ireland, Portugal, and the Netherlands.
[4]The exposures are calculated in percent of the equity of banks that have foreign exposures. Banks that do not have exposures to Greece, Ireland, Portugal, and Spain are not included in the computation.

remain sizable and concentrated within euro area creditor countries (Waysand, Ross, and de Guzman, 2010) (Figure 1.9). Hence, the system would still be severely tested if euro area stresses were to intensify.

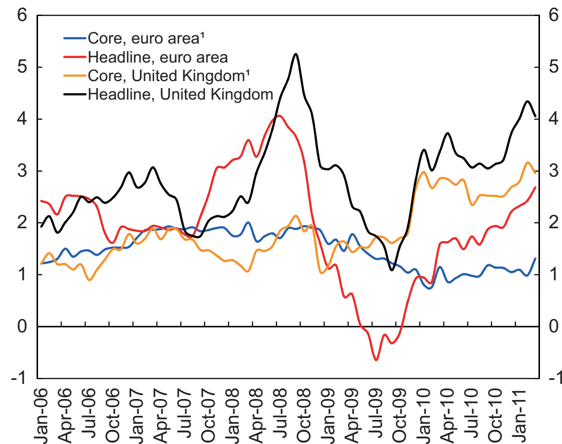
Inflation Picks Up

Inflation will continue to pick up throughout 2011 against the backdrop of accelerating commodity prices. In the euro area, headline inflation is expected to exceed the 2 percent ECB target for most of 2011 before moderating to 1.7 percent in 2012, although the impact on core inflation and inflation expectations is seen to be minimal for now (Figure 1.10). Higher inflation is foreseen throughout the currency union: in the core, higher commodity prices are accompanied by narrowing output gaps (for example, in Finland), while in

Figure 1.10

Selected European Countries: Headline and Core Inflation, January 2006–March 2011

(Percent; year-over-year change)



Sources: Eurostat; Haver Analytics; national authorities; and IMF staff calculations.
[1]Harmonized index of consumer price inflation (excluding energy, food, alcohol, and tobacco).

the periphery, indirect tax changes contribute to positive headline inflation. Ireland, nonetheless, is expected to experience subdued price increases in 2011, at 0.5 percent, following two years of deflation. Outside the euro area, the pickup in inflation has been further amplified in the United Kingdom by a series of VAT increases and the lagged effects of the currency depreciation: inflation is expected to stay significantly above the Bank of England target, at 4.2 percent in 2011, before cooling to 2 percent in 2012, as base effects come into play. In contrast, monetary tightening and the unfolding appreciation of the krona are expected to keep Sweden's inflation more stable, at 2 percent in both years, despite the strength of its economy. Switzerland too is expected to continue experiencing very low inflation, at just 1 percent, as the appreciation of the currency feeds through. Nonetheless, in all countries, inflation risks have become tilted to the upside, and guarding against second-round effects will be critical.

Turning the Page on the Crisis: Policy Requirements

Policy actions taken in Europe since the emergence of the sovereign debt turmoil helped to contain the crisis, but not sufficiently to decisively put it behind us. Bold steps are needed to assuage market concerns about sovereign and financial risks and to tackle the underlying root causes of the crisis. Ultimately, more rather than less economic and financial integration will be key to the region's success, along with a strengthening of euro area-wide economic governance. Although policymakers have started addressing these difficult issues—most notably at the March 2011 European Council—further improvements in the macroeconomic landscape will depend on rapid implementation of their commitments.

Strong National Policies as the First Line of Defense

Strong national policies to rectify structural weaknesses remain crucial throughout Europe and are the foundation for restoring confidence in the countries under severe market pressures. In the euro area periphery, adjustments to past imbalances will take time to deliver better growth and employment prospects. Measures to date have been wide ranging (Table 1.2). But it will be essential for governments to maintain their resolve to tackle fiscal consolidation, repair their financial systems, and continue critical structural reforms.

Structural reforms will also be needed elsewhere in Europe because solid sustainable growth will be a major postcrisis antidote to entrenched unemployment, declining standards of living, and deteriorating fiscal positions. Efforts to increase employment rates in the core euro area and to improve educational outcomes in the whole region would go a long way to achieving these goals. In Scandinavian countries, measures are already in the works to lower labor taxation (Sweden) or reorient labor market policies toward upgrading skills (Denmark). The agreement by European leaders on the "Pact for the euro" is encouraging in the sense that it cuts through the debate about whether and what reforms are still needed, but national authorities must now commit to the immediate implementation of specific actions. In parallel, better surveillance needs to be established within the euro area to flag and to nip in the bud future macroeconomic imbalances to avoid a replay of the current crisis (see Chapter 3).

These reforms can and should go hand in hand with reducing inequalities, which are strongly linked to unemployment and more generally to the low rate of labor utilization in Europe (Box 1.3). In countries where unemployment remains unacceptably high, measures put in place to improve labor market functioning also aim to equalize opportunities for all citizens, by reducing rents for insiders in both the labor and product markets. Pension reforms that lengthen the contribution period in line with rising life expectancy increase intergenerational fairness (for example, in France, Greece, and Spain). Measures to harmonize employment protection between types of job contracts should reduce the disproportionate burden on temporary workers—those last hired and first fired. Removing the

Table 1.2

Greece, Ireland, Portugal, and Spain: Authorities' Measures to Restore Confidence and Regain Competitiveness

	Fiscal	Financial	Structural
Greece	* Front-loaded fiscal adjustment (measures worth 8 percent of GDP in 2010), through elimination of 13th and 14th month bonuses and freeze of public wages and of pensions; increase in VAT rates, indirect taxes, and nontax revenues; cuts in operation costs and investment spending; rationalization of pharmaceutical spending; wage cuts and tariff increases in public enterprises. * Reduction in public employment through attrition. * Pension reform aimed at reducing pension spending from 12½ percent of GDP to 2½ percent over 2010–60. * Reforms to fight tax evasion, improve tax compliance, and improve budget controls and fiscal reporting.	* Introduction of government-guaranteed uncovered bank bonds usable as collateral at the ECB. * Set-up of a financial stability fund as a backstop for capital needs for viable banks under pressure. * Strengthened banking supervision through enhanced reporting requirements and reduced reporting lags.	* Freeze/reduction in minimum wages and relaxation of collective dismissal and employment protection regulation to facilitate job reallocation. * Reform of collective bargaining system, in particular to allow firms to opt out of industry-level agreements. * Liberalization of regulated professions. * Liberalization of road transportation sector; and reform of the railway sector. * Strengthening of the competition authority. * Easing of business licensing and start-ups; and full implementation of the Services Directive. * Fast-tracking of large investment projects.
Ireland	* Front-loaded medium-term consolidation plans (measures worth 6 percent of GDP in 2009–10, 9½ percent of GDP over 2011–14) through public sector wage and employment reductions; social transfer reforms (including through entitlement reforms); savings on capital spending; a broader income tax base; and VAT increase. * Institutional reforms, including a medium-term budgetary framework and a budgetary advisory council. * Increase in the retirement age starting in 2014 and reform of public sector pension entitlements for new entrants.	* Asset valuation and stress tests to provide an assessment of capital needs to achieve a regulatory capital ratio of 10.5 percent. * Prudential liquidity assessment to calibrate stable funding of the banking system. * Substantial downsizing of the banking system, including by unwinding noncore assets and resolution of unviable banks. * Strengthening of the bank resolution framework. * Strategy to address the financial weakness of credit unions.	* Removal of structural impediments to competitiveness, including by amending competition legislation. * Reform of benefits system to incentivize work and eliminate unemployment traps. * Independent assessment of the electricity and gas sectors, with possible privatization of state-owned assets, to reduce energy costs.
Portugal[1]	* Front-loaded fiscal adjustment, through tax increases, cuts in public wages by 5 percent, hiring and pension freeze, cuts in social spending and transfers to local governments. * Introduction of quarterly fiscal targets. * Reforms under way to introduce a medium-term budgetary framework, program budgeting, and an independent fiscal council.	* Set up a financial stability facility for liquidity and capital support. * Banks increased core tier 1 capital ratio to 8 percent following Bank of Portugal's recommendation.	* Administrative and credit-support measures targeted at export-oriented firms. * Reforms of the wage-bargaining system, reduction of dismissal costs, and promotion of flexibility in working hours. * Reinforcement of active labor market policies, especially for young job seekers. * Deregulation of the rental market. * Measures to reduce informal activity, fraud, and tax evasion.
Spain	* Front-loaded fiscal adjustment (4.1 percent of GDP measures in 2010–11) through tax increases, a 5 percent cut and freeze in public wages, pension freeze, and cuts in investment and subnational government spending. * Improved dissemination and transparency of regional budgets. * Pension reform, with increases in the statutory retirement age, the length of contribution for full pension rights, and the reference period to compute pension.	* Law on savings banks to allow equity-like instruments to have voting rights, reform their legal statute with option to become listed, and strengthen corporate governance requirements. * Increase in core capital to 8 percent and to 10 percent for institutions reliant on wholesale funding and with limited private shareholding. * Individual recapitalization plans requested and assessed by Banco de España. * Extended support of the FROB (public recapitalization fund) through the purchase of common equity.	* Reduction in dismissal costs and criteria, and reform of the collective bargaining system, in particular to allow firms to opt out of collective agreements. * Reinforcement of active labor market policies, and enhanced links between vocational training, businesses, and the general education system. * Cut in social contributions for part-time employment of the young and the long-term unemployed. * Simplification of administrative procedures to set up a business. * Greater independence and powers of network industry regulators. * Improved incentives for the rental market and removal of tax incentives for housing investment.

Source: IMF staff.
[1] Measures predating the authorities' request for external financial assistance.

Box 1.3

Unemployment and Inequality in the Wake of the Crisis

Unemployment rose more in the euro area periphery than in other European countries, but youth and temporary workers everywhere were particularly hard hit by the crisis. In most of northern Europe, the deterioration in labor markets was generally contained compared with past recessions—despite the sharper output contractions experienced this time—with firms resorting to labor hoarding, and in some countries part-time schemes further supported job retention. In contrast, unemployment rose more sharply in some peripheral countries, such as Spain and Ireland, where the burst of housing bubbles exacerbated the recession (figure). And the more fragile segments of the labor market—young, low-skilled, and temporary workers—suffered the most. With long-term unemployment slowly creeping up, there is a risk that many unemployed will become discouraged and leave the labor market. This would have adverse consequences on Europe's social fabric, public finances, and growth.

How have labor market developments likely affected income inequality in Europe during the crisis? What features of labor markets aggravated the impact of the crisis on inequality? And what can be done to alleviate the problem? Cross-country econometric analysis of the determinants of inequality in Organization for Economic Cooperation and Development countries (over a period, 1980–2005, that does not include the recent crisis) suggests that the recession likely exacerbated inequality through rising unemployment and dwindling job creation, despite the safety nets and automatic stabilizers at work. A jobless recovery or ingrained long-term unemployment could further worsen economic disparities and undermine both economic performance and social cohesion. "How" the economy recovers and grows (that is, which income groups benefit the most) will matter for income inequalities.

Cross-country differences in income inequality reflect the interplay of labor, social, and educational factors. In line with the literature, the following robust results were found (see table):

- *Labor utilization significantly influences income distribution.* Unemployment is found to have a regressive impact on income equality, and a higher employment rate is associated with lower economic disparities. Social expenditures play an important role in alleviating income inequality across all specifications, highlighting the supporting role of unemployment benefits in times of crisis, and more generally of social protection in assisting the most vulnerable. Educational attainment, proxied by the share of population with at least secondary education, is associated with a more even income distribution.

- *The longer the unemployment duration, the higher the income inequality.* Both short- and long-term unemployment widen income dispersion, with a slightly higher coefficient for the latter, reflecting deeper income losses as the spell of unemployment lengthens.

- *Better job opportunities for underutilized groups enhance equity.* Higher employment rates for women and youth reduce disparities.

- *Dual labor markets worsen inequality.* A higher share of temporary contracts in total employment contributes to widening income distribution because it tends to be associated with more wage and benefit disparity between the temporary and permanent workforces. This is particularly relevant for countries that used a "dual" system to enhance labor market flexibility, resulting in increased use of temporary contracts.

The results suggest that the rise in unemployment during the crisis increased inequality by an estimated 2 percentage points in the euro area as a whole, and by as much as 10 percentage points in Greece, Ireland, Portugal, and Spain, where the labor market situation deteriorated much more sharply. The recession also increased the number of discouraged workers who dropped out of the labor force, a factor that is likely to have

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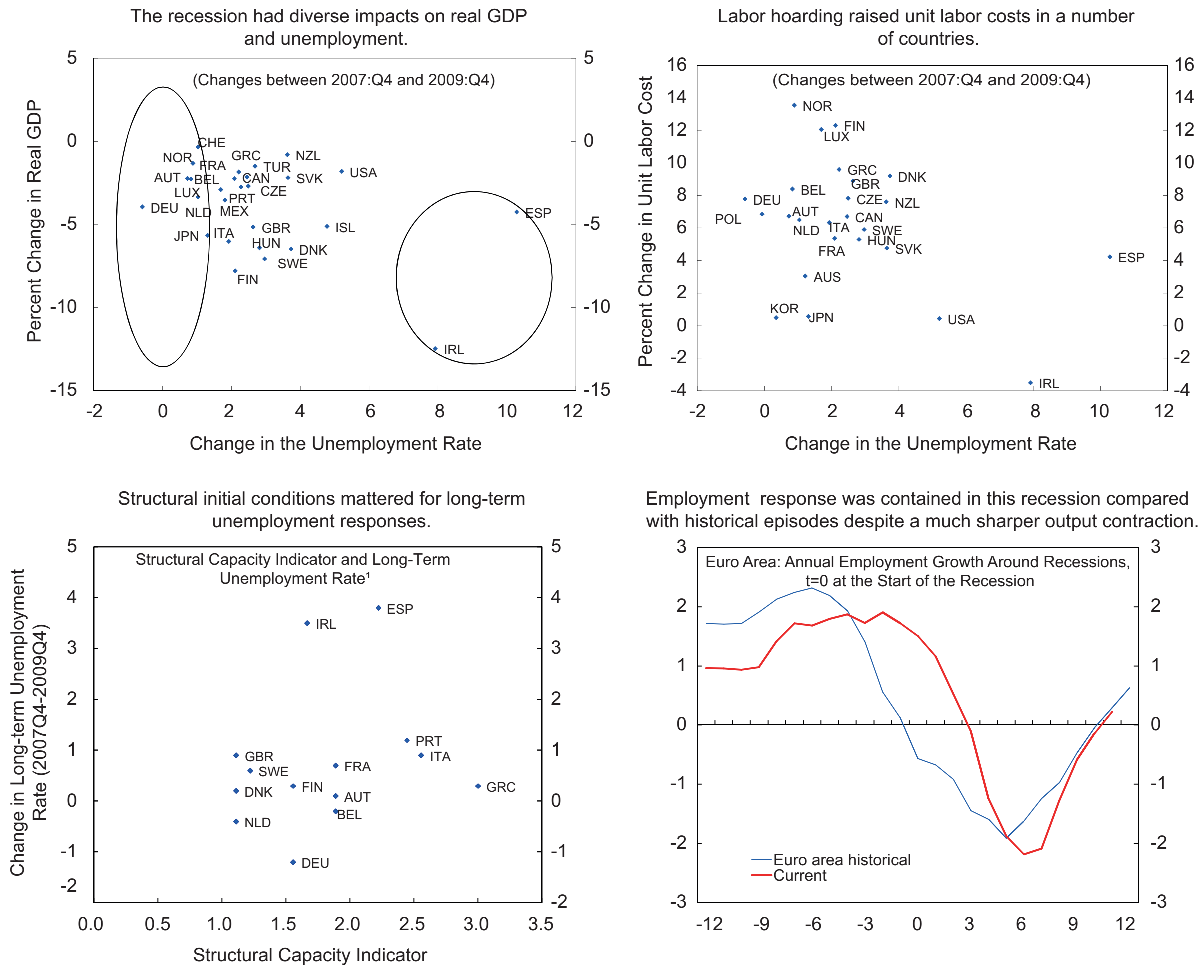
Note: The main author of this box is Hanan Morsy.

Impact of the Crisis on the Labor Market



Sources: Eurostat; Fraser Institute; Organization for Economic Cooperation and Development; World Economic Forum; and IMF staff calculations.
[1]Structural capacity indicators are constructed as country averages of assigned scores from 1 to 3 on the nine variables of the structural reform heatmap by Darius and others (2010), where a higher score indicates a greater need for structural reforms.

further exacerbated income disparities. On the other hand, social safety nets are likely to have cushioned the impact of unemployment on inequality.

This suggests the following policy recommendations:

- *More inclusive labor markets will be required to narrow income inequalities.* Evidence shows that a pervasive dual system, with a flexible temporary workforce and a highly protected permanent workforce, can actually increase unemployment (Blanchard and Landier, 2002; Jaumotte, 2010; and Dao and Loungani, 2010). Combining that evidence with the analysis here suggests that reforms to rebalance employment protection—with a view to supporting job creation—by relaxing protection on regular workers while enhancing it for temporary workers would be beneficial for income equality, too. Improving wage-bargaining arrangements to allow wages to reflect productivity more closely in countries where they have grown most out of line would also help.
- *Active labor market measures could help reduce structural unemployment.* Longer unemployment duration poses a risk of entrenching cyclical unemployment into a structural phenomenon as workers lose human capital and become detached from the labor force. Lam (forthcoming) found evidence of the effectiveness of certain active

Box 1.3 *(concluded)*

Determinants of the Gini Coefficient

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Unemployment	0.21 *	0.46 ***					
	(0.12)	(0.09)					
Long-term unemployment			0.50 ***				
			(0.15)				
Short-term unemployment			0.38 *				
			(0.22)				
Employment	-0.15 ***			-0.22 ***			
	(0.06)			(0.04)			
Women employment					-0.16 ***		
					(0.03)		
Youth employment						-0.09 ***	
						(0.03)	
Temporary contract employment							0.13 *
							(0.07)
Social expenditures to GDP	-0.76 ***	-0.86 ***	-0.87 ***	-0.71 ***	-0.64 ***	-0.81***	-0.80 ***
	(0.08)	(0.08)	(0.08)	(0.07)	(0.08)	(0.08)	(0.11)
Population share with at least secondary education	-0.09 ***	-0.08 ***	-0.08 ***	-0.09 ***	-0.08 ***	-0.08 ***	-0.04
	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)	(0.04)
Constant	58.47 ***	47.97 ***	48.49 ***	64.00***	56.27 ***	55.53 ***	47.37 ***
		(0.03)	(2.28)	(3.20)	(2.24)	(2.67)	(3.24)
Observations	107	107	104	107	107	107	83
Adjusted R-squared	0.68	0.65	0.65	0.67	0.68	0.61	0.51

Note: Standard errors are in parentheses; * denotes significance at the 10 percent level, ** denotes significance at the 5 percent level, *** denotes significance at the 1 percent level. The equations include time dummies and are estimated using two-stage least squares with instrumenting for social expenditures with size of government.

labor market measures, such as job-search assistance, training, and incentives to private sector employment, in improving employment rates and, in turn, countering structural unemployment.

- *The young need to be better integrated into the labor market.* Policies could ensure better integration between employment services and the education system through outreach programs, training, apprenticeships, and access to job-search assistance measures.

hurdles to entering closed professions and decisively fighting tax evasion will level the playing field, too. Finally, tighter regulation on banks will ensure that the fallout from excessive risk taking by a few does not have to be shouldered by taxpayers.

A Stronger Euro Area-Wide Safety Net

European leaders took further steps to strengthen the crisis management framework at their March 2011 summit, but a number of elements of the required comprehensive package remain to be clarified. The main new elements are threefold.

- The lending capacity and pricing of the facilities were adjusted. Policymakers committed to increasing the effective lending capacity of the EFSF to €440 billion—but without yet specifying how. The lending capacity of the European Stability Mechanism (ESM), the successor to the EFSF beyond 2013, will reach €500 billion using a combination of paid-in capital, callable capital, and guarantees. Pricing for ESM loans will be in line with IMF pricing principles. Accordingly, the loan conditions for Greece have been relaxed through a decrease in the interest rate and an extension in maturity, but not those for Ireland.

- Decisions to provide financing under the ESM will be made by mutual agreement in the Eurogroup—by which non-abstaining member states must agree unanimously—on the basis of debt sustainability analysis, which will involve the IMF. In addition to lending to member countries, the euro area-wide facilities will be allowed to participate in primary markets in the context of a program with strict conditionality, on an exceptional but yet-to-be defined basis.
- Private sector involvement in the context of ESM loans will remain an action of last resort, decided on a case-by-case basis consistent with IMF policies, and financing will be provided only if debt sustainability is demonstrated to be achievable. Collective actions clauses will be introduced starting in June 2013 and ESM loans will enjoy preferred creditor status.

Clearer parameters for the crisis management mechanisms are certainly welcome but challenges now lie in their implementation. The larger effective size of the EFSF should bolster market confidence, provided the mechanism by which this is secured is clarified as soon as possible, and a decision on adapting the interest rate charged on EFSF loans taken to help support fiscal sustainability. Beyond 2013, the proposed permanent facility, with its emphasis on prevention and early support, provides a robust and orderly framework for assisting euro area members, including through strict conditionality to support discipline. To broaden the avenues of support, though, some added flexibility in the instruments would be helpful. Additionally, in the shorter run, the interdependence between national banking systems and sovereigns remains unaddressed, and the onus of dealing with financial sector issues was left squarely with the national authorities, despite the high potential for cross-border contagion.

Accelerate Financial Sector Reforms and Resume Financial Integration

Indeed, addressing weaknesses in the banking sector remains a prerequisite for breaking the negative interaction between sovereign debt risks and banking risks. The agenda includes reducing uncertainty about asset quality, increasing capital buffers of viable banks, and identifying and resolving insolvent banks. While the July 2010 EU stress tests increased transparency with regard to banking sector exposures, they failed to identify the most pressing risks, as evidenced in Ireland where the two largest banks—at the core of the country's difficulties—passed the stress tests. The new round of stress tests to be released in June 2011 will need to be far more probing. And to give teeth to these tests, member states need to put in place credible and specific ex ante plans to deal with the vulnerable institutions identified by the stress tests. In some countries, such as Ireland, Spain, and the United Kingdom, national supervisors have already moved ahead. But in many other countries, the resolve to put the banking sector on a stronger footing still needs to be demonstrated.

An additional issue is that financial integration in EU banking markets remains incomplete. While capital flows cross borders with little impediment, and banks transact freely in the money market, other elements of the financial system, including portfolio allocation, securitization, and retail banking, remain very much national affairs. Moreover, apart from some regional clusters, cross-border mergers and acquisitions are still limited. This is unfortunate because deeper financial integration carries the potential to alleviate some of the current banking sector weaknesses, allowing, in particular, for the injection of fresh capital in circumstances where domestic sources are constrained. Clearing the obstacles to further financial integration will require rapid progress on the single rulebook for banks and harmonization of supervisory practices. Standardization of products and more uniform consumer protection regimes are also needed (see Chapter 3 for more details).

The need for an integrated, pan-European approach to supervision and regulation has become even more evident. The European Supervisory Authorities (ESAs) and European Systemic Risk Board (ESRB)—all launched in January 2011—will provide much needed tighter coordination of financial supervision and macroprudential

policies within the euro area and the EU. Adequate resources, good information gathering and sharing, and focused coordination of their activities will be critical to the success of these new institutions.

Moving toward a robust and flexible framework for crisis management and resolution, with appropriate tools and mandates to intervene and resolve ailing institutions at an early stage, is equally urgent. The EU proposal to harmonize these tools across countries is the right step toward ensuring more orderly ex ante solutions. But more needs to be done to progress from a setting structured along national lines to an integrated EU framework that fully addresses unavoidable coordination problems. Clear rules for allocating losses to private stakeholders and sharing the burden of potential public support among member states are still missing; so are mechanisms for rapid financing of resolution efforts—including through a deposit guarantee scheme prefunded by the industry. Ultimately, only a European Resolution Authority would be able to deal cost effectively with the resolution of cross-border EU credit institutions, thereby underpinning a truly single financial market while maintaining financial stability.

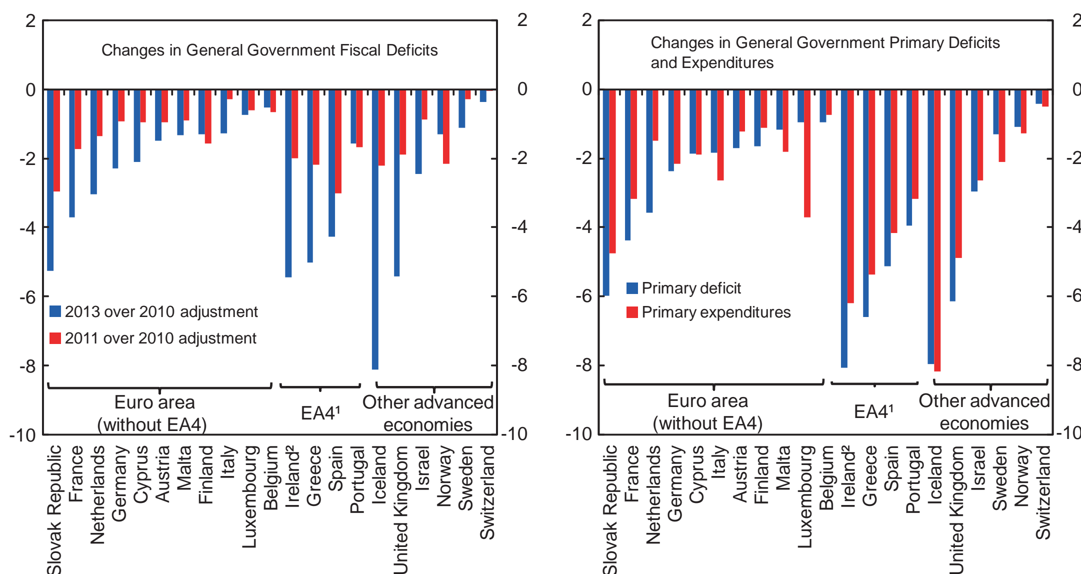
Restore Fiscal Health

Securing public debt sustainability constitutes another vital ingredient to an enduring solution to the crisis. With the recovery gradually broadening, now is the time to start reconstituting the fiscal buffers that proved essential during the recession and to secure medium-term sustainability. Absent such action, markets would feel increasingly uncomfortable funding ever-rising public debt in Europe—as they did in the most vulnerable euro area countries—in turn, jeopardizing the recovery. Getting the speed, size, and composition of the fiscal adjustment right is imperative too. Sovereigns that have come under market scrutiny have had no choice but to front-load the consolidation, but other European countries can afford to phase in the tightening to smooth over time the negative impact on domestic demand and employment.

Figure 1.11

Selected Advanced European Countries: Changes in General Government Fiscal Deficits, 2010–13

(Percentage points of GDP)



Source: IMF staff calculations.

[1]Greece, Ireland, Portugal, and Spain.

[2]Excluding bank support measures for Ireland.

Table 1.3

Advanced European Countries: Main Macroeconomic Indicators, 2009–12

(Percent)

	Current Account Balance to GDP				General Government Overall Balance to GDP[1]			
	2009	2010	2011	2012	2009	2010	2011	2012
Advanced European economies[2]	0.5	0.8	0.9	0.9	-6.3	-6.1	-4.5	-3.6
Euro area	-0.6	-0.6	0.0	0.0	-6.3	-6.1	-4.4	-3.6
Austria	2.9	3.2	3.1	3.1	-3.5	-4.1	-3.1	-2.9
Belgium	0.8	1.2	1.0	1.2	-6.0	-4.6	-3.9	-4.0
Cyprus	-7.5	-7.0	-8.9	-8.7	-6.0	-5.4	-4.5	-3.7
Estonia	4.5	3.6	3.3	3.1	-2.1	0.2	-1.0	-0.7
Finland	2.3	3.1	2.8	2.6	-2.9	-2.8	-1.2	-1.1
France	-1.9	-2.1	-2.8	-2.7	-7.6	-7.7	-6.0	-5.0
Germany	5.0	5.3	5.1	4.6	-3.0	-3.3	-2.3	-1.5
Greece	-11.0	-10.4	-8.2	-7.1	-15.4	-9.6	-7.4	-6.2
Ireland	-3.0	-0.7	0.2	0.6	-14.4	-32.2	-10.8	-8.9
Italy	-2.1	-3.5	-3.4	-3.0	-5.3	-4.6	-4.3	-3.5
Luxembourg	6.7	7.7	8.5	8.7	-0.7	-1.7	-1.1	-0.8
Malta	-6.9	-0.6	-1.1	-2.3	-3.7	-3.8	-2.9	-2.9
Netherlands	4.6	7.1	7.9	8.2	-5.4	-5.2	-3.8	-2.7
Portugal	-10.9	-9.9	-8.7	-8.5	-9.3	-7.3	-5.6	-5.5
Slovak Republic	-3.6	-3.4	-2.8	-2.7	-7.9	-8.2	-5.2	-3.9
Slovenia	-1.5	-1.2	-2.0	-2.1	-5.5	-5.2	-4.8	-4.3
Spain	-5.5	-4.5	-4.8	-4.5	-11.1	-9.2	-6.2	-5.6
Other EU advanced economies								
Czech Republic	-1.1	-2.4	-1.8	-1.2	-5.8	-4.9	-3.7	-3.6
Denmark	3.8	5.0	4.8	4.8	-2.8	-4.9	-3.6	-2.6
Sweden	7.2	6.5	6.1	5.8	-0.8	-0.2	0.1	0.4
United Kingdom	-1.7	-2.5	-2.4	-1.9	-10.3	-10.4	-8.6	-6.9
Non-EU advanced economies								
Iceland	-10.4	-8.0	1.1	2.1	-9.0	-6.8	-4.6	-1.3
Israel	3.6	3.1	3.3	3.1	-5.6	-4.1	-3.2	-2.2
Norway	13.1	12.9	16.3	16.0	10.4	10.9	13.0	12.7
Switzerland	11.5	14.2	13.2	12.8	0.8	0.2	0.3	0.6
Memorandum								
European Union[2]	-0.2	-0.1	-0.2	-0.1	-6.8	-6.6	-4.8	-4.0

Source: IMF, World Economic Outlook database.

[1] Net lending only. Excludes policy lending.

[2] Weighted average. Government balance weighted by purchasing power parity GDP; current account balance by U.S. dollar-weighted GDP.

Along this metric, current plans are appropriately differentiated (Figure 1.11). Greece, Ireland, Portugal, and Spain, as well as the United Kingdom—where the fiscal position deteriorated relatively more during the recession—have committed substantial fiscal consolidation for this year and for 2012–13, while Germany approaches the task at a slower pace. For the euro area as a whole, the fiscal improvement will reach 1¾ percentage points of GDP this year and ¾ percentage point the next two years (Table 1.3). In addition, the expected composition of the

consolidation in the euro area and other European countries over the next three years is broadly appropriate, with the bulk of the deficit reduction occurring through expenditure reductions.

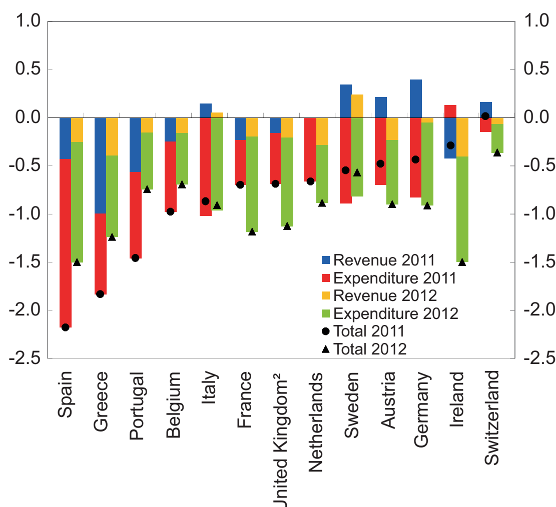
The negative impact of fiscal consolidation on growth is expected to be limited this year for most European countries, but more substantial in 2012—a suitable timing given the strengthening recovery. Lagged effects from the stimulus measures still occurring in 2010 in most countries will likely smooth the effects of the consolidation measures, with the drag on growth this year ranging from 1½ to 2 percentage points in Greece, Portugal, and Spain to ½ percentage point or less in Austria, Germany, Ireland, and Switzerland (Figure 1.12).

Still, these fiscal consolidation strategies will only fully work if embedded in credible medium-term plans. Some countries—such as Greece, Ireland, Portugal, and Spain, but also Austria, France, Germany, Italy, and the United Kingdom—have already elaborated specific consolidation plans beyond this year. Others have yet to flesh them out.

Figure 1.12

Selected European Countries: Impact of Fiscal Policies on GDP Growth, 2011–12[1]

(Percentage points)



Source: Ivanova and Weber (forthcoming), based on IMF, World Economic Outlook database.

[1] The approachapplies multipliers to the changes in public expenditure and revenue ratios to GDP, both in the domestic country and in its trade partners, to derive the impact on growth. Fiscal policy affects growth in the same year and in the following year (lagged effect).

[2] United Kingdom estimates use weighted average of fiscal year numbers.

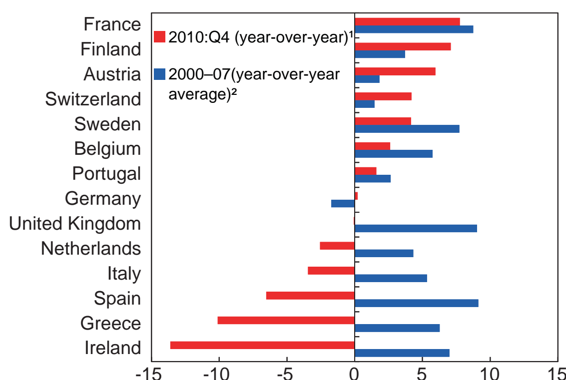
Set the Stage for Gradual Monetary Policy Normalization

With the recovery in train, monetary policy should also move closer to normalization. In countries most advanced in the recovery cycle, central banks have already started raising policy rates (for example, Israel, Norway, and Sweden). The ECB has recently followed suit as the output gap in the euro area is gradually closing—even after taking into account fiscal consolidation. In a few countries both inside and outside the euro area, strong momentum in mortgage credit and housing prices highlights the risk that assets could become overvalued again when loose monetary conditions are in place for too long (for example, Austria, Finland, France, Sweden, and Switzerland) (Figure 1.13). Conversely, in the United Kingdom, where the recovery is currently more tepid and fiscal tightening stronger, policy rate normalization may need to proceed more slowly.

Figure 1.13

Selected European Countries: Residential Real Estate Prices

(Percent change, in real terms)



Sources: Bank for International Settlements; Organization for Economic Cooperation and Development; Global Property Guide; and national sources.

[1]Latest data for Belgium, Finland, Greece, Ireland, Italy, and the Netherlands are 2010:Q3.

[2]Average data for Austria are 2001–07.

Table 1.4

Selected European Countries: Headline Inflation and Contribution of Food and Fuel Prices

	Dec-09		Feb-11[1]	
	Inflation	*of which*: Contribution from food and fuel	Inflation	*of which*: Contribution from food and fuel
Euro area	0.9	0.1	2.4	1.8
United Kingdom	2.8	0.7	4.0	1.7
Sweden	2.8	0.9	1.2	0.7
Denmark	1.2	0.1	2.6	1.7
Switzerland	0.2	-0.2	0.5	0.4

Sources: Eurostat; and IMF staff caclulations.
[1] For United Kingdom, data are for January 2011.

In the shorter term, commodity price increases pose a challenge to the anti-inflation credentials of central banks: following the recent surge in commodity prices, fuel and food inflation now accounts for between half and three-quarters of current headline inflation across Europe, in sharp contrast with just a year ago (Table 1.4). Although core inflation is projected to remain low, and the impact of recent increases in commodity prices should prove temporary, central banks will have to keep a watchful eye on wage developments and inflation expectations for potential second-round effects. Removal of automatic wage indexation mechanisms in countries where they are still in place (for example, Spain) would help prevent these second-round effects from materializing.

In the euro area, remaining fragility in the financial system could hold growth back, justifying a flexible approach to exiting extraordinary crisis measures. The eventual exit will need to occur gradually as national actions to strengthen banking sectors are implemented and systemic uncertainty recedes. Depending on these, the ECB may need to extend further in time its regime of full-allotment refinancing for some of its liquidity operations, while refining its collateral framework to discourage systemic bidding, minimize distortions to market-based bank financing, and avoid moral hazard associated with unlimited liquidity provisions. Meanwhile, macroprudential policies will need to play a larger role in mitigating risks in member countries where these conditions encourage less cautious lending behaviors.

Strengthen Preventive Surveillance

In the run-up to the crisis, the Stability and Growth Pact (SGP) failed to prevent the trend increase in public debt. Stronger enforcement, as well as required corrective actions on a preemptive basis—even before the Excessive Deficit Procedure is activated—and until medium-term objectives are reached, will go some way to improving its effectiveness. However, national fiscal frameworks must also be strengthened, given member states' reluctance to relinquish additional fiscal prerogatives to the center. Some countries have announced their intentions to introduce national fiscal rules (for example, Germany and France). There is also room to strengthen fiscal governance arrangements, transparency, and public finance management at the national level. The planned EU directive to define minimum standards and goals for such frameworks should help ensure they are fully in line with common objectives.

Coordination fell short of identifying the broader risks of growing macroeconomic imbalances within the EU, and even more important, within the euro area. As further detailed in Chapter 3, rather than a lack of fiscal integration, it was the inability of national authorities to react to local developments in credit, demand, and wages that led to the buildup and eventual bursting of imbalances in some countries, with detrimental consequences for the area as a whole. The new Excessive Imbalance Procedure should be strengthened to provide an effective platform for discussing and coordinating national responses at the EU level.

2. Emerging Europe: Underwriting a Solid Recovery

Emerging Europe returned to growth last year, but performance varied widely across the region, reflecting the idiosyncratic legacies of previous boom-bust cycles. For 2011 and 2012, an economic expansion of 4¼ percent is projected with much less disparity in intraregional growth, as domestic demand takes over as the main driving force. Policymakers' emphasis should be on protecting the solidifying recovery against still-considerable downside risks from unsettled global and euro area financial markets and from reemerging inflationary pressures. To this end, they need to tackle fiscal and financial sector vulnerabilities. Fiscal policy should support monetary policy to the extent possible to stave off price pressures in the wake of high global commodity prices and narrowing output gaps. For the many countries hard hit by the 2008–09 crisis, bringing down unemployment while reorienting their economies toward the tradable sector remains an ongoing task.

Developments in 2010

On the Back of an Overall Favorable External Environment, Emerging Europe Turned the Corner in 2010

Emerging Europe put the deep recession of 2009 firmly behind it and expanded by 4.2 percent in 2010, broadly in line with projections in the previous *Regional Economic Outlook*. Exports benefited from the revival of global demand, while feared spillovers from sovereign debt trouble in the euro area periphery did not materialize. Recoveries of domestic demand were uneven across the region though, giving rise to large growth disparities. Poland and Turkey grew strongly, at higher-than-expected rates of 3.8 and 8.2 percent, respectively. A heat wave and surging oil prices had opposing effects on Russia's growth, which came in at 4 percent. The recovery remained in its infancy in much of southeastern Europe.

Note: The authors of this chapter are Phakawa Jeasakul, Christoph Klingen, and Jérôme Vandenbussche.

Exports Were Key for Getting the Recovery Under Way …

Exports expanded by a solid 9.3 percent, putting legs under the recovery in emerging Europe. Exports were the first demand component to rebound following the 2008–09 crisis, buoyed by the pickup in growth of critical trading partners in advanced Europe, especially Germany. By end-2010, export volumes matched or exceeded precrisis levels in most countries. In contrast, the recovery of domestic demand came later and often struggled to sustain itself (Figure 2.1).[1]

In an encouraging sign, average export growth during 2009–10 outpaced growth of trading partner imports (Figure 2.2). Export sectors seem to be generally competitive and able to gain share in their traditional markets, expand beyond them, or improve the quality of their product mix. This speaks to competitiveness gains from postcrisis real devaluations. Relative incentives to produce tradables have also improved given that profit margins for nontradables fell sharply in the aftermath of the 2008–09 crisis.

… While Domestic Demand Developments Were Mixed across the Region

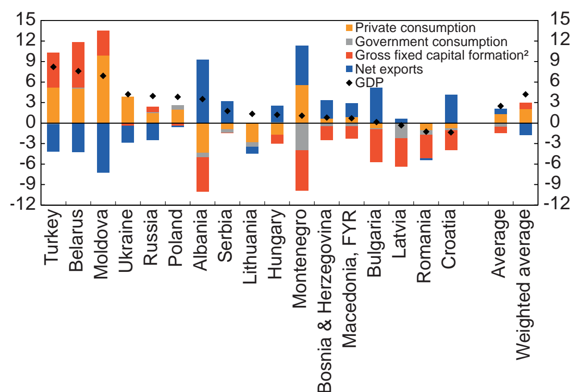
On average, domestic demand growth in the region was a strong 5.8 percent. However, this average primarily reflects powerful dynamics in Poland and Turkey, both countries where precrisis overheating had been more contained, and in the European CIS countries, which benefited directly or indirectly from the rebound of commodity prices. In contrast, domestic demand still declined in the rest of the region, albeit not as much as in 2009.

[1] The early revival of exports did not always translate into a sizable contribution of net exports to economic growth in 2010. The subsequent pickup of domestic demand was strong in some countries, reducing the growth contribution or even turning it negative for the year as a whole.

Figure 2.1

Emerging Europe: Contributions to GDP Growth, 2010[1]

(Percentage points)



Sources:IMF, World Economic Outlook database; and IMF staff estimates.
[1]Contributions from inventories and statistical discrepancy not shown.
[2]Investment in the case of Macedonia, FYR.

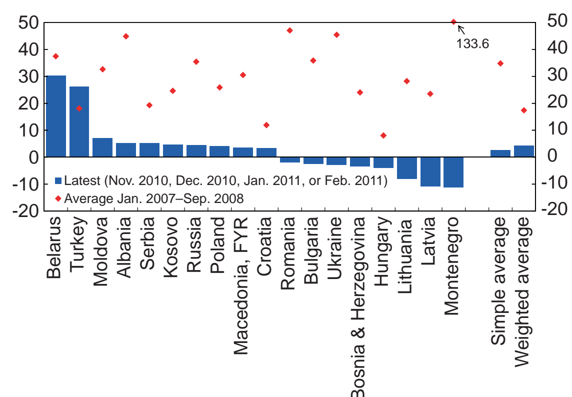
High unemployment, restricted credit, subdued confidence, and lack of policy space all weighed on spending (Figures 2.3 and 2.4).

Divergent domestic demand developments were also responsible for the region's stark intraregional growth disparities. Economic performance ranged from growth of more than 7½ percent in Belarus and Turkey to contractions of about 1½ percent in Croatia and Romania. This variation mainly reflects the legacy of boom-bust cycles that differed across countries in size, timing, and speed of postcrisis adjustment. Differences in the policy stance also played a role. Global commodity prices heavily influenced developments in Russia (Box 2.1).

Figure 2.3

Emerging Europe: Real Private Sector Credit Growth[1]

(Percent, 12-month change)

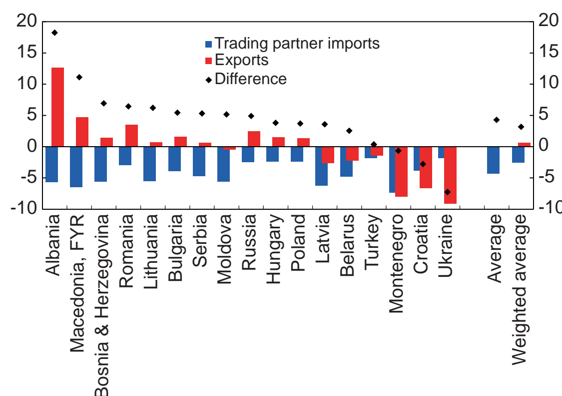


Sources: IMF, *International Financial Statistics*; and IMF staff calculations.
[1]Derived from stock data in domestic currency, adjusted by CPI inflation. May include valuation effects from foreign-currency-denominated loans.

Figure 2.2

Emerging Europe: Real Exports and Trading Partner Imports, 2009–10

(Real annual average growth in percent)



Sources: IMF, World Economic Outlook database; and IMF staff estimates.

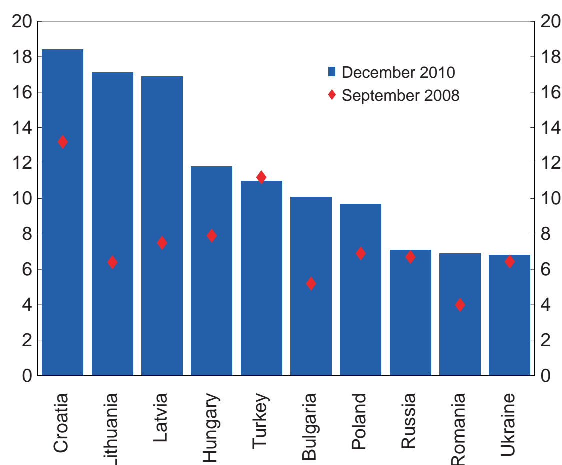
Inflation Is Picking Up …

Disinflation is giving way to a pickup of inflation as the global recovery takes hold (Figure 2.5). Inflation fell sharply in the wake of the 2008–09 crisis, reaching a trough between March 2009 (Albania and Hungary) and July 2010 (Poland and Russia). It has since drifted up to reach

Figure 2.4

Emerging Europe: Unemployment Rate

(Seasonally adjusted, percent)



Sources: Haver Analytics; and IMF, World Economic Outlook database.

Box 2.1

Russia: A Tepid Recovery from a Deep Recession

Russia's recent experience, during both the crisis and the recovery, has differed notably from that of other countries in the region. These differences reflect Russia's reliance on commodity exports, significant policy shortcomings, and some one-off factors.

Crisis

During the global crisis, Russia's swing in growth was appreciably larger than in most other countries (first figure). This weak performance occurred despite Russia's formidable reserve holdings and large current account and fiscal surpluses before the crisis—characteristics that, other things equal, should have put it in a relatively strong position to weather the storm. The output collapse also defied the relatively strong policy response by the authorities—a massive fiscal stimulus, large-scale liquidity support to the banking system, and deft management of the ruble exchange rate (at the cost of about US$200 billion in reserves), which bought time for the private sector to hedge its foreign exchange exposures.

The main explanation for the depth of the slump during the crisis is Russia's dependence on its oil and gas sectors, which left it highly exposed to the sharp decline in oil prices in the second half of 2008. Although energy directly accounts for about two-thirds of Russia's exports and for an estimated 20 percent of GDP, the overall impact of oil prices on the Russian economy extends beyond these numbers as, indirectly, oil prices are key determinants of capital flows, credit availability, investment, and incomes. In addition, oil prices are important for public finances because every US$10 per barrel decline in oil prices reduces fiscal revenues by some 62 billion rubles (about 1½ percent of GDP).

The abrupt drop in oil prices during the crisis highlighted the connection between oil prices and capital flows to Russia when Russian corporations hedged their uncovered foreign currency exposures, triggering massive capital outflows. In turn, as cheap foreign funding dried up, long-standing weaknesses in the banking sector were exposed and private sector credit collapsed, thereby compounding the recession.

At the same time, as in many other countries in the region, adjustment from precrisis overheating—which in Russia had been fueled by expansionary fiscal and monetary policies owing to weak policy frameworks—further deepened the downturn.

Recovery

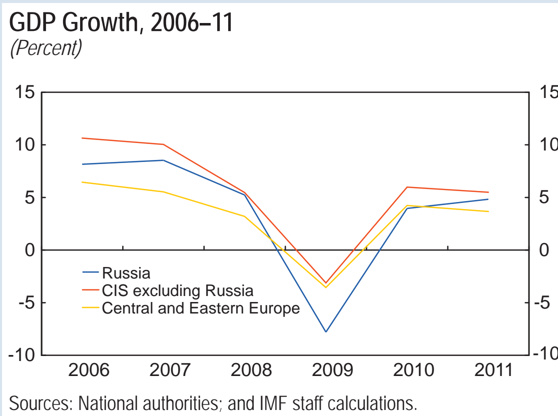
Russia has experienced only a sluggish recovery from the recession thus far. Real GDP grew 4 percent in 2010, about half of which reflected carryover from 2009. Even though estimates of potential growth have been lowered from about 5½ percent before the crisis to about 4 percent at present, this performance could be regarded as somewhat disappointing when considering the large remaining output gap, the continued highly accommodative policies of the government, and strongly rebounding world oil prices. Several factors have contributed to this outcome.

First, a historic heat wave and drought in the summer temporarily derailed Russia's recovery. The severe weather, which lasted for several weeks, affected harvests, construction activity, industrial production, and retail activity, and was the key contributor to a sharp contraction of real GDP in the third quarter (0.9 percent, quarter over quarter, seasonally adjusted). The dismal third quarter had a large downward effect on average GDP growth for the year in 2010, even though some catching up from summer production losses likely took place in the fourth quarter.

Note: The main author of this box is David Hofman.

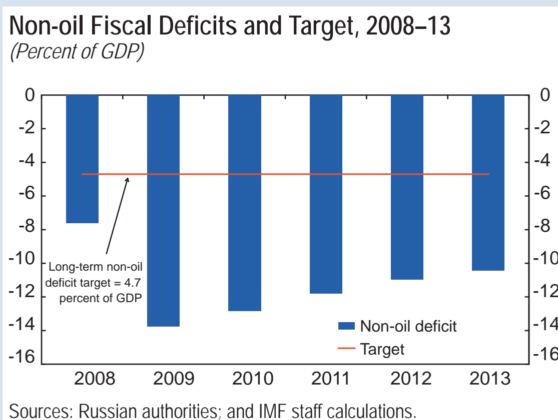
Box 2.1 *(continued)*

Second, Russia continued to experience substantial capital outflows in 2010, in sharp contrast to many other emerging market economies and despite high oil prices. In addition to scheduled debt repayments, the outflows likely reflected investors' renewed focus, in the wake of the crisis, on the lack of progress in addressing the economy's fundamental underlying problems. These problems include, in particular, the poor investment climate—as evidenced by Russia's consistently low scores on the World Bank's Doing Business indicators (where Russia ranks 123rd for overall ease of doing business) and other international comparisons—and persistent weaknesses in monetary and fiscal policy frameworks.



Sources: National authorities; and IMF staff calculations.

Third, the slow recovery also reflects ongoing problems in the banking system, including a large overhang of nonperforming and restructured loans. Credit growth remained stagnant through the first quarter of 2010 and recovered only timidly in the course of the year.

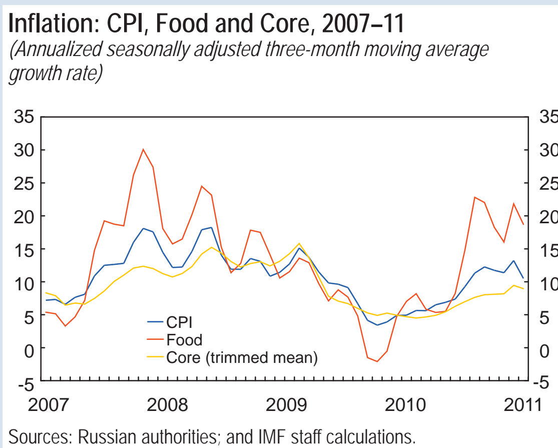


Sources: Russian authorities; and IMF staff calculations.

Fourth, structural reforms—much needed to develop the economy's productive capacity and develop new engines of sustainable growth—remained stalled, and investors perceived the prospects for their reinvigoration to be limited in the run-up to the 2012 elections.

Policies

Against the background of this fragile recovery, the Russian authorities have continued their exit from crisis-related policy support. However, the exit strategy has not been sufficiently bold and is undermined by weak policy frameworks, posing further risks to a sustainable recovery.



Sources: Russian authorities; and IMF staff calculations.

On the fiscal policy side, the withdrawal of the massive stimulus provided during the crisis has been lagging. Most of the fiscal expansion during the crisis took the form of permanent measures, which increases the risk that the stimulus will not be reversed and that fiscal policy will become procyclical as the economy recovers further. At 12.9 percent of GDP, the 2010 federal government non-oil deficit—which should be the anchor for fiscal policy in an oil-producing country like Russia, given the volatility of oil prices and the nonrenewable nature of oil—remains nearly 8 percentage points higher than the government's long-term target of 4.7 percent of GDP, a target that remains appropriate (second figure).

The 2011–13 budget envisages a reduction in the federal non-oil deficit of only 2.5 percent of GDP over three years, mostly resulting from a significant hike in the payroll tax, a reduction in civil service

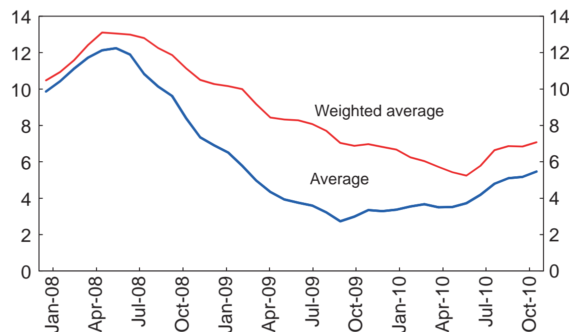
employment, and cuts in investment—a combination of adjustments that is, overall, unlikely to be supportive of long-term growth.

On the monetary side, the Central Bank of Russia (CBR) has been slow to respond to rising inflation, owing in part to concerns about growth. Monetary easing was paused in June but policy rates effectively remained on hold for the remainder of the year despite a surge in inflation from a low of 5½ percent in July to 9.5 percent in March 2011 (third figure). Although spikes in food and petroleum prices largely drove the sharp increase in inflation, core inflation has also been steadily on the rise, pointing to significant second-round effects. Following an initial increase in the CBR deposit rate by 25 basis points in late December 2010, in February 2011, the CBR raised both the deposit rate and several of its key lending rates by 25 basis points, more clearly signaling the start of a tightening cycle. The CBR also raised reserve requirements in February and March.

In the financial sector, the extraordinary liquidity support extended to banks during the crisis has been withdrawn and regulatory forbearance is being unwound. However, banks remain fettered by bad loans, with weak balance sheets weighing on credit growth. Delays in implementing consolidated supervision and connected lending regulations amplify financial sector risks.

Against this background, the outlook remains for a moderate recovery in Russia with GDP growth projected to reach 4.8 percent in 2011. Higher-than-projected oil prices could result in a more favorable growth outcome in the short term, but achieving a sustainable recovery will require completion of the exit from crisis-related support, strengthening fiscal and monetary policy frameworks, and reinvigorating the structural reform agenda. Regarding the latter, President Medvedev's recently proposed 10-point action plan to improve Russia's investment climate—which includes measures to enhance governance and business infrastructure, and reduce the influence of the state in the economy—is an encouraging step in the right direction, but effective and timely implementation of these measures is key.

Figure 2.5
Emerging Europe: Inflation, 2008–10
(Percent, year-over-year)



Source: IMF, Information Notice System.

7.1 percent at end-2010, ½ percentage point more than anticipated in the previous *Regional Economic Outlook*. So far, price developments reflect primarily global factors, such as food and energy inflation, as well as the one-off effects from indirect tax hikes.[2] Countries' domestic demand conditions have yet to reassert their dominance over price developments. Output gaps are still substantially negative in most countries, or, where they are not, strong demand is accommodated by wider external deficits. Nonetheless, inflation currently runs above target in Albania, Belarus, Moldova, Poland, Serbia, Romania, and Russia, although indirect tax hikes explain much of Romania's overrun. Inflation in Serbia flared up even while its output gap was strongly negative, amid currency weakness—a reminder that spare capacity by itself offers insufficient protection from inflation.

… And External Imbalances Remain Mostly in Check, Often Easily Financed by Reviving Capital Flows

The regional current account deficit came to ½ percent of GDP in 2010—little changed from the year before and preserving the large external adjustment of 2008–09. Countries with externally driven recoveries generally saw

[2] Indirect tax increases are estimated to have contributed 0.6 percentage points.

their current account positions improve further. Russia and Ukraine benefited from pronounced terms-of-trade gains and their current account balances did not change dramatically despite a strong rebound in domestic demand. However, buoyant domestic demand translated into sharply wider external deficits in Belarus, Moldova, and Turkey. Poland's current account deficit also widened.

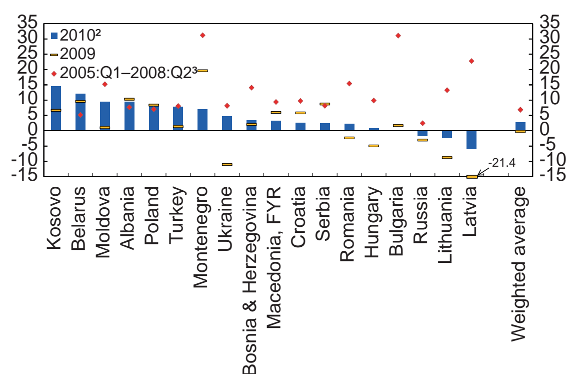
Capital flows are returning to the region, albeit, compared with the boom years, in more modest amounts and in a more discriminatory way (Figure 2.6). Poland and Turkey were the main magnets for foreign investors, in light of their favorable recent growth records and the accessibility of their capital markets. However, financially less integrated countries and economies still struggling to overcome the crisis or beset by large vulnerabilities were shunned. Serbia, for example, suffered exchange rate weakness during much of last year. Russia, traditionally an important destination for emerging market investors, could not attract net inflows in 2010, amid a poor investment climate and persistent weaknesses in its monetary and fiscal frameworks.

Exchange rate developments also reflected the return of selected capital inflows. Over the course of the year, nominal effective exchange rates

Figure 2.6

Emerging Europe: Net Capital Inflows[1]

(Percent of GDP)



Sources: Haver Analytics; and IMF, *International Financial Statistics*.

[1]Excludes financial transactions with the IMF and the EU under Balance of Payments support programs and SDR allocations.

[2]Data for Kosovo and Montenegro are 2010:Q1–Q3.

[3]No data are available for Kosovo.

were broadly stable for the region as a whole—appreciation was strongest in Turkey (4 percent), and depreciation was largest in Serbia (9 percent). On average, they remained 14.5 percent depreciated from their peak in August 2008.

Capital inflows primarily took the form of portfolio investment. Traditionally, portfolio investment makes up less than 10 percent of inflows to the region, with bank/other investment and foreign direct investment (FDI) accounting for the rest in roughly equal shares. In 2010, however, two-thirds of the inflows were portfolio investment, with banks still in no mood to ramp up leverage and direct investors more cautious about the region's prospects. This eased the financing of government deficits, although at the price of public finances becoming more vulnerable to the vagaries of financial markets.[3]

Nine countries in the region maintain active or precautionary arrangements with the IMF (Appendix). In light of selective and potentially unstable capital flows, a number of countries received balance of payments support from the IMF. FYR Macedonia secured a precautionary credit line, and Poland renewed and augmented its flexible credit line in January 2011. The stand-by arrangement with Belarus was completed in March 2010, although the need for external adjustment has since resurfaced. Hungary's program supported by the EU and the IMF lapsed in October 2010.

Credit remains tight in the region, although with a few exceptions. The worst of the credit crunch is over, but real credit still contracts in just under half of the region's economies. At the other end of the spectrum, Belarus and Turkey experienced double-digit growth. In between are a number of countries, such as Poland, that have returned to positive but moderate credit growth (Figure 2.3). In general, credit growth in the region remains constrained by

[3] In 2007, nonresidents held more than 40 percent of Hungary's public debt denominated in domestic currency, the highest share in the region. The crisis of 2008–09 was particularly quick to spill over to Hungary when foreigners exited the government bond market en masse.

rising nonperforming loans, already highly leveraged borrowers, and the tightness of critical funding from foreign parent banks. Between late-2008 and mid-2010, western banks reduced their exposure to emerging Europe by a cumulative 15 percent. A small increase in exposure occurred in the third quarter of 2010—the result of renewed flows to a few well-performing countries.

Equity markets in emerging Europe generally performed well in 2010 on the back of the global and regional recoveries, low global interest rates, and a return of risk appetite. Unsurprisingly, economies doing well or displaying strong indications of a decisive turnaround recorded the best performance in equity markets. Poland and Turkey, and to a lesser extent Russia, fall in the first category with equity market gains between 20 and 30 percent. By end-2010, stock market indices exceeded their precrisis peaks in Turkey and had some 20 percent to go in Poland and Russia. Sharply improved economic prospects in Latvia, Lithuania, and Ukraine meant large stock market gains and recovery levels similar to those in Poland and Russia. In contrast, stock markets advanced little from their depressed levels in southeastern Europe, with its fledgling economic recovery. Hungary's financial markets moved sideways amid changing directions in economic policy.

Concerns about Deficits Motivated Fiscal Consolidation …

The region's fiscal deficit narrowed from 6.1 percent of GDP in 2009 to 4.5 percent of GDP in 2010. Most of the improvement was cyclical, as the recovery lifted revenues and Russia's treasury benefited from oil- and gas-related receipts, but many countries also adopted tightening measures. Fiscal consolidation efforts differed across countries: Albania, Bulgaria, Latvia, Lithuania, Moldova, and Romania all put in place measures in excess of 2 percent of GDP in an effort to curb high deficits; Poland refrained from discretionary fiscal policy changes; and Belarus and Russia actually loosened fiscal policy further last year.

… And Monetary Policy Took First Steps toward Tightening

A number of countries tightened monetary policy. Poland and Russia stepped up their anti-inflationary rhetoric toward year-end as inflation rose and followed up with hikes of headline policy rates early this year. Fast-growing Turkey raised reserve requirements and increased the volatility of market interest rates, then subsequently lowered policy rates, to defuse risk to financial stability from capital inflows and rapid credit growth (Box 2.2). Rate hikes in Hungary and Serbia responded to inflationary pressures, but were also motivated by the need to alleviate financial strains (Hungary) and to continue building central bank credibility in the face of currency depreciation (Serbia). Albania hiked policy rates in late March.

Poland, Serbia, and Turkey also adopted macroprudential measures to contain risky lending and inflationary pressures. Turkey introduced ceilings for loan-to-value ratios for housing loans and increased minimum payments on credit card balances. Poland's regulators tightened criteria for the assessment of retail loans and required higher debt-service-to-income ratios for foreign currency loans. The Serbian authorities moved to phase out a credit subsidy program.

Most countries continued to phase out their crisis-related support measures for the banking sector, although lowered required reserve ratios remain common and outstanding liquidity support is still considerable in Belarus and Ukraine. Moreover, regulatory frameworks were strengthened in many countries.

The Outlook for 2011 and 2012

High frequency indicators point to a continuation of the recovery in 2011. Industrial production is currently expanding in most countries in the range of 5–15 percent, with little sign of loss of momentum; industrial confidence is improving too. Only in Croatia and Serbia are industries still struggling to sustain growth. On the demand

Box 2.2

Turkey's New Monetary Policy Strategy

In response to surging capital inflows, the Central Bank of Turkey (CBT) stepped up its efforts to safeguard financial stability. Differences in the phasing of business cycles around the world translated for Turkey into stronger domestic than external demand, a widening current account deficit financed primarily through short-term inflows, and rapid credit expansion. Against this background, the CBT has emphasized both financial and price stability in its policy decisions since November 2010. This is consistent with the CBT's mandate in the Central Bank Law to enhance the stability of the financial system, although price stability remains its primary objective. The CBT has also called for a coordinated response from the financial supervision and fiscal authorities to the financial stability concerns arising from large capital inflows.

In the view of the CBT, the simultaneous achievement of price and financial stability goals requires additional policy tools. The CBT saw the policy interest rate as unable to deliver both objectives simultaneously—the level appropriate to containing inflation could accentuate risks to financial stability by attracting additional capital flows. The CBT has therefore expanded its toolkit, using the policy interest rate to achieve the inflation target while direct liquidity measures—reserve requirements and the CBT's interest rate corridor—are assigned to moderating credit growth and lengthening the duration of capital flows and bank funding.

In line with this strategy, the CBT's monetary policy has several key elements:

Greater volatility of short-term market interest rates. The CBT drastically cut its overnight borrowing rate (the rate at which banks place deposits at the CBT) by 400 basis points to 1¾ percent in early November to push down the short end of the yield curve. This measure was reinforced by periodic adjustments to the amount of auctioned repurchase agreements (repos) to generate greater volatility in short-term market interest rates within the now-wider interest rate corridor. The corridor was widened slightly further in December.

Liquidity withdrawal. Required reserves on lira-denominated liabilities were raised in several steps from November to April to withdraw liquidity, while rates were differentiated by maturity to lengthen the duration of bank funding and broaden the base.[1] In addition, daily preannounced foreign currency purchases by the CBT were sharply scaled back in steps from US$140 million in mid-December to US$50 million at the beginning of 2011, thereby reducing the creation of counterpart domestic liquidity.

Lowering the policy rate. With headline inflation projected to decline sharply in the near term, the policy interest rate was reduced by ½ percentage point in December to curb the trend appreciation of the lira. A further cut of ¼ percentage point was made in January.

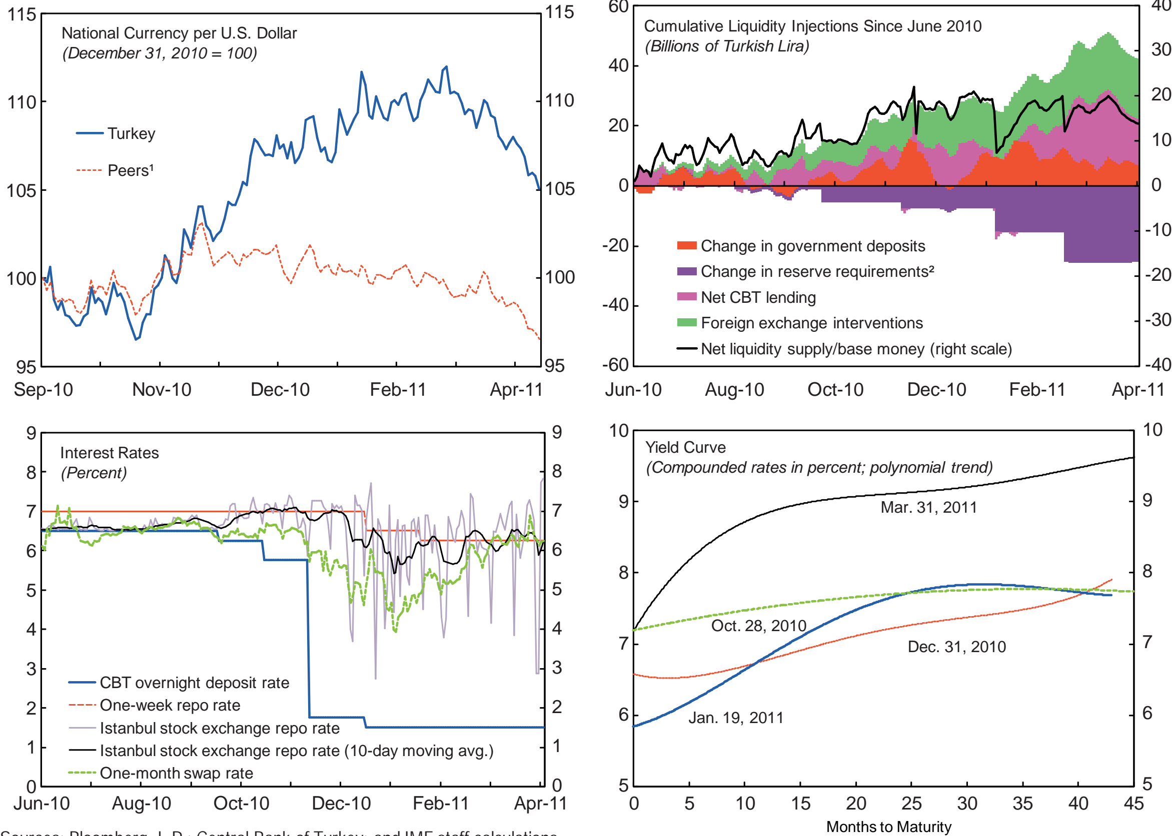
The CBT regards its new strategy as similar in spirit to conventional inflation targeting. It considers the combination of tools—repo rate, required reserve ratios, interest rate corridor—as its new policy instrument, and that the mix can be adjusted as needed to secure both price and financial stability. Moreover, it expects that the recently taken measures tightened the policy stance, with the higher required reserve ratios more than offsetting the loosening effect of the lower policy rate.

Turkey's new monetary policy strategy has achieved some success, but its ability to contain inflation and credit growth has yet to be proved (figure). The strategy has been effective at moderating exchange rate pressures, as can be seen from the decoupling of the lira from other emerging market currencies since mid-November.

Note: The main author of this box is Justin Tyson.

[1] Proceeds from repos with foreign banks and domestic nonbanks were included in the base. As a result, the required reserve base is very comprehensive and includes all banks' liabilities with the exception of proceeds from CBT and domestic bank repos.

Monetary and Exchange Rate Indicators



Sources: Bloomberg, L.P.; Central Bank of Turkey; and IMF staff calculations.
[1]Simple average of Brazil, Chile, Colombia, Hungary, Indonesia, Poland, Korea, South Africa, and Thailand.
[2]Calculated as the net liquidity injection implied by July 2010, Sep., 2010, Dec., 2010 , Jan., 2011 and Feb., 2011 changes in the reserve requirement ratios.

This decoupling likely reflects the lower average and higher volatility of returns on very short-term inflows (as can be seen from the initial decline in the short end of the yield curve and the increased variability in the market repo rate). However, rapid credit growth continues unabated, and the recent nominal depreciation will add to inflation pressures from a closed output gap and global commodity price increases. The limited progress made through March in slowing credit growth may be due in part to the cuts in the policy rate. This is because the CBT is injecting sufficient liquidity to enable banks to meet the higher required reserve ratios while also allowing interbank interest rates to settle, on average, near the new lower policy rate. Moreover, with banks borrowing more from the CBT, their marginal funding costs have fallen—because of the lower policy rate and exemption of CBT repos from required reserves—reducing the need for higher interest rates on bank loans. Market concerns about the effectiveness and sustainability of the lower policy rate may underpin the 200-basis-point increase in government bond yields in recent months.

side, retail sales growth is firmly back in positive territory everywhere except Croatia, Bulgaria, and Romania. Consumer confidence improved across the board, though often from low levels. With industrial production recovering, capacity utilization has picked up and is now close to long-term averages. Indeed, senior loan officers report higher demand for credit from enterprises. Demand for loans by households is also up, though not yet in Romania. A long period with ever-tighter credit standards seems to be drawing to a close.

Table 2.1

Emerging Europe: Growth of Real GDP, Domestic Demand, Exports, and Private Consumption, 2009–12

(Percent)

	Real GDP Growth				Real Domestic Demand Growth				Real Exports Growth[1]				Real Private Consumption Growth			
	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
Baltics[2]	-15.9	0.7	4.1	3.9	-26.2	1.6	5.0	4.1	-13.2	14.1	9.2	7.5	-20.1	-2.6	2.7	3.0
Latvia	-18.0	-0.3	3.3	4.0	-27.6	-0.9	3.0	4.3	-14.1	10.3	7.0	5.7	-24.1	-0.1	3.0	4.0
Lithuania	-14.7	1.3	4.6	3.8	-25.4	3.0	6.1	4.0	-12.7	16.3	10.5	8.5	-17.7	-4.1	2.5	2.4
Central Europe[2]	-0.1	3.3	3.6	3.4	-3.1	2.9	3.2	3.4	-7.4	11.0	7.5	6.7	0.2	2.0	3.2	3.3
Hungary	-6.7	1.2	2.8	2.8	-10.8	-1.6	2.3	2.5	-9.6	13.9	9.3	8.7	-6.8	-2.6	1.5	2.2
Poland	1.7	3.8	3.8	3.6	-1.0	4.0	3.4	3.7	-6.8	10.2	7.0	6.2	2.0	3.2	3.6	3.6
Southeastern Europe–EU[2]	-6.6	-0.9	1.9	4.1	-12.8	-1.9	1.0	4.0	-6.9	14.0	9.4	8.0	-9.5	-1.5	1.7	4.0
Bulgaria	-5.5	0.2	3.0	3.5	-12.7	-4.5	3.0	3.5	-11.2	16.2	9.8	7.5	-7.6	-1.2	3.6	4.0
Romania	-7.1	-1.3	1.5	4.4	-12.9	-1.0	0.3	4.2	-5.3	13.1	9.3	8.2	-10.2	-1.7	1.0	4.1
Southeastern Europe–non-EU[2]	-3.0	0.8	2.5	3.6	-7.2	-3.3	1.3	3.4	-12.8	14.0	9.3	6.8	-4.2	-1.0	1.1	3.4
Albania	3.3	3.5	3.4	3.6	3.1	-8.0	4.1	2.6	-1.7	29.0	1.2	7.6	6.5	-5.1	3.3	2.4
Bosnia and Herzegovina	-3.1	0.8	2.2	4.0	-6.4	-1.4	1.3	4.1	-6.2	9.7	6.0	4.8	-3.9	0.8	0.8	3.3
Croatia	-5.8	-1.4	1.3	1.8	-9.3	-5.1	0.7	2.0	-16.2	4.1	3.3	2.1	-8.5	-1.2	0.1	0.5
Kosovo	2.9	4.0	5.5	5.2	...	...	...	...	...	...	...	...	...	...	...	...
Macedonia, FYR	-0.9	0.7	3.0	3.7	-2.9	-1.1	2.4	3.8	-10.7	22.7	18.7	13.0	-3.9	1.1	2.4	3.9
Montenegro, Republic of	-5.7	1.1	2.0	3.5	-16.9	-3.3	-1.2	1.2	-22.4	9.0	8.2	5.3	-13.4	6.8	-2.3	-0.1
Serbia, Republic of	-3.1	1.8	3.0	5.0	-8.6	-1.2	0.9	4.8	-15.0	19.1	16.6	10.2	-2.4	-1.3	1.3	6.6
European CIS countries[2]	-8.2	4.2	4.9	4.6	-14.4	6.5	7.6	6.1	-7.3	10.0	3.4	4.2	-5.7	3.4	7.2	6.8
Belarus	0.2	7.6	6.8	4.8	-1.1	10.3	6.1	5.0	-9.0	5.1	13.3	4.7	0.0	8.6	6.9	6.9
Moldova	-6.0	6.9	4.5	4.8	-18.6	9.6	5.9	5.5	-12.1	12.8	7.1	9.2	-8.0	9.0	5.8	5.3
Russia	-7.8	4.0	4.8	4.5	-14.0	6.3	7.8	6.3	-4.7	10.2	2.4	3.8	-4.9	2.8	7.1	7.0
Ukraine	-14.8	4.2	4.5	4.9	-22.6	6.2	6.3	5.3	-25.1	10.4	5.9	6.7	-13.9	5.9	7.5	5.3
Turkey	-4.7	8.2	4.6	4.5	-7.2	12.2	5.3	5.1	-5.3	2.6	6.2	6.1	-2.2	7.3	6.1	5.7
Emerging Europe[2,3]	-5.9	4.2	4.3	4.3	-10.9	5.8	5.6	5.2	-7.3	9.3	5.4	5.4	-4.5	3.3	5.6	5.6
New EU member states[2,4]	-3.5	2.2	3.0	3.5	-7.0	1.4	2.4	3.4	-9.0	13.0	8.3	6.8	-3.1	0.6	2.4	3.3
Memorandum																
Czech Republic	-4.1	2.3	1.7	2.9	-3.7	1.1	1.0	2.2	-10.8	18.0	10.3	6.3	-0.2	0.4	0.9	2.3
Estonia	-13.9	3.1	3.3	3.7	-20.5	-3.8	3.5	3.7	-18.7	21.7	4.1	4.9	-18.8	-1.9	2.4	2.4
Slovak Republic	-4.8	4.0	3.8	4.2	-7.9	2.7	1.8	3.6	-15.9	16.4	8.5	6.6	0.3	-0.3	2.3	3.8
Slovenia	-8.1	1.2	2.0	2.4	-10.1	0.4	1.0	2.2	-17.7	7.8	6.8	5.7	-0.8	0.5	1.2	2.2
European Union[2,5]	-4.1	1.8	1.8	2.1	-4.2	1.3	1.0	1.6	-12.6	10.1	6.6	5.1	-1.7	0.8	1.2	1.6

Source: IMF, World Economic Outlook database.

[1] Real exports of goods and services.

[2] Weighted average. Weighted by GDP valued at purchasing power parity.

[3] Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Republic of Montenegro, Poland, Romania, Russia, Republic of Serbia, Turkey, and Ukraine.

[4] Includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

[5] Includes Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, and the United Kingdom.

Growth Should Hold Steady at Slightly More Than 4 Percent This Year and Next …

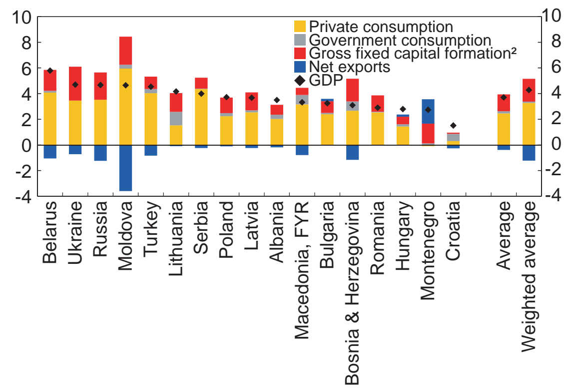
Growth projections for 2011 and 2012 have been revised up slightly for emerging Europe, to 4.3 percent in both years (Table 2.1).

- Exports will likely continue to support growth. Trading partner imports are projected to expand by 6½ percent, down from the rebound rates of last year but still solid. The region's exporters are expected to retain much of the edge they gained in the previous two years.
- Domestic demand will become the main pillar of growth as it catches up to recover in those countries where it had languished. Private consumption and investment are both expected to do well, as suggested by the improved readings for confidence, credit tightness, and capacity utilization (Figure 2.7). Investment and consumption ratios should stabilize and start to pick up modestly, reversing some of their steep declines in the wake of the 2008–09 crisis. In a virtuous cycle, the initial domestic demand impulse lifts incomes and employment, further strengthening domestic demand (Figure 2.8).
- Consequently, intraregional growth differentials are abating. Growth rates are expected to be positive in all countries this year for the first time since the crisis and will move into a relatively narrow range of 1¾ percent to 5¼ percent by 2012. Very fast growth in Belarus and Turkey is projected to slow as the macroeconomic policy stance tightens and base effects run their course, respectively. The Baltics, Bulgaria, and, with somewhat of a delay, Romania will reap the full-year effect of the ongoing recovery. Growth in Russia will also likely strengthen, by an estimated ¾ percentage point, absent a repeat of last year's heat wave. In Poland, growth is expected to hold steady. Hungary's government is putting in place considerable fiscal stimulus through tax cuts financed by a rollback of pension reform, while also imposing special levies on selected industries. Growth there is

Figure 2.7

Emerging Europe: Contributions to GDP Growth, 2011–12[1]

(Percentage points, annual average)

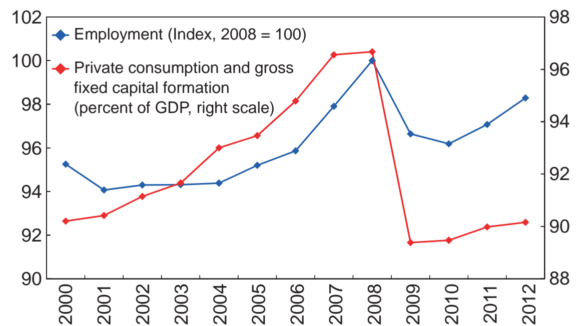


Sources: IMF, World Economic Outlook database; and IMF staff estimates.
[1]Contributions from inventories and statistical discrepancy not shown.
[2]Investment in the case of Macedonia, FYR.

Figure 2.8

Emerging Europe: Private Consumption and Investment Ratios, and Employment, 2000–12

(Simple averages across countries of the region)

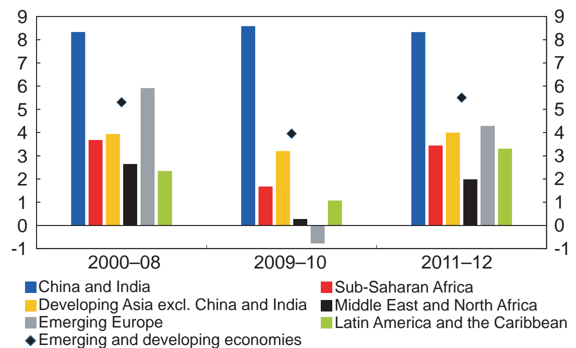


Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Figure 2.9

Emerging Europe and Selected Regions: Real Per Capita GDP Growth

(Percent per year)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

projected to pick up to a moderate pace of some 2.8 percent.

… A Performance Similar to That in Other Emerging Markets, Apart from China and India

In per capita terms, emerging Europe is projected to expand at a rate similar to the rates in other emerging market regions—only China and India are expected to enjoy considerably higher growth (Figure 2.9). However, no extra rebound effect is expected from the especially deep recession in 2009, suggesting that the recession was largely a correction to excessive growth in the precrisis years.

The Outlook for the Overall External Positions Is Benign…

Regional Economic Outlook projections put this year's aggregate current account deficit at 0.3 percent of GDP, essentially unchanged from 2010, and expect a widening to 1.1 percent of GDP next year (Table 2.2). Russia's current account surplus rises further in 2011, but it is expected to fall back somewhat in 2012 as the balance of payments impact from buoyant import growth is no longer trumped by rising oil prices. Elsewhere, rising oil prices put pressure on current account balances this year. Current account balances deteriorate in the Baltics, Bulgaria, Hungary, and Poland, but all deficits should remain easily financed by FDI and net transfers from the EU. In Turkey, Belarus, and Serbia, deteriorations build on already large deficits in 2010 and therefore are a cause for concern. External debt ratios are set to decline very gradually, remaining above 75 percent of GDP in Bulgaria, Croatia, Hungary, Latvia, Lithuania, Montenegro, Romania, and Ukraine.

… While Inflation Is Projected to Remain Moderate

Current projections hold that inflation will remain unchanged at 7.1 percent at the end of this year, and decline over the course of 2012 (Table 2.2). By end-2011, inflation will still exceed 5 percent in Bulgaria, Kosovo, FYR Macedonia, Serbia, Turkey, and all European CIS countries. These projections assume that the second-round effects from the large commodity price increases that have already occurred will be small—the result of still considerable negative output gaps in most countries of the region.

Risks to the Outlook

Commodity Prices Pose a Downside Risk to the Outlook

High commodity prices pose adverse risks to the inflation and growth outlook.

- Food and energy prices account for a large share in the CPIs of the region.[4] The full first-round effects on consumer prices of global commodity price increases to date might yet be unfolding. And commodity prices might turn out to be higher than suggested by futures prices amid unexpectedly tight supply conditions.
- Negative output gaps may put less downward pressure on wages and prices than envisaged. Estimates of output gaps are inherently imprecise. Moreover, spare capacity in the economy as a whole might not curb wage and price demands when underemployed resources cannot be reallocated to high demand sectors in the short term.
- Monetary policymakers will need to stay on high alert. Even countries with well-anchored inflation expectations may find it hard to avoid second-round effects if first-round effects are large or persistent, as global commodity prices rise disproportionately over the medium term.
- Even if second-round effects on inflation are largely avoided, high commodity prices can

[4] Shares range from 25 percent in Hungary to 60 percent in Ukraine. This compares to a euro area average of slightly more than 20 percent.

Table 2.2

Emerging Europe: CPI Inflation, Current Account Balance, and External Debt, 2009–12

(Percent)

	CPI Inflation (Period average)				CPI Inflation (End of period)				Current Account Balance to GDP				Total External Debt to GDP			
	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
Baltics[1]	4.0	0.3	3.1	2.5	0.3	3.2	2.9	2.4	6.2	2.5	0.5	-1.2	118.2	117.4	109.6	103.0
Latvia	3.3	-1.2	3.0	1.7	-1.4	2.4	1.9	2.3	8.6	3.6	2.6	1.5	156.3	165.2	152.0	141.2
Lithuania	4.4	1.2	3.1	2.9	1.3	3.6	3.5	2.5	4.5	1.8	-0.9	-2.9	91.4	85.7	82.2	78.5
Central Europe[1]	3.6	3.1	4.1	3.0	3.9	3.3	3.8	2.8	-1.8	-2.2	-2.8	-3.1	85.3	83.5	83.7	81.5
Hungary	4.2	4.9	4.1	3.5	5.6	4.2	3.9	3.2	-0.5	1.6	1.5	0.9	153.3	143.9	140.6	131.5
Poland	3.5	2.6	4.1	2.9	3.5	3.1	3.8	2.7	-2.2	-3.3	-3.9	-4.2	64.9	66.8	68.4	68.5
Southeastern Europe–EU[1]	4.7	5.3	5.7	3.5	3.9	7.0	4.4	2.8	-5.5	-3.4	-4.2	-4.4	81.4	80.6	82.4	78.5
Bulgaria	2.5	3.0	4.8	3.7	1.6	4.4	5.3	2.4	-10.0	-0.8	-1.5	-2.0	113.6	102.3	94.7	88.2
Romania	5.6	6.1	6.1	3.4	4.8	8.0	4.0	3.0	-4.2	-4.2	-5.0	-5.2	71.8	74.2	78.7	75.6
Southeastern Europe–non-EU[1]	3.7	3.2	6.1	3.1	3.1	5.1	4.9	3.0	-7.8	-5.7	-6.9	-6.6	78.4	78.4	73.8	72.5
Albania	2.2	3.6	4.5	3.5	3.7	3.4	4.0	2.9	-14.0	-10.1	-11.2	-9.8	33.5	41.6	37.7	39.1
Bosnia and Herzegovina	-0.4	2.1	5.0	2.5	0.0	3.1	5.0	2.5	-6.9	-6.0	-6.0	-5.7	54.9	54.6	58.6	58.4
Croatia	2.4	1.0	3.5	2.4	1.9	1.9	3.5	2.4	-5.5	-1.9	-3.6	-3.6	101.9	99.3	93.4	91.4
Kosovo	-2.4	3.5	8.2	2.1	0.1	6.6	5.6	2.0	-16.8	-17.3	-23.1	-25.6	...	...	...	...
Macedonia, FYR	-0.8	1.5	5.2	2.0	-1.6	3.0	7.5	2.0	-6.4	-2.8	-4.2	-4.8	57.5	56.5	57.3	58.2
Montenegro, Republic of	3.4	0.5	3.1	2.0	1.5	0.7	3.0	1.8	-30.3	-25.6	-24.5	-22.1	97.8	100.2	99.0	97.5
Serbia, Republic of	8.1	6.2	9.9	4.1	6.6	10.3	6.0	4.0	-6.9	-7.1	-7.4	-6.6	78.7	81.6	74.0	72.8
European CIS countries[1]	12.2	7.2	9.5	8.1	9.2	8.9	8.9	7.6	2.9	3.6	4.2	2.7	43.1	37.3	30.7	28.1
Belarus	13.0	7.7	12.9	9.7	10.1	9.9	13.0	9.0	-13.0	-15.5	-15.7	-15.2	44.9	51.5	57.9	63.4
Moldova	0.0	7.4	7.5	6.3	0.4	8.1	7.5	5.0	-8.5	-10.9	-11.1	-11.2	65.5	67.4	70.3	74.0
Russia	11.7	6.9	9.3	8.0	8.8	8.8	8.5	7.5	4.1	4.9	5.6	3.9	38.6	32.3	25.5	22.6
Ukraine	15.9	9.4	9.2	8.3	12.3	9.1	10.2	7.7	-1.5	-1.9	-3.6	-3.8	88.0	83.9	80.7	80.3
Turkey	6.3	8.6	5.7	6.0	6.5	6.4	7.0	5.4	-2.3	-6.5	-8.0	-8.2	43.7	40.7	43.7	46.2
Emerging Europe[1,2]	8.5	6.3	7.3	6.2	7.0	7.1	7.1	5.8	-0.1	-0.5	-0.3	-1.1	57.3	52.0	47.7	45.4
New EU member states[1,3]	3.2	2.9	3.9	2.9	2.9	3.7	3.6	2.7	-2.0	-2.2	-2.6	-2.8	75.7	75.1	73.9	71.2
Memorandum																
Czech Republic	1.0	1.5	2.0	2.0	1.0	2.3	2.2	2.0	-1.1	-2.4	-1.8	-1.2	45.5	47.4	44.0	42.0
Estonia	-0.1	2.9	4.7	2.1	-1.7	5.4	3.5	2.0	4.5	3.6	3.3	3.1	125.8	117.6	100.5	95.0
Slovak Republic	0.9	0.7	3.4	2.7	0.1	1.3	3.4	2.9	-3.6	-3.4	-2.8	-2.7	71.9	72.1	70.4	67.8
Slovenia	0.9	1.8	2.2	3.1	1.8	1.9	3.0	2.7	-1.5	-1.2	-2.0	-2.1	105.2	113.8	113.3	114.4
European Union[1,4]	0.9	2.0	2.7	1.9	1.2	2.5	2.5	1.9	-0.2	-0.1	-0.2	-0.1	...	...	...	...

Source: IMF, World Economic Outlook database.

[1] Weighted average. CPI inflation is weighted by GDP valued at purchasing power parity, and current account balances and external debt are weighted by U.S. dollar GDP.

[2] Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Republic of Montenegro, Poland, Romania, Russia, Republic of Serbia, Turkey, and Ukraine.

[3] Includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

[4] Includes Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, and the United Kingdom.

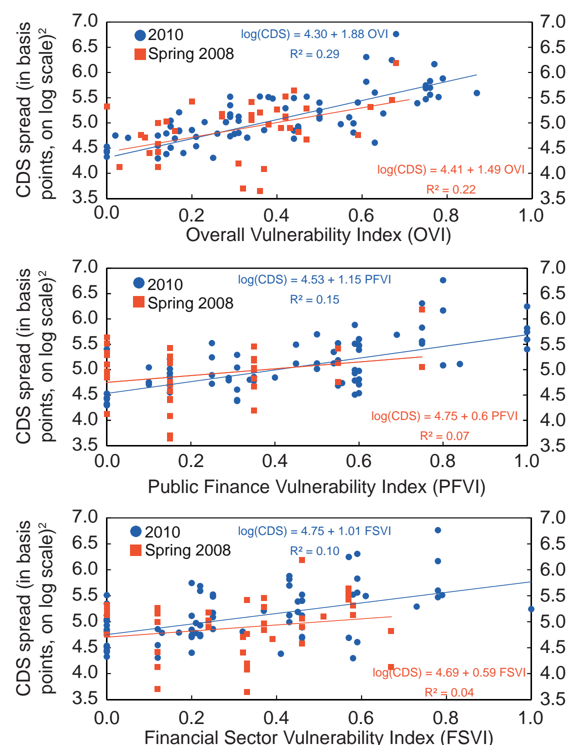
still hurt growth through several channels. Most countries would have to cope with sizable adverse terms-of-trade effects. Domestic, as well as external, demand would suffer if inflationary pressures make tighter macroeconomic policies necessary in both emerging Europe and its trading partners. Tighter policies could also spell the end of the favorable financing conditions that sovereigns in the region now generally enjoy.

Sovereign Debt Problems in the Euro Area Are Another Concern

Strong financial and economic linkages with advanced Europe mean that an escalation of the sovereign debt problems in the euro area could have serious repercussions for emerging Europe.

Figure 2.10

Selected Emerging Market Economies: Costs of Funding and Vulnerabilities[1]



Sources: Datastream; IMF, World Economic Outlook database; and IMF staff calculations.

[1]Covers 36 economies that have CDS spread data. Outliers such as Argentina, Pakistan, and Venezuela are excluded.

[2]Average over January–March 2008 for spring 2008, and January–March and July–September 2010 for combined spring and fall 2010.

In an adverse scenario in which western banks take a significant hit, they might have to resort to sizable cuts of their exposures to emerging Europe, and access to funding might become more difficult generally for all but the strongest of borrowers as investors become more averse to vulnerabilities. Even less drastic developments could prompt western banks to curtail financing for banks in emerging Europe, which would choke off the fledgling recovery of private credit and derail the good prospects for growth in the baseline.

Against this background, the authorities in emerging Europe should make every effort to reduce vulnerabilities. Government financing costs are sensitive to vulnerabilities, especially those in the fiscal and financial sectors, and have become more so since the crisis (Figure 2.10).

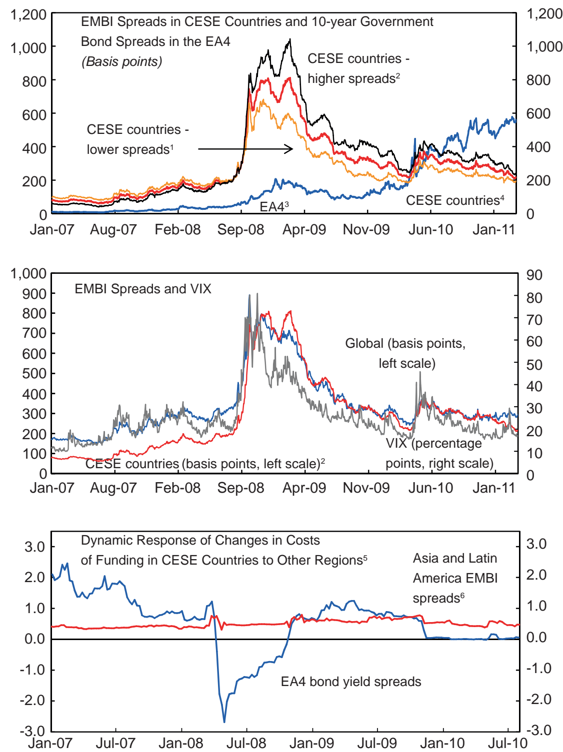
Fortunately, financial tensions in the euro area have not prompted financial markets to price in an extra risk premium for emerging Europe, reflecting the expectation that sovereign debt problems in the euro area periphery will remain contained and will be resolved without major disruptions. Still, financing costs in emerging Europe, just as in emerging market economies more generally, depend on country-specific vulnerabilities and on global risk appetite.

- Sovereign bond spreads in emerging Europe and the euro area countries that have experienced most market pressures (Greece, Ireland, Portugal, and Spain)[5] have demonstrated little correlation with each other. Over the past two years, spreads for sovereigns in emerging Europe have been trending downward while for some euro area countries they have risen sharply (Figure 2.11, panel 1). Financing conditions in emerging Europe have instead moved in lockstep with other emerging markets, with global risk appetite driving both (Figure 2.11, panel 2). Even when controlling

[5] Defined as euro area countries with average bond spreads over 10-year German bunds of 200 bps or more during January to mid-April 2011. Spreads range from just under 900 bps for Greece to just over 200 bps in the case of Spain.

Figure 2.11

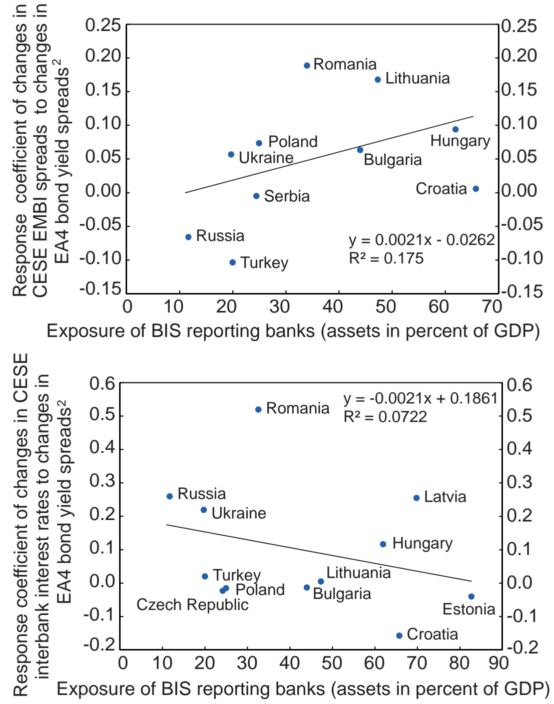
CESE and EA4 Countries: Funding Costs, 2007–11



Sources: Bloomberg L.P.; Datastream; and IMF staff calculations.
[1]Simple average for Bulgaria, Poland, Russia, Serbia, and Turkey.
[2]Simple average for Croatia, Hungary, Lithuania, Romania, and Ukraine.
[3]Simple average for Greece, Ireland, Portugal, and Spain (the EA4).
[4]Simple average for Bulgaria, Croatia, Hungary, Lithuania, Poland, Romania, Russia, Serbia, Turkey, and Ukraine.
[5]Dynamic response is the regression coefficient from regressing changes in costs of funding in CESE countries on counterpart changes in other regions together with a constant term based on a moving window over 26 weeks. Costs of funding refer to EMBI spreads for emerging market economies and 10-year bond spreads for countries in the EA4. Changes in costs of funding are also controlled for global financial market conditions including TED, VIX, and their interactions with the crisis occurrence.
[6]Simple average of regional EMBI spreads.

Figure 2.12

Foreign Bank Presence and Association Between Funding Costs in CESE Countries and the EA4[1]



Sources: Bloomberg L.P.; and IMF staff calculations.
[1]The EA4 comprise Greece, Ireland, Portugal, and Spain.
[2]Response coefficient is the regression coefficient from regressing changes in costs of funding in CESE countries on changes in costs of funding in the EA4 over the period starting from 2007. These changes of costs in funding are also controlled for VIX, TED, and their interactions with the crisis occurrence.

for such global factors, there is no convincing evidence of a systematic link with spreads in the euro area countries facing market pressure (Figure 2.11, panel 3). Apparently, financing conditions in these euro area countries affect emerging Europe only to the extent that they register on a global scale.

- Emerging European countries that depend heavily on financing from Western banks seem to be no more affected by developments in euro area high-spread countries than is the rest of the region. The strength of the association between spreads in euro area countries under market pressure and in emerging Europe is independent of Western banks' exposure to the local economy, and small in any event (Figure 2.12, panel 1). For example, exposure to Hungary is some 60 percent of GDP compared with exposure to Poland of about 20 percent of GDP. Yet, the association of these countries' spreads with spreads in euro area countries under market pressure is about the same and very small. Likewise, local interbank interest rates seem no more sensitive to spreads in euro area high-spread countries with heavy dependence on funding from Western banks than in those without (Figure 2.12, panel 2). Apparently, financial markets are not yet concerned about spillovers through the bank funding channel.

Table 2.3

Emerging Europe: Evolution of Public Debt and General Government Balance, 2009–12[1]

(Percent of GDP)

	General Government Balance				Public Debt			
	2009	2010	2011	2012	2009	2010	2011	2012
Baltics[2]	-8.7	-7.7	-5.8	-4.2	30.8	39.1	43.1	43.8
Latvia[3]	-7.8	-7.9	-5.3	-1.9	32.8	39.9	42.5	41.0
Lithuania	-9.2	-7.6	-6.0	-5.5	29.6	38.7	43.5	45.4
Central Europe[2]	-6.6	-7.1	-3.7	-4.2	56.7	60.8	60.7	61.3
Hungary[4]	-4.3	-4.1	3.9	-4.3	78.4	80.4	76.6	76.9
Poland	-7.2	-7.9	-5.7	-4.2	50.9	55.7	56.6	57.3
Southeastern Europe-EU[2]	-5.6	-5.7	-3.9	-2.6	25.8	30.5	32.8	32.8
Bulgaria[3]	-0.9	-3.6	-2.6	-1.5	15.6	18.0	19.7	20.0
Romania	-7.3	-6.5	-4.4	-3.0	29.6	35.2	37.8	37.7
Southeastern Europe-non-EU[2]	-4.5	-4.4	-4.5	-3.9	37.5	41.8	42.6	43.6
Albania[3]	-7.5	-3.7	-4.6	-4.6	60.2	59.7	59.9	60.4
Bosnia and Herzegovina	-5.6	-4.0	-3.0	-1.9	35.4	36.9	41.4	41.4
Croatia[3]	-4.1	-5.3	-6.3	-6.1	35.4	40.0	44.1	47.6
Kosovo[3]	-0.7	-2.9	-3.3	-4.1	...	...	...	...
Macedonia, FYR	-2.7	-2.5	-2.5	-2.2	23.9	24.8	26.8	27.4
Montenegro, Republic of[3]	-6.5	-3.8	-3.4	-2.5	40.7	44.1	43.1	42.2
Serbia, Republic of[3]	-4.3	-4.5	-4.1	-2.8	36.8	44.0	40.5	39.8
European CIS countries[2]	-6.0	-3.7	-1.7	-1.8	14.3	14.1	13.3	13.8
Belarus[3]	-0.7	-1.8	-1.9	-2.0	20.0	22.4	25.3	27.1
Moldova[3]	-6.3	-2.5	-1.9	-0.7	31.6	29.8	30.4	32.4
Russia[3]	-6.3	-3.6	-1.6	-1.7	11.0	9.9	8.5	8.8
Ukraine[3]	-6.2	-5.8	-2.8	-2.5	35.3	40.5	42.6	43.5
Turkey[3]	-6.2	-3.4	-2.2	-2.0	45.5	41.7	39.4	37.6
Emerging Europe[2,5]	-6.1	-4.5	-2.5	-2.4	29.5	30.1	29.4	29.4
New EU member states[2,6]	-6.4	-6.5	-3.9	-3.7	43.4	48.1	49.4	50.1
Memorandum								
Czech Republic	-5.8	-4.9	-3.7	-3.6	35.4	39.6	41.7	43.4
Estonia	-2.1	0.2	-1.0	-0.7	7.2	6.6	6.3	6.0
Slovak Republic	-7.9	-8.2	-5.2	-3.9	35.4	42.0	45.1	46.2
Slovenia[3]	-5.8	-5.7	-2.0	-3.3	35.4	37.2	42.3	44.9
European Union[1,7]	-6.8	-6.6	-4.8	-4.0	72.3	78.2	80.6	81.8

Source: IMF, World Economic Outlook database.

[1] As in the *World Economic Outlook*, general government balances reflect IMF staff's projections of a plausible baseline, and as such contain a mixture of unchanged policies and efforts under programs, convergence plans, and medium-term budget frameworks.

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

[3] Reported on a cash basis.

[4] Fiscal surplus in 2011 reflects revenue from rollback of pension reform. Assets of 11 percent of GDP are transferred from private-sector to public pension funds.

[5] Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Republic of Montenegro, Poland, Romania, Russia, Republic of Serbia, Turkey, and Ukraine.

[6] Includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

[7] Includes Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, and the United Kingdom.

Key Policy Questions Going Forward

In light of these downside risks to the outlook and the considerable slack evident in many economies in emerging Europe, policymakers face three main policy questions. What should be done to reduce fiscal and financial vulnerabilities? How far has the region progressed in switching to a new growth model driven by the tradable sector? What can policymakers do to nudge it toward that model?

Fiscal Policy

Fiscal Positions Are Set to Tighten in 2011 and Remain Unchanged in 2012

The region's fiscal deficit is projected to decline from 4½ percent of GDP in 2010 to 2½ percent of GDP in 2011, and remain largely unchanged in 2012 (Table 2.3). Discretionary measures equivalent to 1.7 percent of GDP are chiefly responsible for the 2011 deficit reduction. Much of the regional improvement is attributable to Russia, while consolidation measures in the rest of the region are similar to last year's (about 1 percent of GDP). Poland is assumed to put in place consolidation measures of about one percent of GDP, in line with its convergence plan. A few countries, including Croatia, Hungary, Kosovo, and Turkey, go against the grain and loosen their fiscal stances. Projections for 2012 do not factor in significant further measures for the region as a whole.

Despite this consolidation, fiscal vulnerabilities remain elevated in many countries.

- Public debt ratios in 2012 will still be trending upward in two-thirds of the countries and will exceed 40 percent of GDP in half the region.
- Aggregate indicators disguise much weaker public finances in individual countries. Key fiscal vulnerability indicators in many countries are above both emerging market averages and, even more so, prudent thresholds (Figure 2.13).[6] Debt stock vulnerabilities are high in Albania and Hungary, as well as arguably in Poland.[7] Albania and Hungary, along with Turkey, also have uncomfortably high short-term government debt, which exposes them to rollover risk. High fiscal deficits constitute a considerable flow vulnerability in Latvia, Lithuania, Poland, and Romania. Foreign-currency-denominated debt is high in Hungary and Serbia, exposing their public finances to exchange rate risk.
- Emerging Europe's public finances no longer compare favorably with other emerging markets (Figure 2.14). In 2007, both deficit and public debt indicators for the region matched up well against other emerging markets, but 2012 deficit ratios are expected to remain above those in Latin America and emerging Asia, and public debt has lost much of the edge it once had over emerging Asia.
- The cross-regional comparison does not take into account particularly pronounced population aging in emerging Europe and the strains it will inevitably put on public finances.[8]

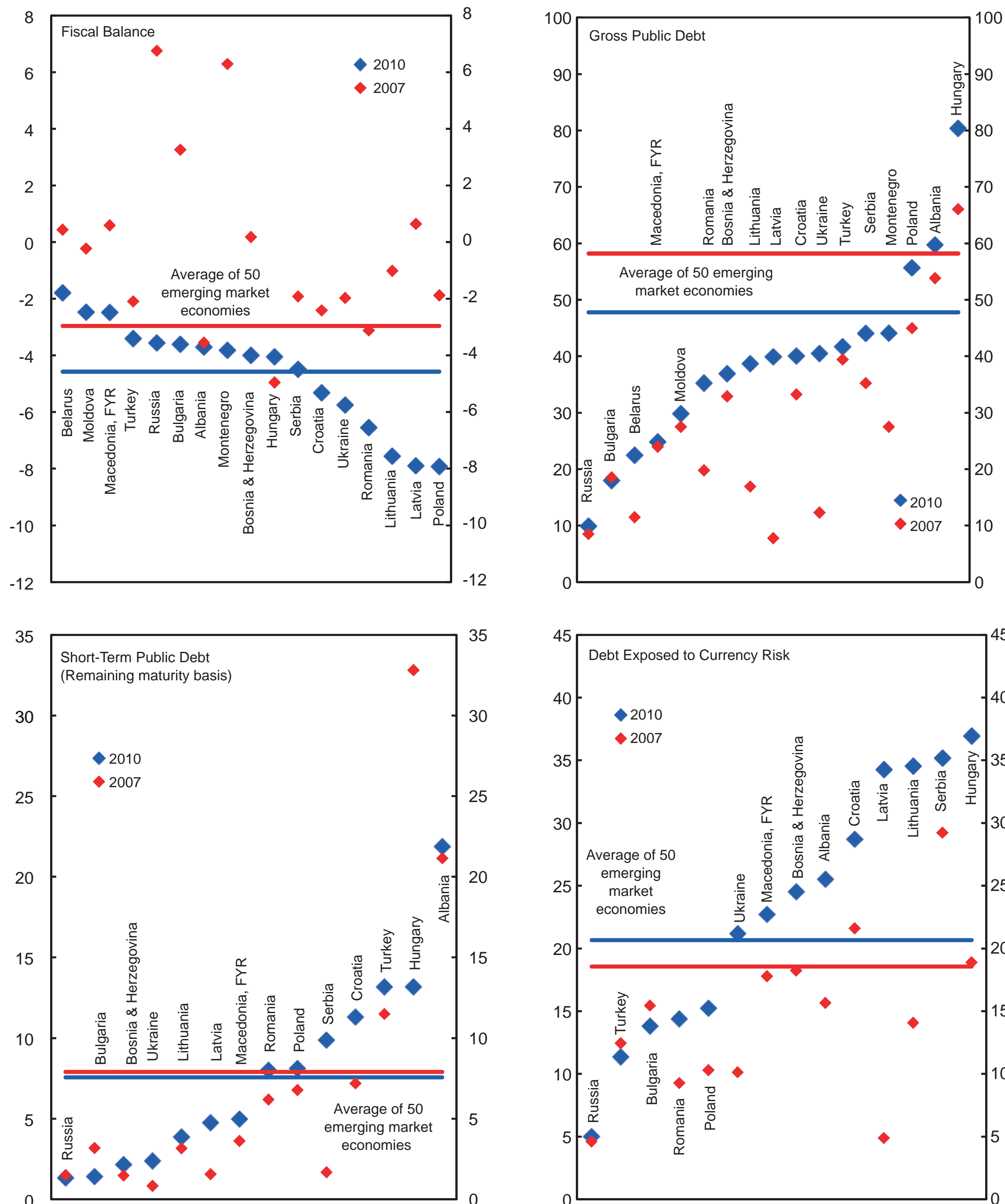
Recent experience further underscores the need for robust fiscal positions with regard to solvency

[6] Key fiscal indicators that should not exceed prudent thresholds include public debt, the fiscal balance, public debt exposed to foreign currency risk, and public debt exposed to rollover risk, all expressed as a percentage of GDP. The primary gap is generally another key indicator of fiscal vulnerability. However, in emerging Europe the primary gap identifies the same countries as particularly vulnerable as the primary balance and is therefore omitted. The primary gap is defined as the difference between the actual and the debt-stabilizing primary balance.

[7] Poland's debt-to-GDP ratio of 56 percent of GDP is high by emerging market standards. However, Poland has set aside assets of some 15 percent of GDP in second-pillar private pension funds, much more than other countries. Public debt net of these assets is close to the emerging market average. Assets of second-pillar private pension funds are also considerable in Hungary but public debt net of these assets is still uncomfortably high.

[8] Over the next 20 years, the old-age dependency ratio will rise to 29 percent in emerging Europe compared with 18 percent in Latin America and the Caribbean and in Asia according to U.S. Census Bureau projections.

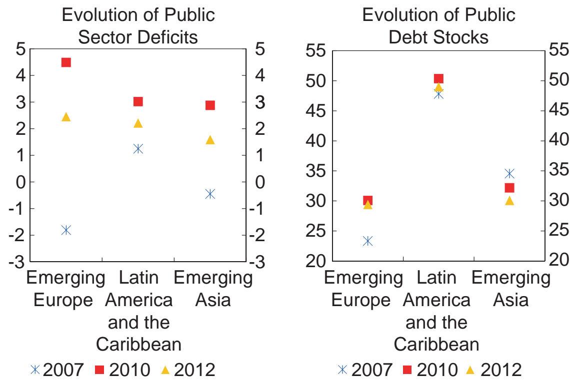
Figure 2.13
Emerging Europe: Fiscal Vulnerability Indicators in Perspective
(Percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

and liquidity. The possibility of pernicious feedback loops between financing costs and deficits means that buffers need to be built into public finances, and the more jittery financial markets are the bigger the buffers need to be. Otherwise, a jump in financing costs can call public solvency into question, thus justifying the very increase in financing costs. As the problems in the euro area periphery demonstrate, reassessment of solvency risks by financial markets can be swift and come with little warning. Emerging Europe's own experience in the 2008–09 crisis highlights liquidity risk—even governments with little

Figure 2.14
Selected Regions: Deterioration of Public Finances
(Percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

debt found themselves cut off from financing on affordable terms.

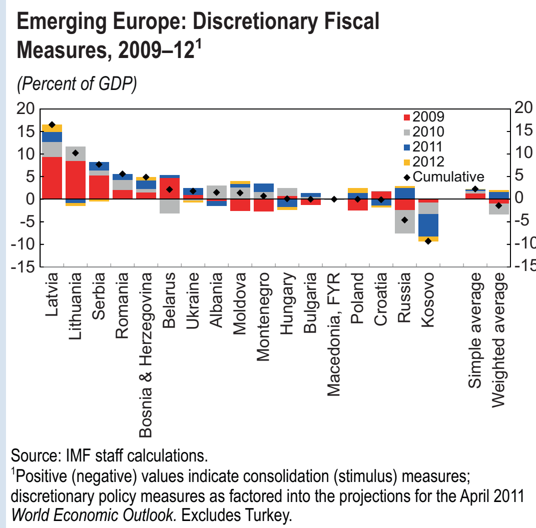
Fiscal Consolidation Will Need to Continue

Although significant consolidation has occurred in a number of countries, and further consolidation is planned, the repairs to public finances remain a work in progress. Public revenues are unlikely to return to the levels at the height of the boom (Box 2.3). Consolidation efforts should be supplemented by a strengthening of fiscal frameworks to include enhanced transparency, better public financial management, and stronger governance arrangements.

Box 2.3

Discretionary Fiscal Policies Since the 2008–09 Crisis

Fiscal efforts during 2009–12 differ widely across countries but on aggregate they are perhaps smaller than generally believed (first figure).[1] A number of countries, such as the Baltic countries, Bosnia and Herzegovina, Romania, and Serbia, put in place very large consolidation measures. These actions were motivated by the need to address rapidly rising deficits, preserve exchange rate pegs, or respond to market pressures. In another group of countries, including Bulgaria, Montenegro, and Poland, fiscal policy is countercyclical, with stimulative discretionary measures in the downturn and largely balancing restrictive measures during the recovery. Russia stands out as having implemented very significant fiscal stimulus operations, only part of which are expected to be rolled back this year and next. As a result of Russia's large weight in the regional economy, cumulative discretionary fiscal measures in emerging Europe are expansionary to the tune of 1.5 percent of GDP, even though most countries implemented more consolidation measures than stimulus measures.



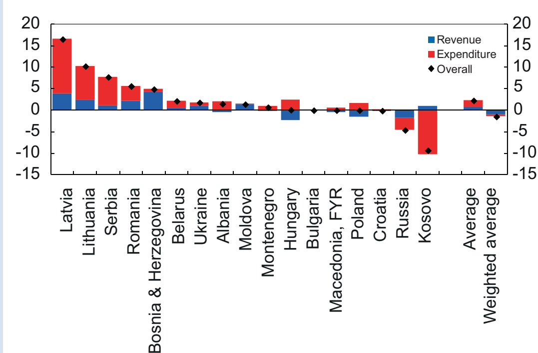
The quality of the fiscal measures varies. On the positive side, some 70 percent of the adjustment for the average country comes from expenditure-side rather than revenue-side measures (second figure). Expenditure-focused fiscal adjustment is typically more durable and less contractionary than reliance on tax hikes and other levies (IMF, 2010e). However, Russia implemented much of its stimulus through permanent expenditure measures,

Note: The main author of this box is Christoph Klingen.

[1] The quantifications of fiscal measures are estimates by IMF country desks. They are consistent with the overall fiscal projections of this *Regional Economic Outlook*. Future fiscal measures may include what is implicit in governments' medium-term budget plans, EU convergence programs, or arrangements with the IMF.

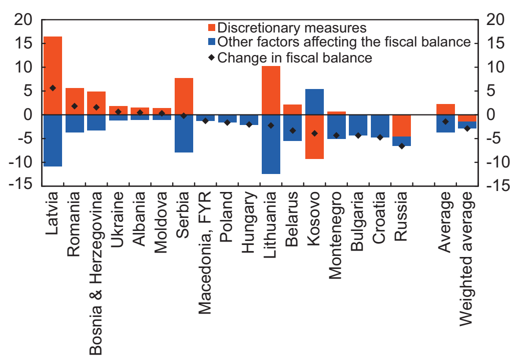
Box 2.3 *(concluded)*

Emerging Europe: Composition of Discretionary Fiscal Measures, 2009–12[1]
(Percent of GDP)



Source: IMF staff calculations.
[1]Positive (negative) values indicate consolidation (stimulus) measures; discretionary policy measures as factored into the projections for the April 2011 *World Economic Outlook*. Excludes Turkey.

Emerging Europe: Discretionary Fiscal Measures and Change of Fiscal Balance, 2008–12[1]
(Percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
[1]Positive (negative) values indicate consolidation (stimulus) measures; discretionary policy measures as factored into the projections for the April 2011 *World Economic Outlook*. Excludes Turkey.

and Hungary has relied on tax hikes for selected industries. A number of countries also resorted to diverting contributions to private second-pillar pension funds to the public pension system. These additional revenues reduce the headline deficit in the short term but fail to improve public finances in the long term because future pension expenditure rises commensurately. Therefore, they are not considered fiscal measures here. Hungary went further: participants in the second pillar would forgo most of their rights under the public pension system unless they transferred their accumulated pension assets back to the public pension system. Most opted for the transfer, enabling Hungary to book a large fiscal surplus in 2011.

Any further cyclical deficit improvement after 2012 is likely to be small. Headline fiscal balances deteriorate significantly during 2009–12, even more than identified discretionary fiscal measures would suggest. On average, they decline by 2.9 percentage points compared with cumulative stimulus measures worth 1.5 percent of GDP (third figure). It seems fair to assume that any remaining economic slack in 2012 is probably quite limited and that revenues not recovered by then will probably be lost permanently. These losses have been very large in some countries, reflecting mainly the evaporation of boom-related revenues. In the absence of fresh measures, one would therefore expect fiscal balances to remain broadly unchanged from 2012 onward.

Continued fiscal consolidation would not only reduce fiscal vulnerabilities, it increasingly would also be helpful from a demand-management perspective. In quickly growing countries, stepped-up fiscal consolidation would ease the burden on monetary policy—an important consideration in an environment in which higher interest rates might attract unduly large capital flows. Countries with still-fledgling recoveries will have to tread more carefully, but the general lesson that recent events have put a premium on sound public finances still applies and confidence effects from tackling fiscal weaknesses decisively should not be discounted. Successful strategies will need to be built around gradual fiscal adjustment, albeit operating at country-specific speeds, to demonstrate that policies are on the right track.

Reducing Financial Sector Vulnerabilities

Not All Countries' Banking Systems Are Back to Business as Usual Yet …

Banking system profitability is uneven across the region (Table 2.4). Banks in Turkey went through the crisis relatively unscathed, and Russian banks'

Table 2.4

Emerging Europe: Selected Financial Soundness Indicators, 2007–10[1]

(Percent)

	Return on Assets					Nonperforming Loans to Total Loans				
Country	2007	2008	2009	2010	Latest	2007	2008	2009	2010	Latest
Albania	1.6	0.9	0.4	0.7	Dec.	3.4	6.6	10.5	13.9	Dec.
Belarus	1.7	1.4	1.4	1.7	Dec.	1.9	1.7	4.2	3.5	Dec.
Bosnia and Herzegovina	0.9	0.4	0.1	-0.5	Sept.	3.0	3.1	5.9	9.2	Sept.
Bulgaria	2.4	2.1	1.1	0.9	Dec.	2.1	2.5	6.4	11.9	Dec.
Croatia	1.6	1.6	1.1	1.2	Dec.	4.8	4.9	7.8	11.2	Dec.
Hungary	1.2	0.8	0.7	0.1	Dec.	2.3	3.0	6.7	9.1	Dec.
Latvia	2.0	0.3	-3.5	-1.6	Dec.	0.8	3.6	16.4	19.0	Dec.
Lithuania	1.7	1.0	-4.2	-0.3	Dec.	1.0	4.6	19.3	19.7	Dec.
Macedonia, FYR	1.8	1.4	0.6	0.8	Dec.	7.5	6.7	8.9	9.0	Dec.
Moldova	3.9	3.5	-0.5	0.5	Dec.	3.7	5.2	16.4	13.3	Dec.
Montenegro	0.7	-0.6	-0.7	-2.7	Dec.	3.2	7.2	13.5	21.0	Dec.
Poland	1.9	1.5	0.8	1.1	Dec.	5.2	4.5	8.0	8.8	Dec.
Romania	1.0	1.6	0.2	-0.1	Dec.	2.6	2.8	7.9	11.9	Dec.
Russia	3.0	1.8	0.7	1.9	Dec.	2.5	3.8	9.5	8.2	Dec.
Serbia	1.7	2.1	1.3	1.2	Sept.	...	11.3	15.5	17.8	Sept.
Turkey	2.6	1.8	2.4	2.2	Dec.	3.6	3.8	5.6	3.8	Dec.
Ukraine	1.5	1.0	-4.4	-1.5	Dec.	3.0	3.9	13.7	15.3	Dec.
Memorandum										
Middle East[2]	...	1.5	1.3	1.4	Dec.	5.6	4.4	5.2	5.2	Dec.
Latin America[3]	2.4	1.8	2.1	2.5	Dec.	2.4	2.7	3.4	2.5	Dec.
Asia[4]	1.3	1.3	1.3	1.5	Dec.	5.5	3.8	3.4	2.9	Dec.

Source: IMF, *Global Financial Stability* Report (April 2011).

[1] Refer to the *Global Financial Stability* Report, April 2011, for detailed notes on cross-country variations in the definitions of the variables.

[2] Average of Jordan, Lebanon, Morocco, Oman, and United Arab Emirates.

[3] Average of Argentina, Brazil, Chile, Colombia, and Mexico.

[4] Average of China, India, Indonesia, Malaysia, Philippine, and Thailand.

profits rebounded strongly. The deterioration of the quality of Russian banks' loan books came to a halt during 2010 as the result of ever-higher oil prices. Banking systems are gradually returning to normalcy in most other countries, yet the recent evolution of profitability and asset quality indicators suggests that the next few quarters will remain challenging in Bosnia, Latvia, Lithuania, Montenegro, Romania, and Ukraine.

… Justifying a Differentiated Pace for Withdrawal of Crisis-Related Measures

A full exit from liquidity and solvency support measures taken during the 2008–09 crisis is not yet in sight. Support measures are being phased out quickly or have been phased out entirely in countries less affected by the crisis or that recovered quickly, such as Moldova and Poland. In contrast, support measures are likely to remain in place where the banking sector is still healing (Latvia and Ukraine) or where the macroeconomic outlook is still cloudy (Croatia).

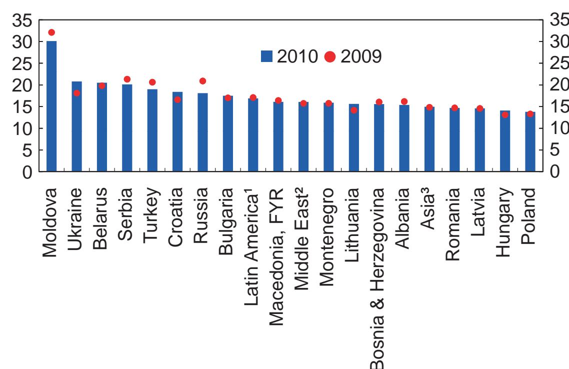
Banks Have Managed to Maintain Comfortable Capital Buffers But Many Remain Dependent on Access to External Funding

Banks' capital adequacy ratios remained high in 2010, on par with other emerging market regions

Figure 2.15

Emerging Europe and Selected Regions: Bank Regulatory Capital to Risk-Weighted Assets, 2009–10

(Percent)



Source: IMF, *Global Financial Stability Report* (April 2011).

[1]Average of Argentina, Brazil, Chile, Colombia, and Mexico.

[2]Averageof Jordan, Lebanon, Morocco, Oman, and United Arab Emirates.

[3]Average of China, India, Indonesia, Malaysia, the Philippines, and Thailand.

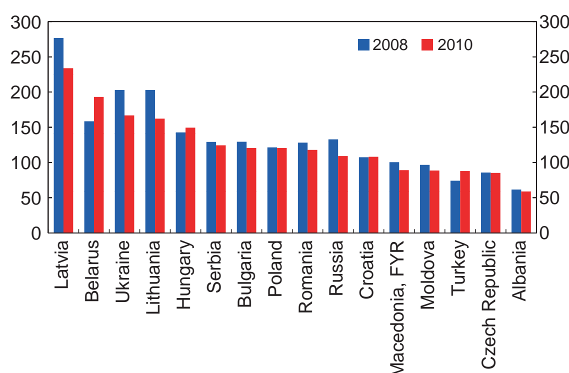
less affected by the crisis and significantly above regulatory minimums (Figure 2.15). This reflects conservative dividend policies, recapitalization with public or private funds (as in Belarus, Croatia, Hungary, Latvia, and Ukraine), and in some cases, countercyclical regulatory policies.

However, despite recent improvements, loans-to-deposits ratios remain high in many countries of the region, potentially limiting the flow of new credit financed externally (Figure 2.16). In 2010, countries

Figure 2.16

Emerging Europe: Private Sector Loans-to-Deposits Ratios

(Percent)



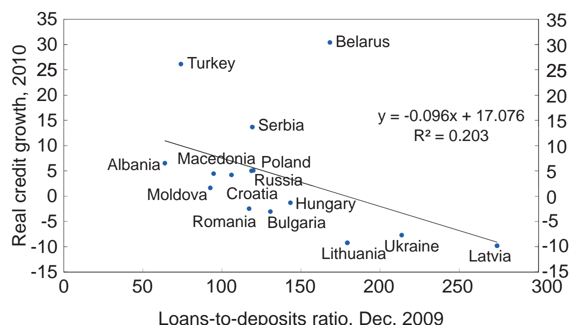
Source: IMF, *International Financial Statistics*.

Note: Deposits data exclude nonresident deposits.

Figure 2.17

Emerging Europe: Loans-to-Deposits Ratio and Credit Growth

(Percent)



Source: IMF, *International Financial Statistics.*

Notes: Credit growth is not corrected for currency movements. Deposits data exclude nonresident deposits.

with higher loans-to-deposits ratios saw weaker credit growth (Figure 2.17). For banks that depend on the continued availability of parent funding, the stricter capital requirements that parents will soon face under Basel III imply less room for supporting their expansions. Banks that rely on short-term wholesale funding will likely experience direct constraints on their ability to tap this source in anticipation of future compliance with the new Net Stable Funding Ratio liquidity standard.

A Second Wave of Consolidation Has Started and Is an Opportunity to Strengthen the Sector

Consolidation has been limited until recently, but several banks are about to change hands as troubled western European parent banks reconsider their presence in some emerging European markets.

Perhaps surprisingly, consolidation took place only on a small scale during the height of the crisis, reflecting strong liquidity support from parent banks—themselves often supported by their countries' governments and central banks—as well as swift domestic policy action. The consolidation that did occur centered on domestically owned banks in Ukraine and Russia.

Recently, however, a few western European banks directly affected by the sovereign debt crisis in the euro area periphery put their Polish subsidiaries up

for sale to preserve capital for their core domestic operations.[9] At the same time, several Austrian, Belgian, and German banks that benefited from state aid, and in some cases took large losses in emerging Europe during the recession, are looking to divest a significant part of their business in the region.[10] These transfers of assets from weaker to stronger owners should enable greater access to capital and enhance capacity to finance credit growth in the future.[11]

A Strategy for Basel III Implementation Needs to Be Designed Soon …

The transition to the Basel III framework is an opportunity to further strengthen the resilience of the region's banking systems.[12] Beyond the much discussed revisions to Basel II's Pillar 1 and the introduction of new liquidity standards, Basel III also contains revisions to the supervisory review process (Pillar 2), including extended guidance on firm-wide governance and risk-management practices and the design and implementation of sound stress-testing programs, which are particularly relevant for the region. The reciprocity agreement embedded in the operation of the proposed countercyclical capital buffer, whereby internationally active banks would be required by their home supervisors to calculate the capital buffer add-on for exposures to a country, whether booked at the local subsidiaries or offshore, will also promote a level playing field that was badly lacking during the most recent boom (Caruana, 2010). The new macroprudential focus of Basel III implies that governance arrangements for financial stability will need to be reviewed, and that the consistency between microprudential, macroprudential, and monetary objectives, instruments, and policies must be examined soon.

… So Supervisors Need to Remain Vigilant

Supervisors need to keep abreast of persistent and emerging vulnerabilities. The legacy of the boom-bust cycle is still present in most countries. Real estate prices remain depressed or keep falling, and are often supported by formal or informal barriers to initiating foreclosure proceedings. The share of foreign currency loans is close to peak levels, making the broader economy vulnerable to exchange rate pressures and exposing banks to indirect currency risk (Figures 2.18 and 2.19). As recommended in a recent European Bank Coordination Initiative report on local currency and capital market development (EBCI, 2011), supervisors should ensure that the pricing of foreign currency loans adequately reflects the associated credit and financial stability risks.[13] The ongoing sovereign debt troubles in the euro area pose funding risks for the region's banks. Furthermore, borrowers' debt servicing capacity could come under strain should persistent inflation pressures prompt steeper-than-expected interest rate hikes.

[9] Allied Irish Banks (Ireland) sold its subsidiary to Banco Santander (Spain); EFG Eurobank (Greece) sold 70 percent of its subsidiary to Raiffeisen (Austria); and press reports suggest that Banco Comercial Portugues (Portugal) is mulling the sale of its Polish unit Bank Millennium.

[10] Hypo Alpe Adria (Austria), which was nationalized in December 2009, has announced it would start selling assets in the region in 2012 (see Bloomberg, 2010b), while Volksbanken AG (Austria) is reported to be aiming for the sale of a majority share of its operations in the region in the first half of 2011 (see Bloomberg, 2010c). KBC (Belgium) committed to sell its subsidiaries in Russia and Serbia as well as its 31 percent share of the largest bank in Slovenia (see FT.com, 2009). BayernLB (Germany) is contemplating selling its Hungarian unit MKB (see Bloomberg, 2010a). WestLB (Germany) already sold its Hungarian subsidiary in July 2009 to domestic investors.

[11] In addition, the second largest Russian bank, VTB, announced its acquisition of a controlling share of Bank of Moscow on March 21, 2011, and the Latvian government is preparing for a privatization of Citadele Bank in the near future. Citadele Bank is the "good bank" that emerged from the recent restructuring of Parex Bank, the country's second largest bank, which had been nationalized in November 2008 to avoid its collapse.

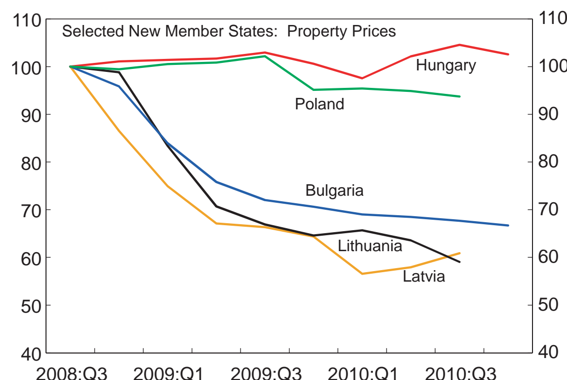
[12] The new framework was published on December 15, 2010. For EU countries, the Basel III framework will be transposed into EU legislation through the Capital Requirements Directive IV, for which the European Commission is expected to deliver a proposal later this year. Russia and Turkey are Basel Committee members, and are therefore expected to implement the accord within the agreed 2013–19 time frame.

[13] See in particular recommendation no. 9 of the report.

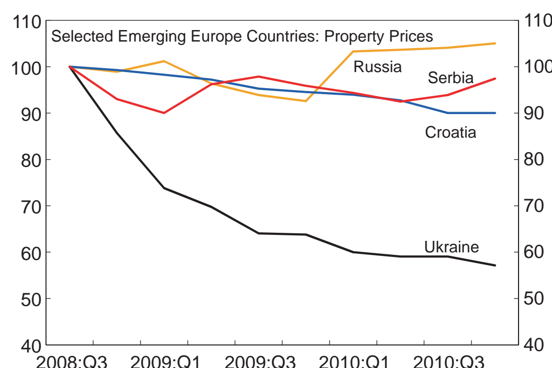
Figure 2.18

Emerging Europe: Property Prices, 2008:Q3–2010:Q4

(Index, 2008:Q3=100)



Sources: BIS, Property Price Statistics; and IMF staff calculations.
Note: All prices are in local currency.

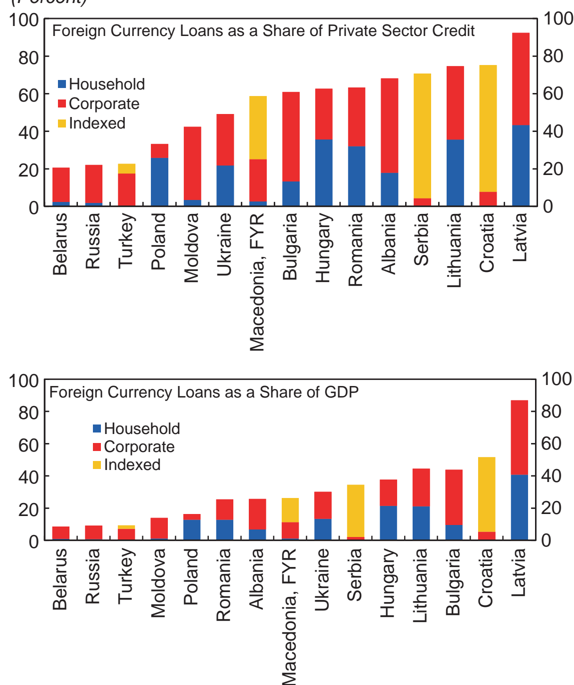


Sources: BIS, Property Price Statistics; Centar Nekretnina; Statistical Office of the Republic of Serbia; Blagovist; and IMF staff calculations.
Note: Prices in Russian rubles (Russia), euros (Croatia, Serbia), and U.S. dollars (Ukraine).

Figure 2.19

Emerging Europe: Stock of Foreign Currency Loans, December 2010

(Percent)



Sources: IMF, *International Financial Statistics;* and IMF, World Economic Outlook database.
Note: Breakdown between corporate and household is not available for indexed loans. Data for Turkey are for November 2010.

Cross-border cooperation also remains essential. For the new member states, the launch of the European Supervisory Authorities and the European Systemic Risk Board as described in Chapter 1 offers the opportunity to reconcile the goal of developing effective cross-border oversight with enhancing a single EU financial market (IMF, 2010a, Box 7).

Shifting Resources to the Tradable Sector

A New Growth Model Is Needed

As emphasized in previous editions of the *Regional Economic Outlook*, many economies in the region need to reorient toward the tradable sector to achieve sustainable growth.[14] Although the deep recession of 2009 has mostly corrected the large external imbalances built up in the boom years, many resources have been idled. With the old growth model exposed as unsustainable, the goal must now be to reengage most of these resources in a vibrant tradable sector. Empirical evidence suggests that export activity has a significant positive effect on both research and development spending and on product innovation,[15] thus, greater reliance on external demand could yield

[14] See also European Bank for Reconstruction and Development (EBRD, 2010). Several countries in central Europe, such as the Czech Republic, Hungary, and the Slovak Republic, already have large tradable sectors. As these countries show, having a vibrant export sector is not the same as running current account surpluses.

[15] See EBRD (2010), Chapter 4.

Table 2.5

Emerging Europe: Employment Growth, 2008:Q3–2010:Q3

(Percent)

	Total		Construction, Financial Intermediation, and Real Estate		Manufacturing	
Country	2008:Q3–2010:Q3	2009:Q3–2010:Q3	2008:Q3–2010:Q3	2009:Q3–2010:Q3	2008:Q3–2010:Q3	2009:Q3–2010:Q3
Turkey	2.7	5.0	4.5	7.1	0.3	8.8
Macedonia, FYR	2.3	1.0	...	...	...	...
Montenegro	-2.9	-10.9	...	...	...	...
Poland	0.5	0.8	4.2	0.2	-4.6	-4.7
Russia	-0.7	0.7	-0.6	1.3	-3.6	0.5
Hungary	-1.3	1.4	0.0	2.8	-4.1	1.7
Bosnia and Herzegovina	-2.0	-1.6	-3.4	-3.9	-5.9	-4.8
Ukraine	-2.0	0.2	...	...	...	...
Romania	-1.9	-1.9	4.8	4.7	-0.9	-0.9
Albania	-2.8	-5.7	...	...	...	...
Moldova	-3.2	-1.8	-2.1	2.5	-5.0	-3.5
Croatia	-3.9	-5.2	...	...	...	...
Bulgaria	-4.3	-5.2	-9.8	-15.4	-6.4	-3.8
Serbia	-5.2	-2.8	...	...	...	...
Lithuania	-6.2	-5.1	-11.0	-6.0	-10.8	-6.9
Latvia	-8.6	0.1	-17.2	-4.2	-7.0	8.2

Sources: Eurostat; Haver Analytics; and IMF staff calculations.
Note: All data are annualized.

more stable GDP growth and stronger total factor productivity growth.[16]

Its Gestation Will Likely Take Some Time

The cross-sectoral reallocation of labor continues, and countries will have a hard time exporting their way out of high unemployment quickly. In most countries, employment still lingers far below precrisis level, and employment growth in countries with large declines in employment in the year following September 2008 has not been stronger than elsewhere in the region since then (Table 2.5). Where external imbalances were the largest, employment has declined more in the nontradable than in the tradable sector, but only tentative signs of the required labor reallocation across sectors have been detected.[17] Except for Latvia and Turkey, employment has not grown faster in the tradable sector than in the nontradable sector during the past few quarters. Projected real export growth for 2011–12 is generally unrelated to the change in employment since the onset of the crisis (Figure 2.20). Thus, the pace of job creation in the tradable sector will likely fall short of the rate needed to reabsorb the unemployed quickly.

Signs of reallocation of capital from the nontradable to the tradable sector are also still scant. Data on the sectoral distribution of domestic credit to corporations suggest that reallocation has yet to get under way in countries with the largest precrisis external imbalances. In Bulgaria and Lithuania, the ratio of credit to the primary and tradable secondary sectors to GDP

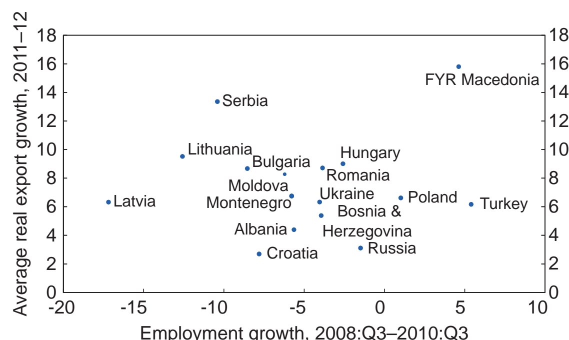
[16] At the same time, large productivity improvements are still to be gained in the nontradable sector throughout the region.

[17] The tradable sector is proxied by manufacturing, and the nontradable sector is proxied by construction, financial intermediation, and real estate.

Figure 2.20

Emerging Europe: Employment Growth and Projected Export Growth

(Percent)



Sources: Haver Analytics; IMF, World Economic Outlook database.

has not increased significantly more (or decreased less) than that of credit to the other sectors since end-2008 (Figure 2.21). In Latvia and Romania, that ratio has grown at a slower pace than that of credit to the construction sector. Data on foreign direct investment (FDI) flows are slightly more encouraging (Figure 2.22). In the Baltics, Croatia, and Serbia, FDI flows to the primary and tradable secondary sectors, even if small, achieved the same level (as a share of GDP) in 2010 as in 2007 despite the general decline of FDI flows to the region. In Bulgaria, they are now higher than flows into construction, real estate, and financial intermediation. However, such flows have significantly declined in most other countries.

Public Policies Can Spur the Transformation

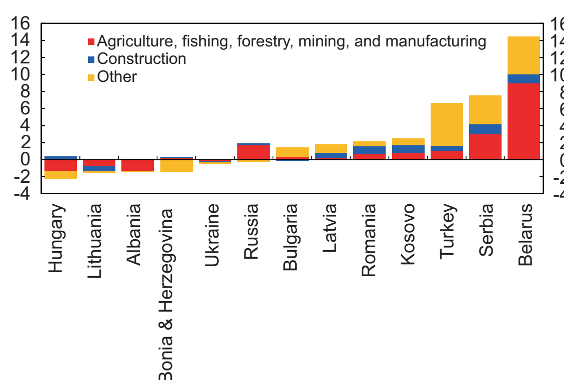
In the short to medium term, macroeconomic policies can encourage the transformation to the tradable sector through their effects on the real exchange rate. In countries with fixed exchange rates, fiscal policy can support competitiveness by preventing overheating that would draw resources to the nontradable sector. Countries with flexible exchange rates should emphasize fiscal rather than monetary tightening as the recovery progresses. Regardless of the exchange rate regime, fiscal policy can support the adjustment to the new growth model through permanent shifts in the composition of public expenditures, especially through public sector wage moderation and highly productive public investment.[18]

Although budgetary resources are scarcer in the postcrisis environment and fiscal consolidation is a priority, public investment in human capital and structural reforms are needed to brighten medium-term growth prospects. Honkapohja (2010)

Figure 2.21

Emerging Europe: Changes in Credit to Corporations by Industry, 2008–10

(Percentage points of GDP)

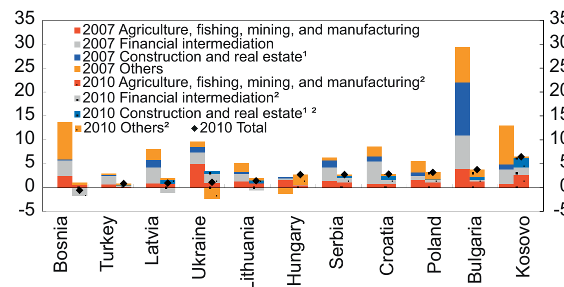


Sources: National central banks; Haver Analytics; and IMF, World Economic Outlook database.
Note: For Bulgaria and Ukraine, data for "other" include only loans to nonfinancial corporations. For Albania, change is from 2008 to 2009.

Figure 2.22

Emerging Europe: Foreign Direct Investment Flows by Sector, 2007, 2010

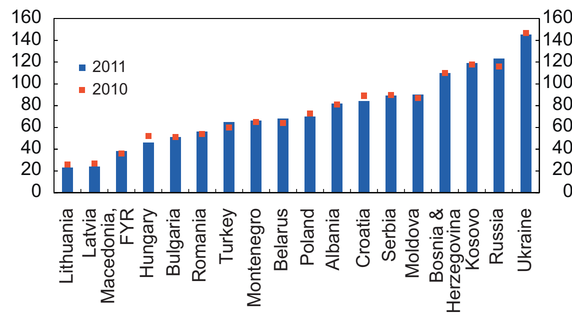
(Percent of GDP)



Sources:Central bank web sites; and national authorities.
Note: Data for Hungary include equity capital only, and exclude special purpose entities.
[1]Latvia, Turkey, and Ukraine: Construction and real estate, renting, and business activities.
[2]Poland: Data are for 2009.

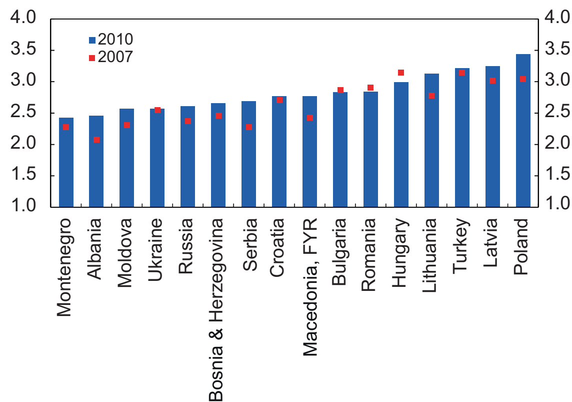
[18] On the revenue side, discriminatory taxation by sector of economic activity is best avoided.

Figure 2.23
Emerging Europe: Ease of Doing Business Rank, 2010–11



Source: World Bank, Ease of Doing Business database, 2011.
Note: Countriesare ranked from best to worst out of a group of 183 countries.

Figure 2.24
Emerging Europe: Logistics Performance Index, 2007–10



Source: World Bank.
Note: Countries are graded on a scale from 1 (worst) to 5 (best).

explains how Finland managed to rebound from a deep financial crisis in the early 1990s and experience significant structural change through public investments in education and research and development. Similar investments in emerging Europe would enhance productivity growth and shift production toward increasingly more sophisticated products. At the same time, the extent of the necessary sectoral reallocation of human resources calls for support for training programs to address skill mismatches and, in many cases, for further labor market reforms. Also, micro-competitiveness could be supported through further improvements in the business environment, in particular in the European CIS and western Balkan countries where announced reform plans still await implementation (Figure 2.23). Such improvements would be particularly effective in making skilled labor emigration relatively less attractive and return migration more attractive.

Export potential could also be increased directly by investments in infrastructure and, more broadly, by support for logistics chains. The region still needs significant improvements in physical infrastructure. With limited domestic fiscal space, financing such large projects would be a good use of EU funds. Public-private partnerships should also be sought and innovative private sector financing mechanisms, such as the credit enhancement recently proposed by the European Commission, should be explored.[19] Improvements in logistics and removal of nontariff barriers would also directly benefit export performance. The 2010 World Bank Logistics Performance Index documents both a general improvement in this matter across the region and large scope for intraregional convergence of the western Balkans and the CIS toward the new EU member states and Turkey (Figure 2.24).

[19] See European Commission (2011).

3. Financial Integration, Growth, and Imbalances

In the run-up to the crisis, financial integration in Europe boosted investment and reduced saving in countries that previously had high interest rates. As capital inflows increasingly went into the nontradable sector and contributed to credit and housing booms, countries in the euro area periphery and countries in emerging Europe with fixed exchange rates built up large current account imbalances, with ultimately unsustainable trajectories of net external asset positions. Financial markets did not pay sufficient attention to these vulnerabilities, and policies did too little to address market failures. When capital flows slowed, the boom ended, and sharp recessions ensued. The absence of EU-wide institutions to deal with banking crises and the incomplete integration of capital markets compounded the crisis. To overcome the crisis decisively, the most critical factor in the longer run is restoring growth in the crisis-afflicted countries. To prevent new crises, more vigilance is needed, better institutions to deal with financial sector problems must be developed, and more, rather than less financial and economic integration is needed.

The establishment of the Economic and Monetary Union (EMU) in 1999 marked an important step toward financial integration in Europe. In 1999, 11 member states of the European Union (EU) adopted the euro as their common currency, and six more countries followed in the subsequent years.[1] Several countries in central and eastern Europe (CEE)—notably the Baltic countries and Bulgaria—pegged their currencies unilaterally to the euro, thus tying their monetary policies to that of the European Central Bank (ECB).

Rising current account imbalances accompanied financial integration, and countries with high current account deficits were particularly hard hit by the 2008–09 financial crisis. In the euro area periphery, strong cross-border capital flows in the run-up to the crisis fueled credit, asset price, and domestic demand booms, which led to a surge in imports, rapid expansion of the nontradable sector, deterioration of competitiveness, and widening current account deficits. This pattern was also observed in countries with exchange rates pegged to the euro in anticipation of early euro area entry. When capital flows slowed, the domestic demand booms ended, and sharp recessions ensued.

The legacy of the boom years and subsequent crisis is likely to depress growth in the euro area periphery and countries with exchange rates pegged to the euro for some time. The debt overhang in the private sector and sharply deteriorated public finances will subdue domestic demand, while the erosion of competiveness during the boom is bound to depress exports. In the absence of labor mobility and exchange rate flexibility, and with limited wage and price adjustment capacity, turning these dynamics around is proving to be quite challenging.

This chapter first discusses the contribution of financial integration to rising current account imbalances before the crisis. It shows how financial integration led to sharp compression of interest rate differentials, which boosted investment and reduced saving in countries that previously had high interest rates, and how strong credit and housing booms led to massive current account deficits.

The chapter then reviews why the unwinding of the imbalances led to such a severe crisis. It will show that the widening of current account deficits ultimately was the result of an unsustainable and risky growth pattern, which went on for too long as markets paid insufficient attention to rising risks, and policies did too little to address these market failures.

The aggravation of the crisis by the absence of EU-wide institutions to deal with banking crises and by the incomplete integration of capital

Note: The main authors of this chapter are Lone Christiansen, Yuko Kinoshita, Jeta Menkulasi, Esther Perez, Irina Tytell, Nico Valckx, and Johannes Wiegand.

[1] Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. They were followed by Greece (2002), Slovenia (2007), Cyprus, Malta (both 2008), the Slovak Republic (2009), and Estonia (2011).

markets is also discussed. Although the EU has fostered financial integration by relaxing constraints, harmonizing various aspects of the financial system, and adopting a common currency, this process has been allowed to outpace development of the institutions necessary to support the single financial market. In the absence of EU-wide institutions, the approach to dealing with banking sector problems remained national throughout the crisis. Banking and sovereign debt problems have thus exacerbated each other, leading to vicious circles in the periphery.

Finally, the chapter discusses that while the crisis has led to a sharp adjustment of earlier current account imbalances, just dealing with imbalances is not enough. The most critical factor in the longer term is restoring GDP growth in the crisis-affected countries, with stronger roles for the tradable sector and exports, and less reliance on the nontradable sector, capital flows, and domestic demand. Ultimately, growth and convergence will need to be backed by productivity increases. To foster efficiency increases and prevent the reemergence of imbalances, better policies are needed at the national level, while better governance at the EU level would give teeth to such policies.

The chapter focuses on the original EMU members, Greece, the Baltic countries, and Bulgaria. These countries shared the euro, or had a hard peg to the euro, for at least five years before the start of the global crisis in 2007.[2] To highlight the role of financial integration, as opposed to trade integration, developments in four central European countries (the Czech Republic, Hungary, Poland, and the Slovak Republic), which during the run-up to the global crisis all had flexible exchange rates, are compared with developments in the focus countries.

[2] Cyprus, Malta, Slovenia, and the Slovak Republic, which entered the euro area between 2007 and 2009, did not meet this criterion. Luxembourg is excluded because of its small size and role as a financial center.

Imbalances and Crisis

The elimination of exchange rate risk in the wake of monetary integration led to rapid reductions in risk premiums and to interest rate convergence, particularly for money market and government bond rates (Figure 3.1). Progress in fiscal consolidation, aimed at meeting the Maastricht debt and deficit criteria, further reduced risk premiums. In the first half of the 1990s, the governments of Finland, Italy, Portugal, and Spain still paid spreads of 400 basis points or more over German bund rates, reflecting a history of frequent devaluations. In the run-up to the euro introduction, during 1995 to 1998, these spreads disappeared almost entirely, bringing immediate and tangible benefits in the form of lower funding costs for the public sector, corporations, and households. The process repeated itself for countries adopting the euro at later stages, as well as for the hard peg countries in emerging Europe that had tied their currencies to the euro. Interest rate convergence tended to be far less pronounced in the central European countries that kept flexible exchange rates, and for countries that were not members of the EU.[3]

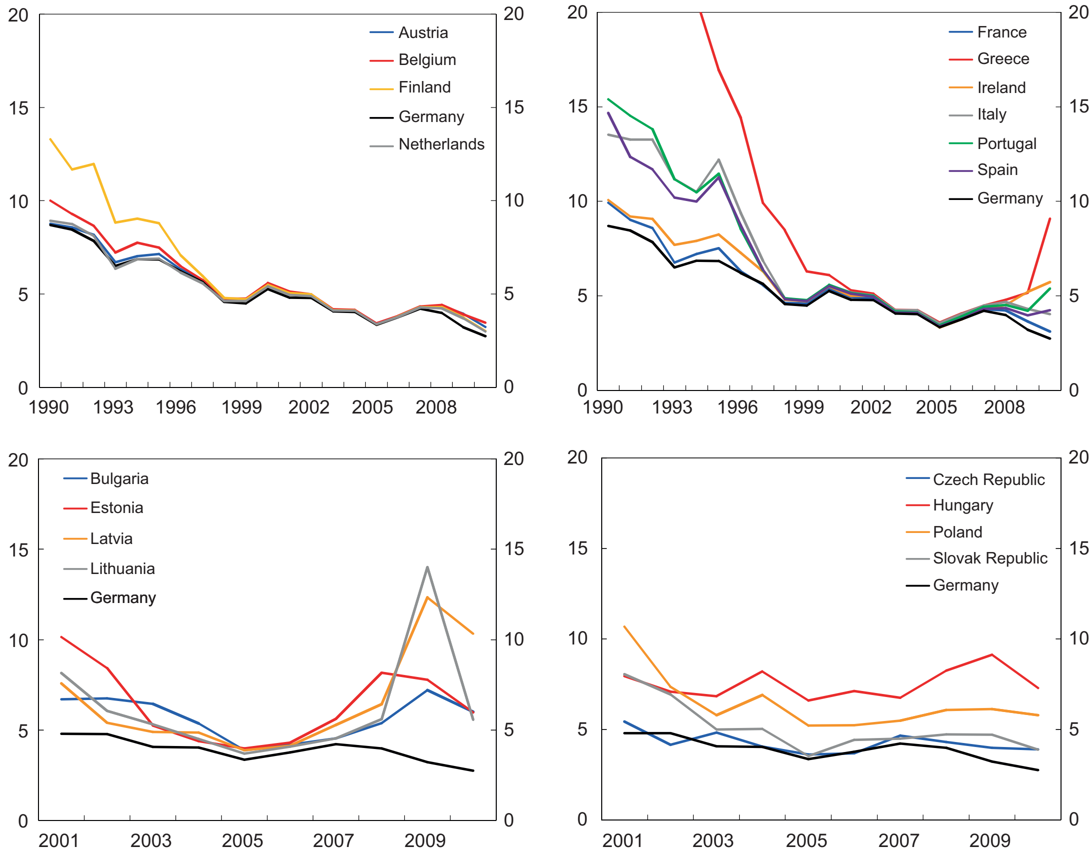
Monetary integration also encouraged larger cross-border financial exposures (Figure 3.2). In the banking sector, the share of interbank loans to banks within the euro area increased from 15 percent in the late 1990s to 25 percent in the late 2000s, and to 20 percent from 10 percent for interbank loans to banks in the EU but outside the euro area. In addition, home bias for investment funds' allocations of equity and debt securities declined significantly.[4]

Not all financial markets became equally integrated: by 2007, debt markets had become most integrated, while cross-border flows in foreign direct investment (FDI) and equity portfolio investment remained more limited. External debt liabilities

[3] The exception is the Czech Republic.

[4] By contrast, retail lending remained largely within national borders because banking groups typically expanded into other European countries by establishing branches or subsidiaries rather than through direct cross-border lending.

Figure 3.1
Selected EU Countries: Convergence of Long-Term Government Bond Rates, 1990–2010
(Percent)



Source: IMF, *International Financial Statistics.*

were generally several times larger than FDI and external equity investment (Figure 3.3). Within debt markets, a number of countries' cross-border holdings were largely confined to sovereign debt (Figure 3.4).

Cross-border mergers and acquisitions remained small compared with domestic mergers and acquisitions (Figure 3.5), and remained much lower than mergers and acquisitions across regions in the United States (Umber, Grote, and Frey, 2010). High concentration of corporate control (Becht and Mayer, 2000), regulatory differences (particularly in the application of takeover regulations), and predictability of national regulatory agencies seem to have been the most important barriers to cross-border equity flows, including in the banking sector in the EU (Koehler, 2007; and Campa and Moschieri, 2008).

The Widening of External Imbalances

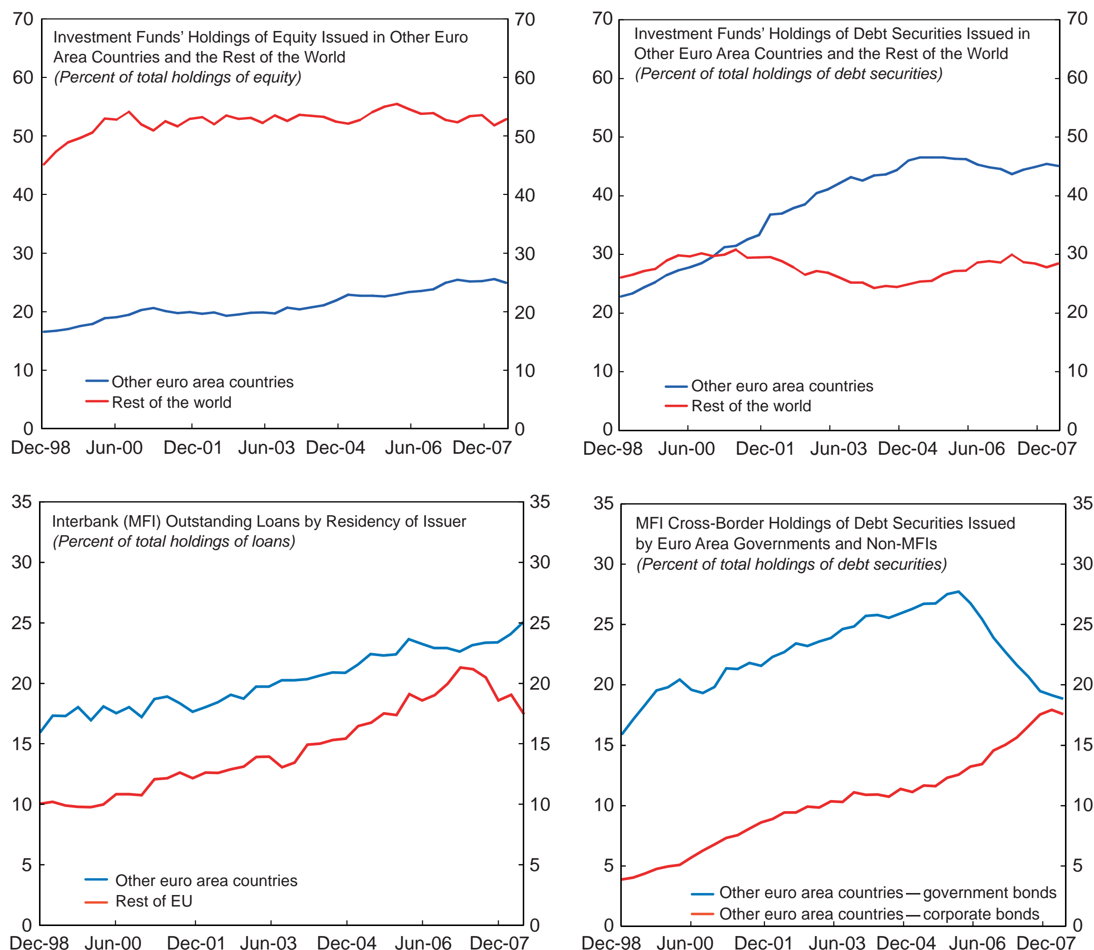
The decline in interest rates boosted investment and reduced saving in countries where interest rates had previously been high. The impact was particularly pronounced in relatively poor countries because the expected rapid income growth there made borrowing more attractive (Figures 3.6 and 3.7, and Table 3.1).

- Household balances deteriorated as household saving declined and residential real estate investment increased. Countries with housing price booms saw the largest deterioration in the saving-investment balance.
- Corporate balances worsened as corporate saving declined, probably as a result of the increase in unit labor costs (see next section). In the hard peg countries, corporate investment

Figure 3.2

Selected EU Countries: Indicators of Financial Integration, 1998–2008

(Percent)



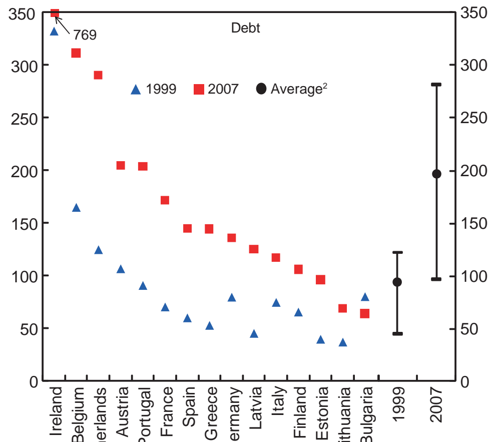
Source: European Central Bank.
Note: MFI stands for monetary financial institutions.

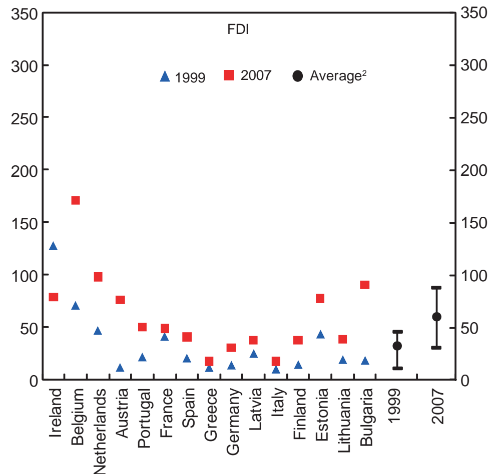
booms also contributed significantly to the current account deterioration.

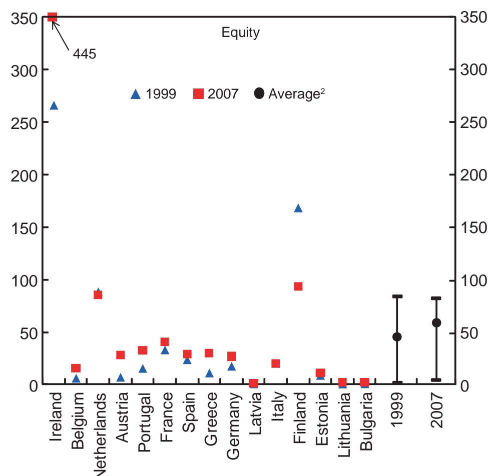
By contrast, in countries where income levels and interest rate levels had already converged, financial integration did not further compress interest rates, and domestic demand remained much more muted. In fact, private sector balances improved, although partly for reasons not directly related to financial integration. Corporate saving increased because wage moderation led to an increase in the share of profits in national income. Germany had entered the euro area with an impaired competitive position, reflecting in part the overhang from German reunification, which took many years of internal devaluation to correct. An additional factor hurting its competitiveness was the convergence of interest rates in the wake of the euro's introduction, which negated Germany's comparative advantage of low funding costs. Corporate investment was weak, reflecting both weak domestic demand and outsourcing to suppliers in emerging Europe.

Current account balances in the EU started to widen as a result, peaking in 2007 (Figures 3.8, 3.9, and 3.10). Current account balances deteriorated sharply in Ireland, Spain, and the hard peg countries. By 2007, current account deficits in Greece, Portugal, Spain, and the hard peg countries

Figure 3.3
Selected EU Countries: International Investment Position, Liabilities[1]
(Percent of GDP)

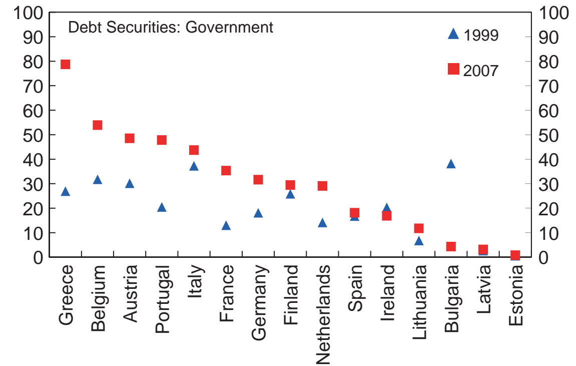


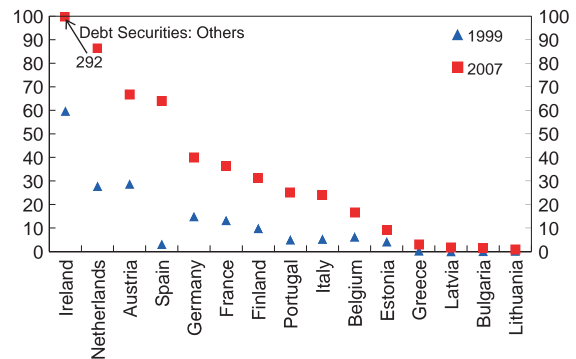




Sources: IMF, Balance of Payments Statistics database; and IMF, World Economic Outlook database.
[1]For Ireland, 2001 instead of 1999 data have been used reflecting lack of data availability.
[2]15th and 85th percentile.

Figure 3.4
Selected EU Countries: Components of Debt Securities Liabilities[1]
(Percent of GDP)





Sources: IMF, Balance of Payments Statistics database; and IMF, World Economic Outlook database.
[1]For Ireland, 2001 instead of 1999 data have been used reflecting lack of data availability.

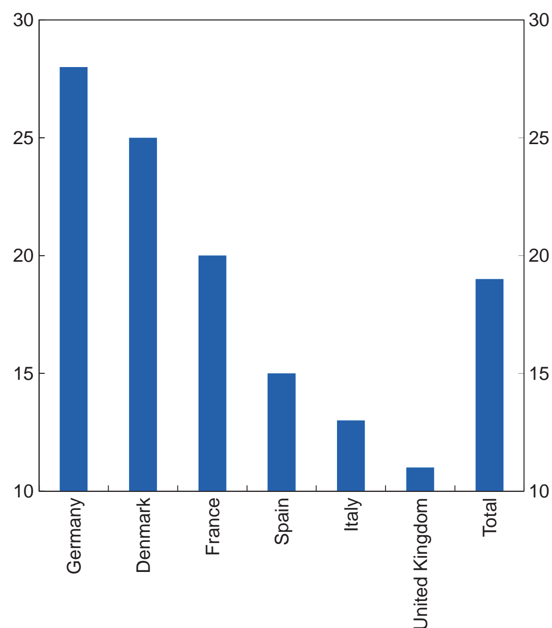
exceeded 10 percent of GDP. By contrast, current account balances improved sharply in Austria, Germany, and the Netherlands.

The convergence in interest rates not only fueled private sector spending, it also boosted government primary spending. The interest rate compression provided a substantial windfall for countries like Italy and Greece, allowing these countries to reduce their overall deficits while increasing primary spending (Figure 3.11). The boom in private sector domestic demand fueled a surge in government tax revenue, which created further space to boost primary expenditure (Figure 3.12). As a result, countries in the periphery saw a sharp increase in primary expenditure between 2000 and 2007—even though this was not visible in headline fiscal balances at the time.

Figure 3.5

Selected EU Countries: Cross-Border Mergers and Acquisitions for Selected Target Countries, 2001–07

(Percent of completed deals)[1]



Sources: Thomson One Banker; and IMF staff calculations.
[1]Completed deals in which the target company and the acquirer company are based in the Europe 15 area (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom). Deals include only those that imply a change of control of the acquired company (20 percent of ownership), but exclude those in which the acquirer already had control before acquisition.

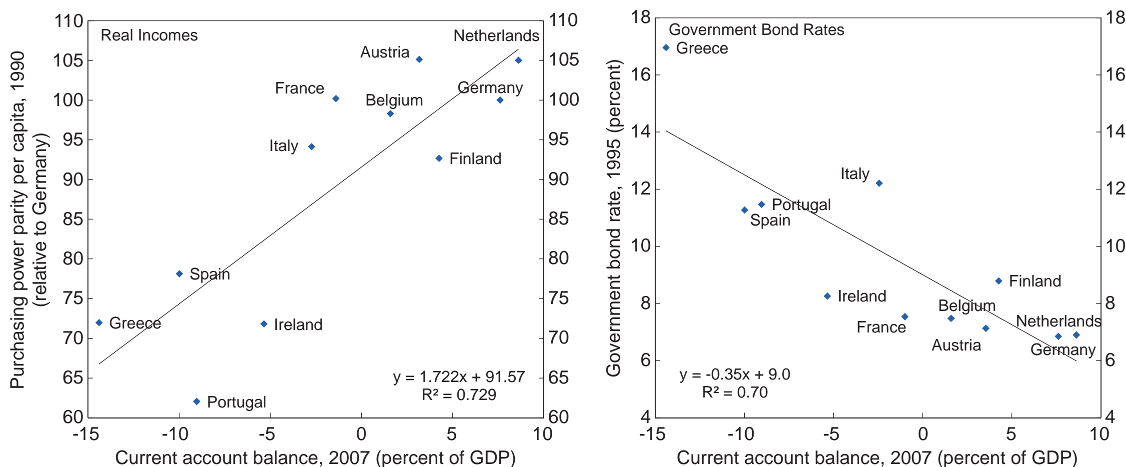
In general, the change in fiscal balances played only a modest part in increasing external imbalances. The improvement in headline balances was the real problem, because it disguised deterioration in the underlying fiscal situation. Interest savings and what turned out to be the temporary revenues had been used to boost primary expenditure.

Shocks external to the EU and euro area also contributed to rising imbalances. The integration of China into the world economy benefited Germany, which exported high-end machinery, but hurt southern Europe (Chen, Milesi-Ferretti, and Tressel, forthcoming). The integration of CEE countries into Europe boosted German firms' productivity as they set up production platforms in the region, but competed with other countries' exports (Marin, 2010). Similarly, the appreciation of the euro between 1999 and 2008 had a bigger impact on some countries in the periphery, for which trade with countries outside the euro area is very important, than on countries in the core, for which trade with other euro area countries is more important.[5]

[5] The bulk of the appreciation of the CPI-based real effective exchange rate in Greece and Portugal was due to the nominal appreciation of the euro (Chen, Milesi-Ferretti, and Tressel, forthcoming).

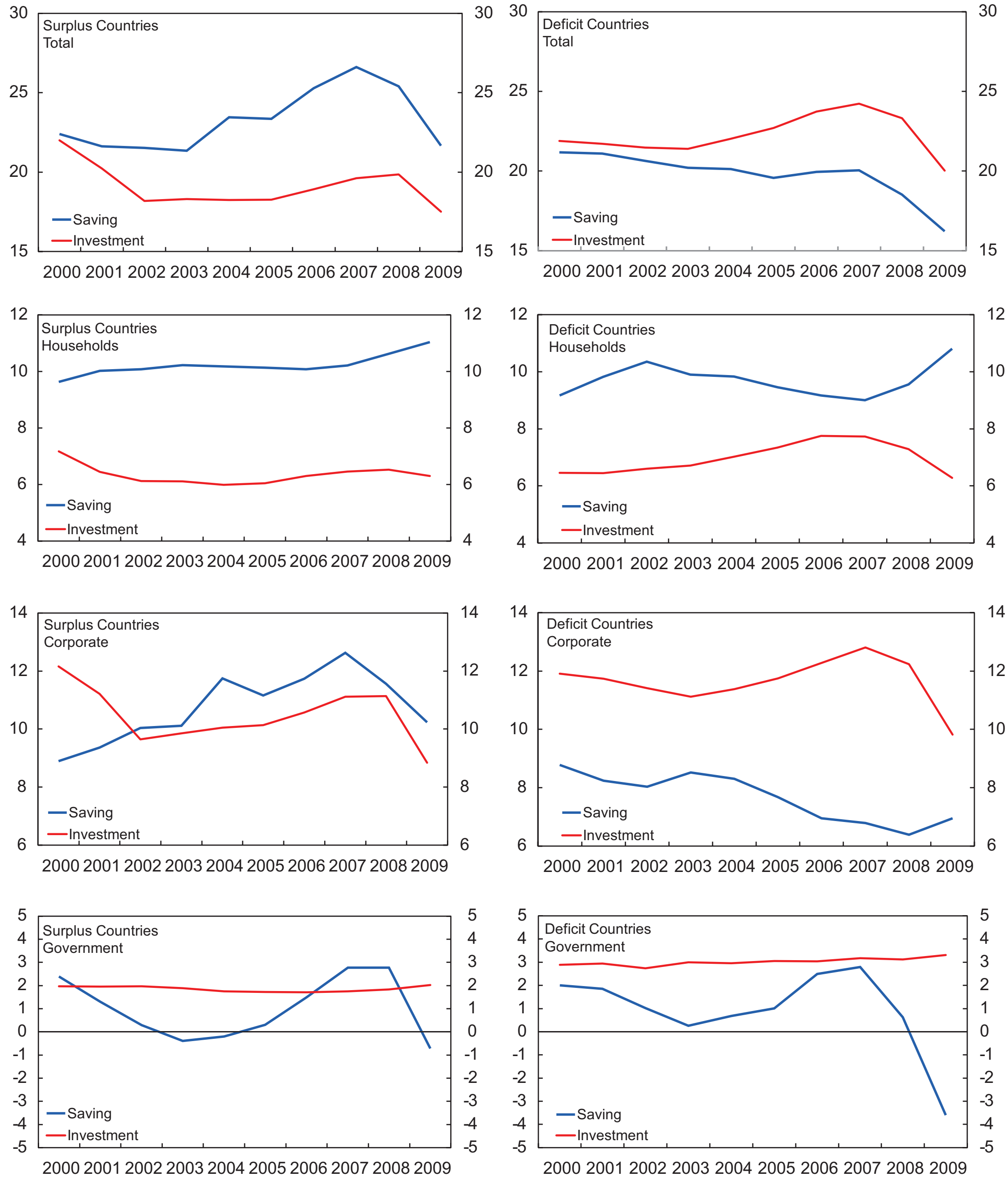
Figure 3.6

Euro Area: Current Account Balances in 2007 and Starting Positions in the 1990s



Sources: IMF, World Economic Outlook database; IMF, *International Financial Statistics*; and IMF staff calculations.

Figure 3.7
Euro Area: Saving-Investment Balances, 2000–09
(Percent of GDP)



Sources: Eurostat; and IMF staff calculations.
Note: Surplus (deficit) countries are countries with a current account surplus (deficit) in 2007. Surplus countries include Austria, Belgium, Finland, Germany, and the Netherlands. Deficit countries include France, Ireland, Italy, Portugal, and Spain.

The Crisis

The credit booms in Europe came to a sudden end in September 2008 after Lehman Brothers filed for bankruptcy. All types of capital flows reversed in the fall of 2008, but cross-border banking flows experienced the most severe retrenchment (Milesi-Ferretti and Tille, 2011). As risk aversion among investors rose sharply and equity markets plunged, many advanced-country banks, when confronted with liquidity and capital shortages, sharply curtailed new lending or even deleveraged.

Table 3.1

Selected EU Countries: Sectoral Saving-Investment Balances, 2000–07

(Percent of GDP, unless otherwise indicated)

	Households			Nonfinancial corp.			Financial corp.			General government			Total		
	S	I	Net	S	I	Net	S	I	Net	S	I	Net	S	I	Net
							2007								
Surplus countries	**10.2**	**6.5**	**3.8**	**12.6**	**11.1**	**1.5**	**1.0**	**0.3**	**0.7**	**2.8**	**1.7**	**1.0**	**26.6**	**19.6**	**7.0**
Netherlands	6.9	7.5	-0.5	17.0	9.3	7.7	1.5	0.4	1.2	3.4	3.3	0.1	28.8	20.4	8.4
Germany	11.5	6.2	5.3	11.4	10.5	0.8	0.7	0.1	0.6	2.4	1.4	1.0	26.0	18.3	7.6
Finland	3.9	7.7	-3.7	14.9	12.5	2.5	0.7	0.3	0.4	7.6	2.5	5.1	27.1	22.9	4.2
Austria	10.2	5.3	5.0	12.0	16.0	-4.0	2.3	0.7	1.6	2.6	1.1	1.4	27.2	23.2	4.0
Belgium	10.0	6.7	3.3	13.6	13.7	0.0	1.3	0.8	0.6	1.7	1.6	0.1	26.7	22.8	3.9
Deficit countries[1]	**9.0**	**7.7**	**-1.0**	**6.8**	**12.8**	**-2.9**	**1.5**	**0.5**	**0.6**	**2.8**	**3.2**	**-0.4**	**20.0**	**24.2**	**-4.2**
Italy	10.2	6.9	3.3	6.3	12.2	-5.9	1.3	0.4	0.9	2.3	2.3	0.0	20.1	21.9	-1.8
France	10.2	7.0	3.1	7.9	11.1	-3.2	0.8	0.8	0.0	1.1	3.3	-2.2	20.0	22.2	-2.2
Ireland	3.3	12.2	-8.8	9.3	9.8	-0.4	4.9	0.6	4.3	4.1	4.7	-0.5	21.7	27.2	-5.5
Spain	6.9	9.7	-2.8	5.2	17.2	-12.0	2.1	0.1	2.0	6.9	4.0	2.8	21.0	31.0	-10.0
Portugal	4.9	5.8	-0.9	5.6	13.6	-8.0	2.6	1.0	1.6	-0.5	2.4	-2.9	12.7	22.9	-10.2
Greece[2]	-1.1	9.4	-10.5	10.7	7.2	3.5	2.0	0.3	1.7	-2.5	2.8	-5.3	9.0	19.7	-10.7
Hard peg	**-6.3**	**4.8**	**-11.1**	**16.0**	**26.0**	**-10.0**	**1.3**	**0.1**	**1.1**	**6.0**	**5.4**	**0.6**	**16.9**	**36.3**	**-19.4**
Lithuania	-3.2	3.9	-7.1	13.9	21.5	-7.6	1.5	0.1	1.3	3.6	5.3	-1.7	15.8	30.9	-15.1
Estonia	-0.9	8.5	-9.4	15.5	26.1	-10.6	-0.2	-0.1	-0.1	7.6	5.1	2.5	22.0	39.6	-17.7
Latvia	-3.0	5.0	-8.0	12.4	29.1	-16.7	3.0	0.0	3.0	5.7	6.3	-0.6	18.1	40.4	-22.3
Bulgaria	-14.9	3.5	-18.4	21.0	28.0	-7.0	0.7	0.4	0.3	7.6	4.9	2.7	14.3	36.8	-22.5
							2000								
Surplus countries	**9.6**	**7.2**	**2.5**	**8.9**	**12.2**	**-3.3**	**1.5**	**0.7**	**0.8**	**2.4**	**2.0**	**0.4**	**22.4**	**22.0**	**0.4**
Netherlands	6.9	7.0	-0.1	13.8	10.4	3.4	3.1	1.4	1.7	4.5	3.1	1.4	28.4	22.0	6.4
Germany	10.5	7.5	2.9	6.9	12.0	-5.1	1.2	0.5	0.7	1.6	1.8	-0.2	20.2	21.8	-1.6
Finland	4.4	6.6	-2.3	14.7	11.6	3.1	0.1	0.2	-0.1	9.3	2.4	6.8	28.5	20.9	7.6
Austria	8.9	5.7	3.1	11.3	16.0	-4.7	2.1	1.0	1.1	1.3	1.5	-0.2	23.6	24.3	-0.7
Belgium	10.6	5.9	4.8	12.5	13.8	-1.3	1.0	0.9	0.1	2.6	2.0	0.6	26.7	22.5	4.2
Deficit countries[1]	**9.2**	**6.5**	**2.7**	**8.8**	**11.9**	**-3.1**	**1.2**	**0.6**	**0.6**	**2.0**	**2.9**	**-0.9**	**21.2**	**21.9**	**-0.7**
Italy	9.9	6.5	3.4	8.6	11.3	-2.8	0.8	0.6	0.3	1.3	2.3	-1.0	20.6	20.7	-0.1
France	9.8	5.7	4.0	8.3	10.8	-2.5	1.4	0.8	0.5	2.1	3.1	-1.0	21.6	20.5	1.1
Ireland[3]	4.9	7.4	-2.5	9.4	8.9	0.6	2.2	0.4	1.8	3.9	4.3	-0.3	20.5	20.9	-0.4
Spain	7.5	7.4	0.1	10.3	15.3	-5.0	1.5	0.4	1.1	3.0	3.2	-0.1	22.3	26.3	-4.0
Portugal	7.5	8.8	-1.2	8.0	15.4	-7.4	1.7	0.7	1.0	0.5	3.7	-3.1	17.8	28.5	-10.7
Greece	2.4	11.5	-9.1	8.3	7.8	0.6	0.7	0.4	0.3	-0.2	3.6	-3.8	11.3	23.3	-12.0
Hard peg	**-1.1**	**2.2**	**-3.3**	**13.4**	**17.6**	**-4.2**	**1.8**	**0.7**	**1.1**	**3.1**	**2.6**	**0.5**	**17.2**	**23.0**	**-5.8**
Lithuania	4.5	3.7	0.9	5.6	12.5	-6.9	1.3	0.4	1.0	1.5	2.4	-0.8	13.0	18.9	-5.9
Estonia	2.3	3.4	-1.0	16.0	21.2	-5.1	1.5	0.3	1.2	3.5	3.8	-0.3	23.4	28.7	-5.3
Latvia	1.5	1.4	0.2	14.4	19.9	-5.5	2.7	1.1	1.6	0.2	1.4	-1.1	18.9	23.7	-4.8
Bulgaria[4]	-9.3	0.8	-10.1	18.8	19.2	-0.4	1.6	0.8	0.8	6.1	2.9	3.2	17.3	23.8	-6.5
							Change (2007 over 2000) *(percentage points of GDP)*								
Surplus countries	**0.6**	**-0.7**	**1.3**	**3.7**	**-1.0**	**4.8**	**-0.5**	**-0.4**	**-0.1**	**0.4**	**-0.2**	**0.6**	**4.2**	**-2.4**	**6.6**
Netherlands	0.0	0.4	-0.4	3.2	-1.1	4.3	-1.6	-1.1	-0.5	-1.1	0.2	-1.3	0.4	-1.6	2.0
Germany	1.0	-1.3	2.3	4.5	-1.4	5.9	-0.5	-0.4	-0.2	0.8	-0.3	1.2	5.8	-3.5	9.3
Finland	-0.4	1.0	-1.5	0.2	0.9	-0.6	0.5	0.1	0.5	-1.7	0.0	-1.8	-1.4	2.0	-3.4
Austria	1.4	-0.4	1.8	0.7	0.0	0.7	0.2	-0.3	0.5	1.3	-0.4	1.6	3.6	-1.1	4.7
Belgium	-0.6	0.9	-1.5	1.2	-0.1	1.3	0.4	-0.1	0.5	-0.8	-0.3	-0.5	0.1	0.3	-0.3
Deficit countries[1]	**-0.2**	**1.3**	**-3.7**	**-2.0**	**0.9**	**0.2**	**0.2**	**-0.1**	**0.1**	**0.8**	**0.3**	**0.5**	**-1.1**	**2.3**	**-3.5**
Italy	0.3	0.4	-0.1	-2.2	0.9	-3.2	0.5	-0.2	0.6	1.0	0.0	1.0	-0.5	1.2	-1.7
France	0.4	1.3	-0.9	-0.4	0.3	-0.7	-0.6	-0.1	-0.5	-1.0	0.2	-1.2	-1.6	1.7	-3.3
Ireland	-1.6	4.7	-6.3	-0.1	0.9	-1.0	2.7	0.2	2.4	0.2	0.4	-0.2	1.2	6.3	-5.1
Spain	-0.6	2.3	-2.9	-5.1	1.8	-6.9	0.6	-0.3	0.9	3.8	0.9	3.0	-1.3	4.7	-6.0
Portugal	-2.6	-3.0	0.4	-2.4	-1.7	-0.6	0.9	0.3	0.6	-1.0	-1.2	0.2	-5.0	-5.6	0.6
Greece	-3.5	-2.1	-1.4	2.4	-0.5	2.9	1.2	-0.1	1.3	-2.4	-0.8	-1.5	-2.3	-3.6	1.3
Hard peg	**-5.3**	**2.6**	**-7.9**	**2.5**	**8.4**	**-5.8**	**-0.5**	**-0.5**	**0.0**	**2.9**	**2.8**	**0.1**	**-0.3**	**13.3**	**-13.6**
Lithuania	-7.7	0.2	-8.0	8.3	9.1	-0.8	0.1	-0.2	0.4	2.1	2.9	-0.8	2.8	12.0	-9.2
Estonia	-3.3	5.1	-8.4	-0.6	4.9	-5.5	-1.7	-0.4	-1.3	4.1	1.3	2.8	-1.4	11.0	-12.4
Latvia	-4.5	3.6	-8.1	-2.0	9.2	-11.3	0.2	-1.1	1.4	5.5	5.0	0.5	-0.8	16.7	-17.5
Bulgaria	-5.6	2.7	-8.3	2.2	8.8	-6.6	-1.0	-0.4	-0.5	1.5	2.0	-0.5	-3.0	13.0	-16.0

Sources: Eurostat; IMF, World Economic Outlook database; and IMF staff calculations.

Note: S denotes gross saving; I denotes gross investment; Net = S minus I. Country group averages are weighted with 2000 and 2007 nominal GDP weights.

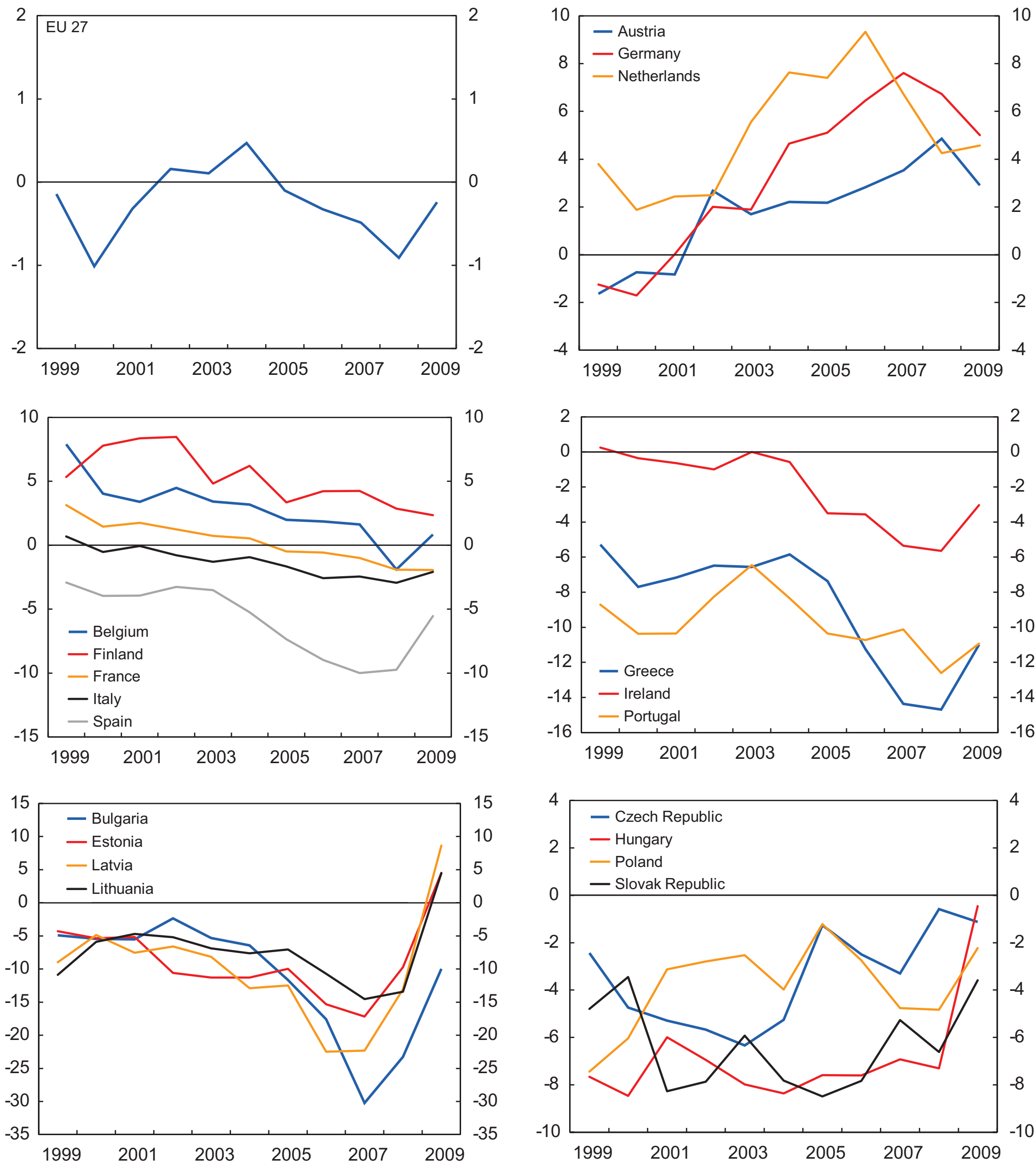
[1] Excluding Greece.

[2] 2005.

[3] 2002.

[4] 2004.

Figure 3.8
Selected EU Countries: Current Account Balances, 1999–2009
(Percent of GDP)



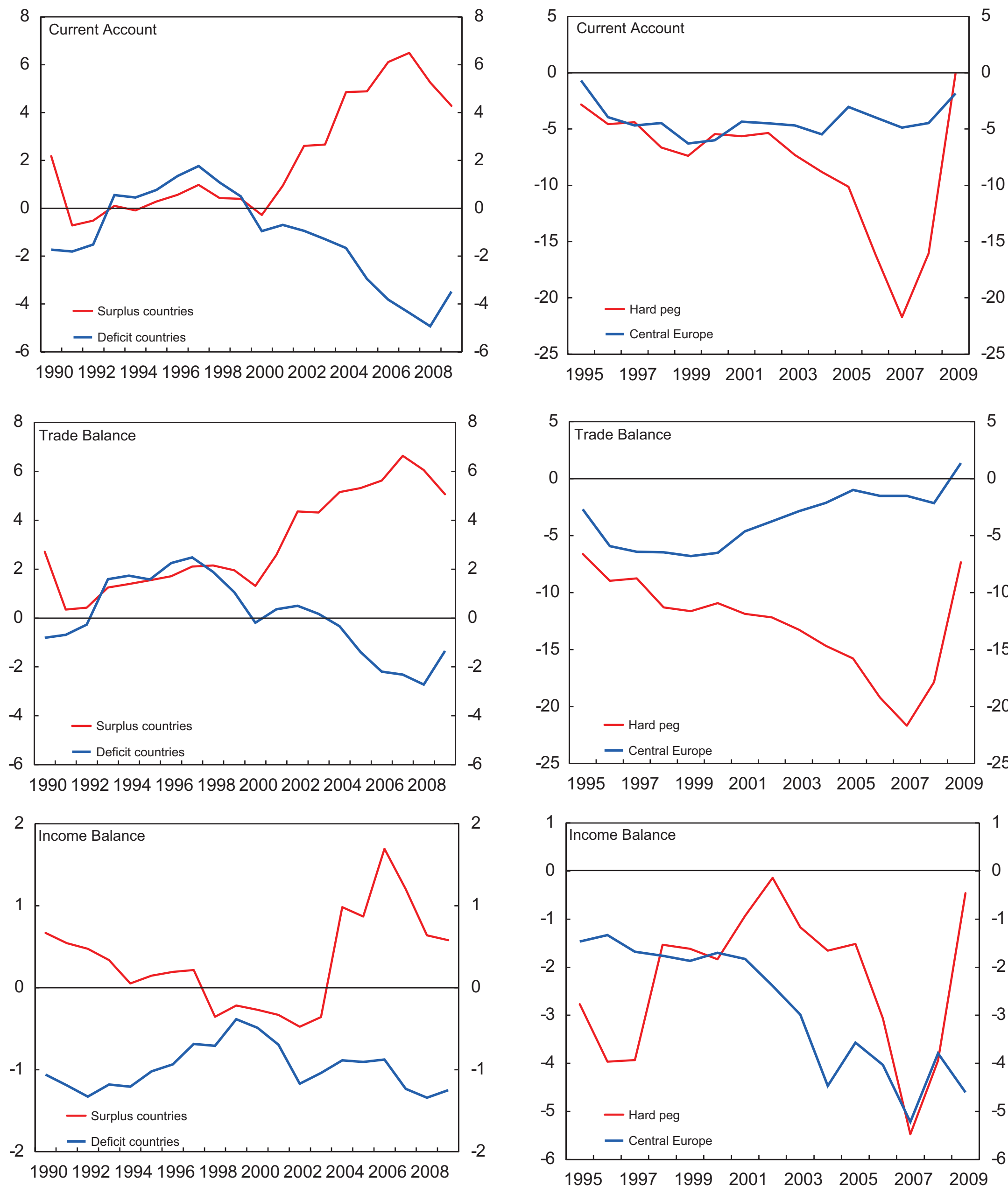
Sources: IMF, World Economic Outlook database; and IMF staff calculations.

In a change of strategy, they advised their subsidiaries and branches in emerging Europe that new credit would henceforth need to be financed solely by increases in local deposits (Figure 3.13).[6]

In the euro area periphery, Ireland and Spain suffered wrenching private sector adjustments. Before the crisis, Ireland and Spain had both experienced investment booms, which now collapsed. In Portugal and Greece, whose investment paths had been stable or declining, the impact of the crisis was initially less severe. Subsequent stress in the public sector affected them more (Figure 3.14, Table 3.2).

[6] The effect was compounded by the freezing of the international syndicated loans market, as well as a halt in the growth of direct cross-border loans.

Figure 3.9
External Balances
(Percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Surplus (deficit) countries are countries with a current account surplus (deficit) in 2007. Surplus countries include Austria, Belgium, Finland, Germany, and the Netherlands. Deficit countries include France, Greece, Ireland, Italy, Portugal, and Spain.

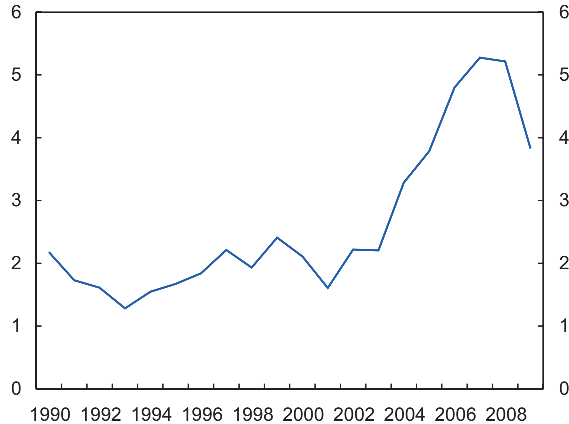
The hard peg countries in emerging Europe, where imbalances had been most pronounced, were also hit hard.[7] Domestic demand plunged, further exacerbated by a collapse in housing prices, and GDP contracted sharply, leading to a steep rise in

[7] Although the adjustment in the Baltics had already started in the fall of 2007, when Swedish banks became concerned about their exposures and wanted to engineer a gradual slowdown, the real shock to the region came in September 2008, after Lehman Brothers filed for bankruptcy.

Figure 3.10

Euro Area 11: Current Account Imbalance Indicator, 1990–2009[1]

(Percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

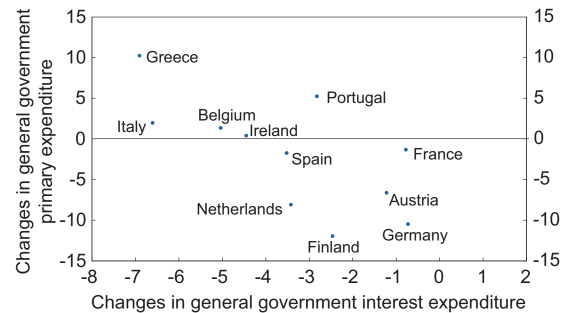
[1] Sum of the absolute values of current account balances in euro area divided by aggregate GDP.

unemployment. The CEE countries that during the boom years had flexible exchange rate regimes suffered a less severe recession. These countries had not experienced the same size credit boom and had much lower current account deficits, and went through much smaller forced adjustments (IMF, 2010b).

Figure 3.11

Euro Area 11: Changes in General Government Expenditure, 1995–2007

(Percentage points of GDP)



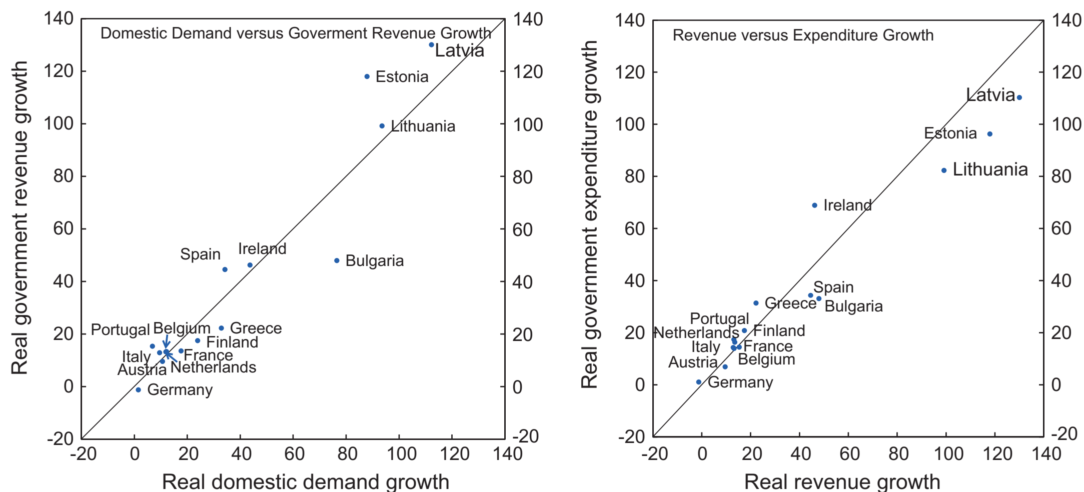
Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Concerns about the public sector soon exacerbated the crisis (Figure 3.15). The decline in domestic demand contributed to a severe drop in government revenue, and fiscal balances deteriorated sharply. Risk premiums in the periphery surged, even in countries that had entered the downturn with low deficits and debt (Figure 3.16). A vicious circle emerged: while the sovereign debt problems worsened as a result of the fiscal costs of banking problems, the concerns about the public sector exacerbated the problems for the private sector and financing costs for both went up in tandem (Figure 3.17).

Figure 3.12

Selected EU Countries: Real Domestic Demand, Government Revenue, and Expenditure Growth, 2000–07

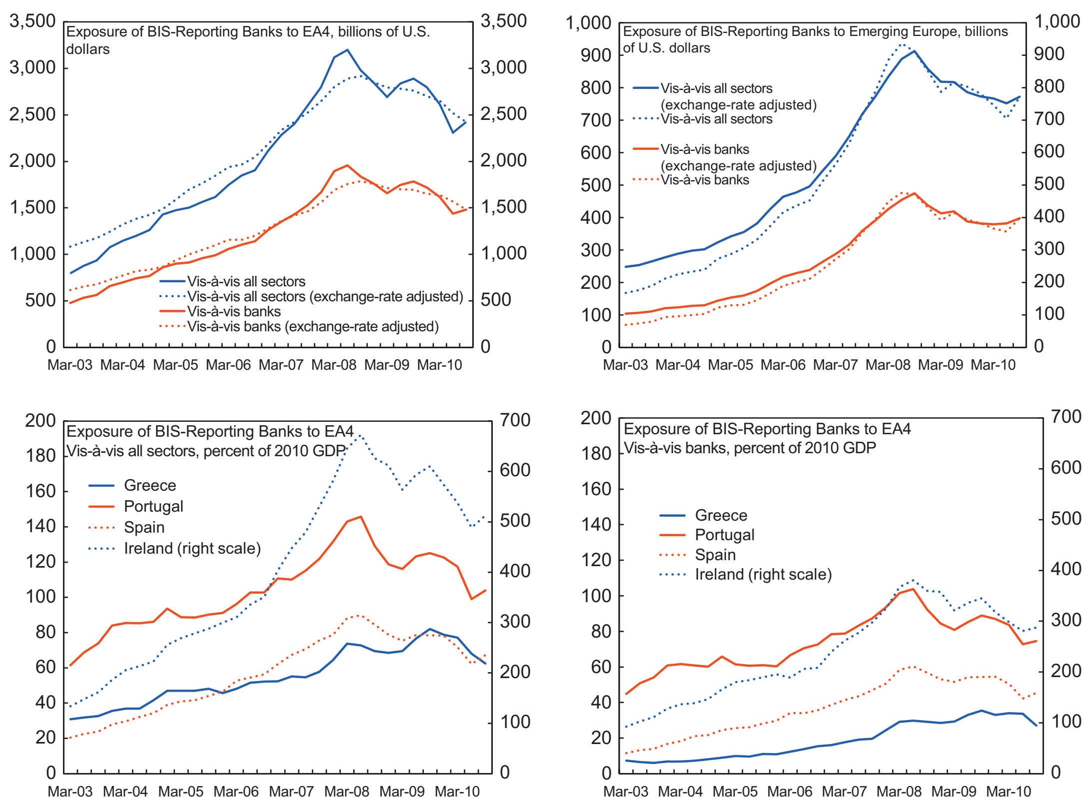
(Percent)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Figure 3.13

Europe: Bank Exposure, 2003–10



Sources: Bank for International Settlements; IMF, World Economic Outlook database; and IMF staff calculations.
Note: EA4 comprises Greece, Ireland, Portugal, and Spain.

Why Was the Crisis So Severe?

Why did the widening of current account imbalances culminate in such a severe crisis? In itself, the widening of external imbalances was not surprising. Capital can be expected to flow from richer to poorer countries, where the marginal productivity of capital is higher. Indeed, current account positions in the late 2000s were closely linked to both per capita income and interest rate differentials before monetary integration (Figure 3.6).[8] Nor are higher current account deficits always a concern. To the extent that inflows are used to expand production, especially export capacity, current account deficits should be temporary and matched by the increased future capacity of the recipient countries to service their debts. As exports subsequently grow, imbalances should decline.

However, these large capital inflows fueled an unbalanced and unsustainable growth pattern:

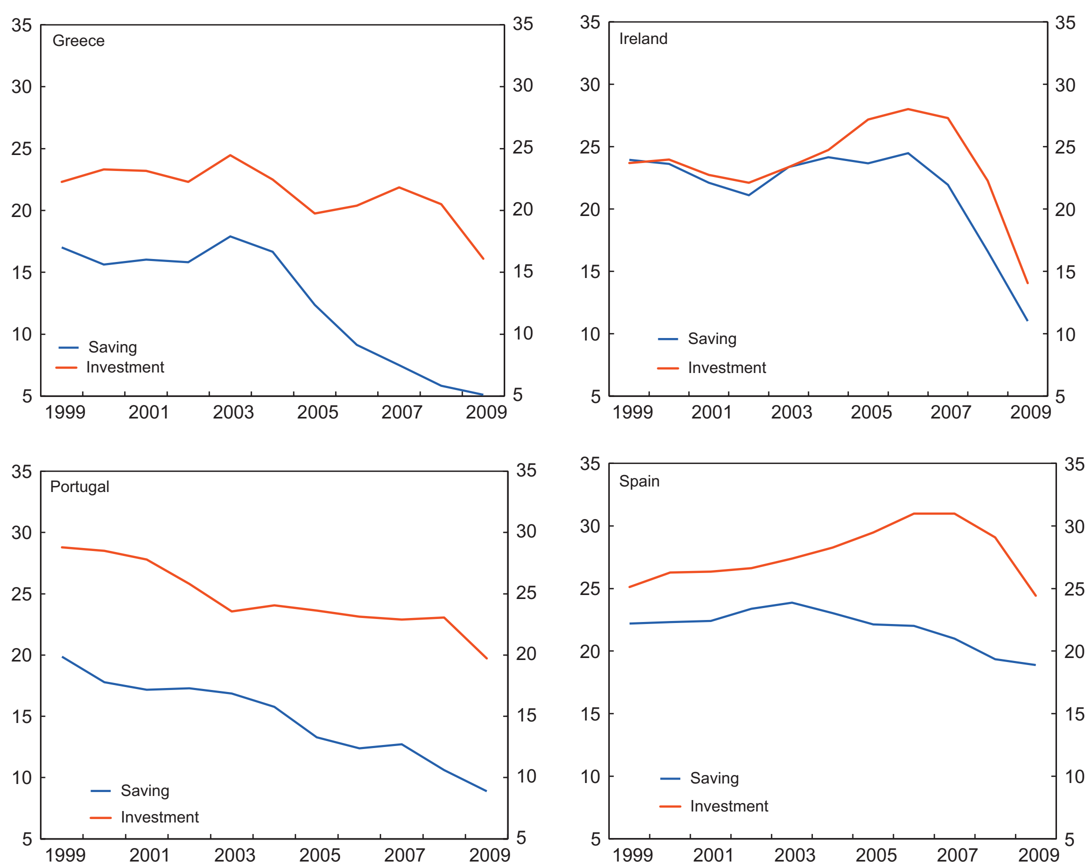
- Growth in the current account deficit countries was increasingly driven by sectors such as construction and financial intermediation with small tradable components, while growth in the surplus countries was tilted toward the tradable sector, especially industry (Table 3.3). As a result, the surplus countries saw sizable increases in their export-to-GDP ratios (Figure 3.18), while countries with small current account deficits experienced much smaller increases, and countries with very high current account deficits became even more closed in the 2000s.

[8] Together, per capita income and interest rate differentials in the early 1990s explain about 85 percent of the variation in current account balances in the late 2000s.

Figure 3.14

EA4: Saving-Investment Balance, 1999–2009

(Percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Table 3.2

Selected EU Countries: Current Account Balances and Real Domestic Demand, 2003–10

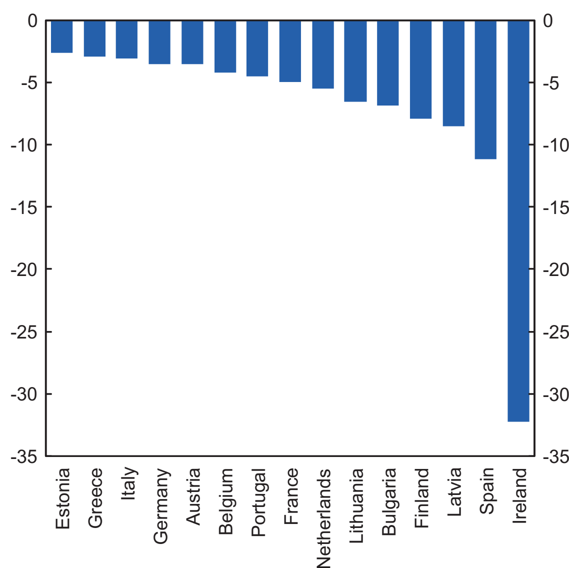
	Precrisis Vulnerabilities		Adjustments During Crisis	
	Current Account Balance, 2007 (percent of GDP)	Real Domestic Demand Growth, 2003–07 (percent)	Change in Current Account Balance, 2007–10 (percent of GDP)	Change in Real Domestic Demand Growth, 2007–10 (percent)
Euro area countries with high current account deficits				
Greece	-14.4	15.8	3.9	-10.0
Ireland	-5.3	27.1	4.6	-22.9
Portugal	-10.1	7.3	0.2	-1.0
Spain	-10.0	20.7	5.5	-7.6
Hard peg				
Bulgaria	-30.2	43.9	29.5	-11.3
Estonia	-17.2	42.5	20.8	-29.3
Latvia	-22.3	62.8	25.9	-35.4
Lithuania	-14.6	53.1	16.4	-20.5

Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Figure 3.15

Selected EU Countries: Change in Fiscal Balance, 2007–10

(Percentage points of GDP)

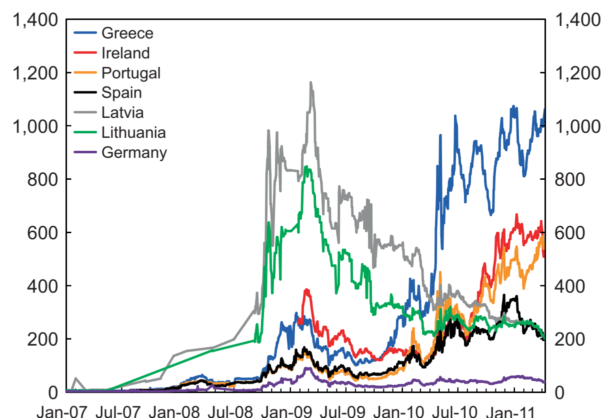


Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Figure 3.16

Selected Countries: Five-Year CDS Spreads, January 2007–April 2011

(Basis points)



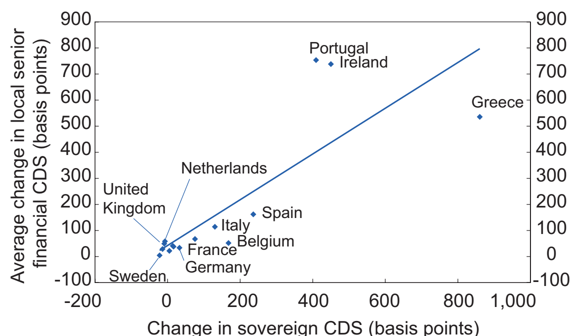
Source: Bloomberg, L.P.

- Strong growth in the nontradable sector, in turn, contributed to rising wages, which put profitability in the tradable sector under pressure (Figures 3.19, 3.20, 3.21) and made the current account deficit countries less attractive for FDI.

- Investment in the nontradable sector received a further boost from its relatively closed nature and the failure to prevent bubbles. With competition rather limited, investors in the nontradable sector enjoyed rents unavailable in the tradable sector, which was fully exposed to the harsh winds of global markets. Profitability in the nontradable sector jumped as asset price bubbles developed unchecked in key subsectors such as construction (Figures 3.22 and 3.23).

Figure 3.17

Selected EU Countries: Change in Sovereign and Bank Credit Default Swap Spreads, January 2010–March 2011



Sources: Bloomberg L.P.; and IMF staff calculations.

Note: Data points not labeled are for Austria, Denmark, Norway, and Switzerland.

- With incentives stacked toward the nontradable sector, investment took off and foreign capital flowed in. Beginning in 2002–03, the share of FDI in the current account deficit countries declined while bank and portfolio inflows surged (Figure 3.24). As the capital stock in the nontradable sector grew, marginal productivity of capital declined over time (Table 3.4).

- This pattern of growth led to a steady widening of current account balances, which resulted in large changes in net external asset positions (Figure 3.25)—an ultimately unsustainable trend.

- As current account deficits widened, countries became increasingly dependent on continuing capital inflows, and a sudden stop of capital inflows could cause a large-scale financial disruption, with a severe impact on growth.

Table 3.3

Selected EU Countries: Growth in Value Added and Contribution by Sector, 2000–07

(Percent)

	Surplus Countries	Deficit Countries	Hard Peg	Central Europe
Total	13.0	14.8	63.2	34.0
Agriculture	0.0	-0.1	-0.7	0.6
Industry	4.3	1.8	14.1	14.4
Construction	-0.6	1.3	6.8	1.1
Trade, transport, and communication	3.3	3.2	23.6	9.4
Financial intermediation, and real estate	4.5	5.7	14.6	6.3
Other services	1.6	2.8	4.8	2.6

Sources: Eurostat; and IMF staff calculations.

Markets Underestimated Risks

Before the recent global crisis, markets tended to underestimate these risks. This pattern was also observed in countries with exchange rates pegged to the euro in anticipation of early euro area entry. Risk premiums remained low, so current account imbalances became wider and more persistent, thus contributing to large changes in net external asset positions. Markets showed little concern until mid-2007, ignoring solvency risk and covering large financing needs at low interest rates, which boosted self-feeding bubbles in nontraded sectors. By failing to demand higher risk premiums, markets failed to rein in this unhealthy development until it was too late for a soft landing. This situation is not unique to the European debt crisis but follows a pattern familiar from other crisis cases, including the Latin American debt crisis of the early 1980s, the Asian crisis of the late 1990s, and the U.S. subprime crisis of the late 2000s.

One reason markets underestimated risks may have been the expectation that euro area banks and governments would be bailed out. Markets found it difficult to imagine that the euro area countries would not come to the rescue of members in trouble—particularly given the interconnectedness of their banking systems. The regulatory environment also considered all sovereign bonds to be safe assets.

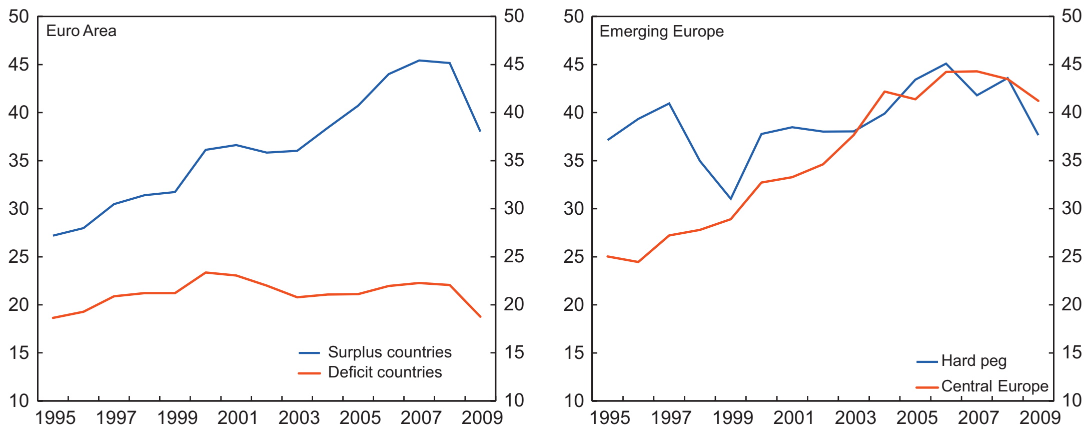
Yet the underestimation of risk was not confined to Europe. The belief was widely held that macroeconomic volatility had declined and the central problem of depression prevention, for all practical purposes, had been solved (the "Great Moderation"). Large capital flows seemed to carry few risks when crisis was seen as a remote possibility.

Economic Policies Failed to Address Imbalances

Economic policies failed to sufficiently correct market failures and check overoptimistic expectations.

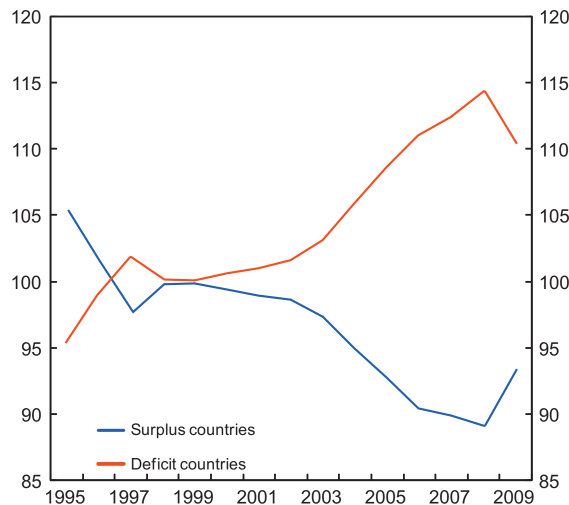
- With interest rates set at the euro area average and markets not differentiating between countries, the credit boom became difficult to stop once it had started. Indeed, as the economy heated up and inflation and wages started to rise, high inflation led to negative real interest rates, further boosting demand for credit (Figure 3.26). In emerging Europe, and as discussed in the October 2010 *Regional Economic Outlook*, the new EU member states that had fixed their currencies to the euro at an early stage (Bulgaria, Estonia, Latvia, and Lithuania) all experienced credit and domestic demand booms and very high current account deficits, while countries that retained greater monetary independence generally experienced less pronounced imbalances (Box 3.1).

Figure 3.18
Selected EU Countries: Exports of Goods, 1995–2009
(Percent of GDP)



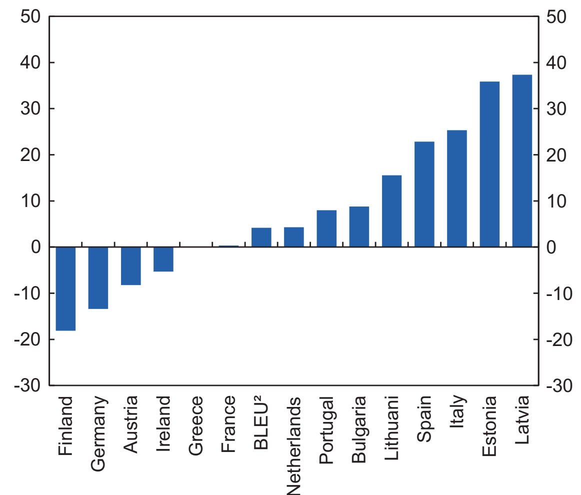
Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Figure 3.19
Euro Area: REER (ULC Manufacturing Based), 1995–2009
(Index, 1999 = 100)



Sources: European Commission; and IMF staff calculations.
Note: Aggregation is weighted by GDP.

Figure 3.20
Selected EU Countries: Appreciation of REER (ULC Manufacturing Based), 2000–07[1]
(Percent)

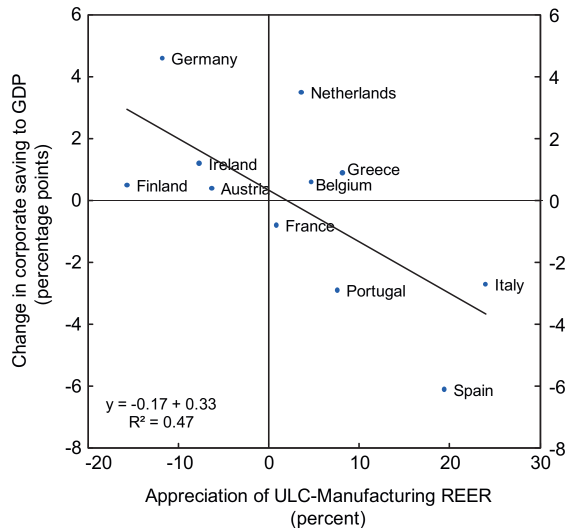


Sources: European Commission; and IMF staff calculations.
[1]Real effective exchange rates are relative to the rest of EU27 and based on quarterly data.
[2]BLEU stands for Belgium-Luxembourg Economic Union.

- However, other policy instruments to curb domestic demand and excessive expansion of the nontradable sector were used insufficiently. Tighter fiscal policy could have dampened domestic demand.[9] Although fiscal balances in the periphery were, on average, not in worse shape than in the core (with the exception of Portugal and Greece, Figure 3.27), this situation primarily reflected savings on interest payments and revenues that turned out to be temporary.
- Stronger macroprudential regulation would have required financial institutions to build up

[9] It would also have created fiscal cushions that could have been used during the subsequent downturn.

Figure 3.21
Selected EU Countries: Appreciation of REER (ULC Manufacturing Based) Versus Change in Corporate Saving to GDP, 2000–07



Sources: European Commission; Eurostat; and IMF staff calculations.

larger capital buffers and provisions in good times, which would have raised the cost of capital and slowed the expansion of financial sector balance sheets, or at least made banks less vulnerable in the subsequent bust.[10]

While credit excesses, housing booms, competitiveness losses, and lack of fiscal discipline all played a role, their contributions were country specific. Greece suffered most from the lack of fiscal discipline. Ireland and Spain experienced a lack of political fortitude to use fiscal policy and macroprudential tools to manage credit and housing cycles.[11]

[10] During the boom years, many countries in emerging Europe strengthened prudential regulations to slow credit growth. Although these measures had limited effectiveness in slowing credit, they resulted in the creation of large capital and liquidity buffers, which protected the banks during the crisis of 2008–09.

[11] During the boom years, Spanish banks were required to build supplemental reserves to cover future loan losses ("dynamic provisioning"). While this helped to build buffers, it was less successful in slowing credit growth.

Why Is Resolution of the Crisis So Protracted?

The boom-bust cycle in the euro area periphery was not unique. During the boom years, countries throughout the world experienced credit and asset price escalations. Stark differences across regions also occurred in other monetary unions. In the United States, Arizona, California, Florida, and Nevada went through severe boom-bust cycles, while other states were much less affected.

The crisis in Europe was prolonged by the incomplete integration of the financial system and the absence of a centralized mechanism to deal with it. The result was a vicious circle in which sovereign debt and banking sector problems aggravated each other.

Financial Integration Is Incomplete

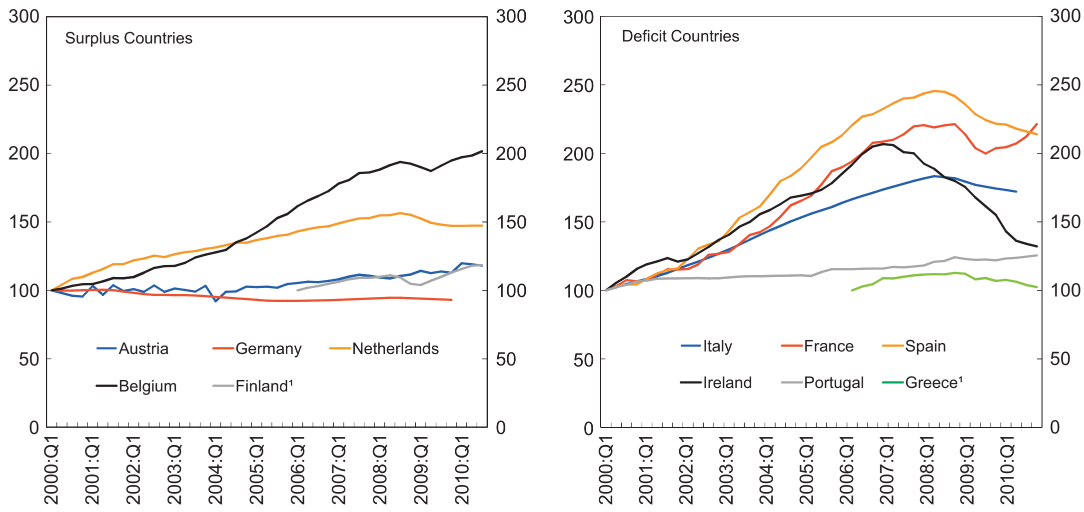
Financial integration in the EU and the euro area is still incomplete and uneven. Some elements of the financial system are highly integrated: capital flows cross borders with little impediment, and banks transact freely in the money market. But home bias in portfolio allocations remains, securitization is very much a national affair (for example, no uniform mortgage contract exists), and cross-border retail banking is virtually nonexistent—cross-border provision of retail financial services amounts to less than 1 percent of total loans. Apart from some regional clusters, cross-border mergers and acquisitions are still limited in most European banking markets, with foreign acquisitions accounting for only 20 percent of banking activity, compared with 40 percent in other sectors.[12] For the euro area as a whole, foreign bank participation in domestic markets amounted to 27 percent in 2009 (Figure 3.28).

[12] The situation is different in many countries of emerging Europe, where foreign banks tend to dominate the banking sector, reflecting a conscious decision by the governments to divest to Western banks because domestic and state-owned banks repeatedly caused crises and slowed the transition process.

Figure 3.22

Selected EU Countries: Nominal House Prices, 2000:Q1–2010:Q3

(Index, 2000:Q1 = 100)

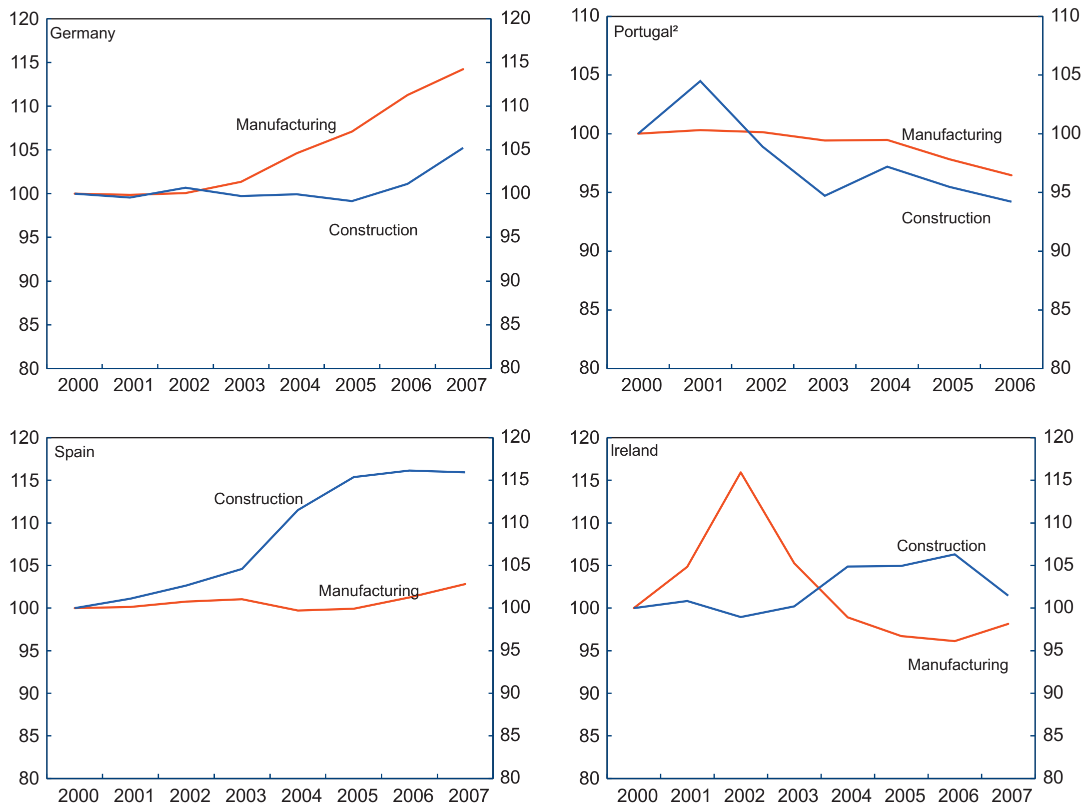


Sources: Bank for International Settlements; national authorities; and IMF staff calculations.
[1]For Finland (panel 1) and Greece (panel 2), 2006:Q1 = 100.

Figure 3.23

Selected EU Countries: Profitability by Sector, 2000–07[1]

(Index, 2000 = 100)

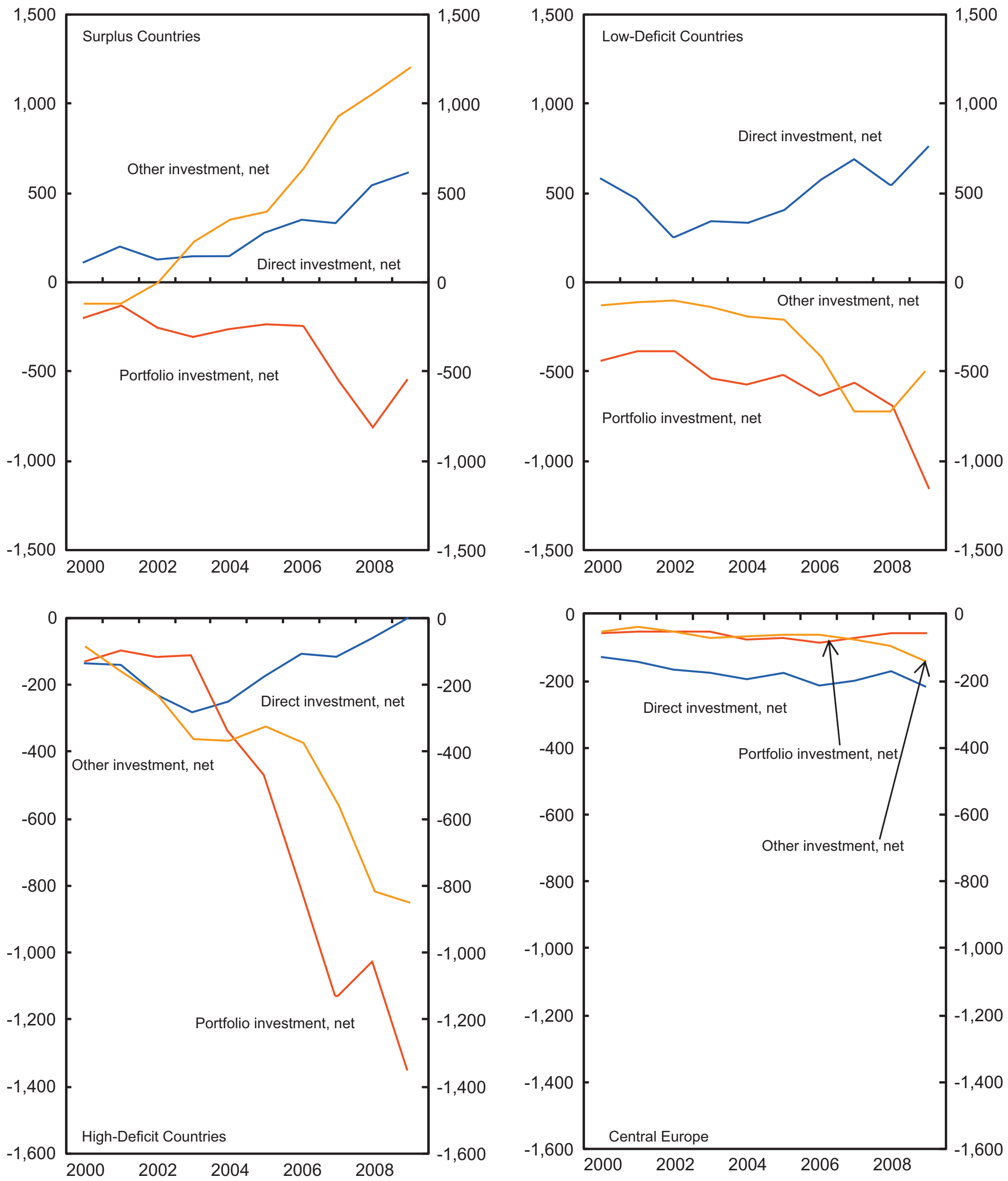


Sources: EU KLEM database; and IMF staff calculations.
[1]Profitability is computed as value added deflator minus wage rate plus gross value added per hours worked (or an inverse of labor productivity).
[2]Data for Portugal are for 2000–06.

Figure 3.24

Selected EU Countries: International Investment Position, 2000–09

(Billions of U.S. dollars)



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.
Note: Surplus (deficit) countries are countries with a current account surplus (deficit) in 2007. Surplus countries include Austria, Belgium, Finland, Germany, and the Netherlands. Low-deficit countries are countries with a 2007 current account deficit less than 5 percent of GDP and include France and Italy. High-deficit countries are Greece, Ireland, Portugal, and Spain.

Perceptions of a lack of cross-border synergies played a role, but differences in business and regulatory environments seem to be important factors explaining the incomplete financial integration in the euro area. The absence of a unified legal framework is a clear obstacle but so is the desire to maintain national champions, build niche activities, take advantage of regulatory and supervisory arbitrage, and retain full national accountability for explicit and implicit guarantees

Table 3.4

Euro Area: Output-Capital Ratios, 2000–07

(Percent)

	Average[1]		Marginal[2]
	2000	2007	2000–07
Italy	0.44	0.39	0.16
Spain	0.44	0.37	0.23
Portugal	0.58	0.52	0.24
France	0.46	0.42	0.26
Netherlands	0.41	0.40	0.32
Germany	0.41	0.40	0.32
Belgium	0.39	0.38	0.32
Greece	0.43	0.40	0.34
Austria	0.38	0.37	0.35
Ireland	0.65	0.62	0.56
Finland	0.42	0.45	0.67

Sources: Organization for Economic Cooperation and Development, Economic Outlook database; and IMF staff calculations.

[1] Real GDP divided by total capital stock.

[2] Change in real GDP divided by change in total capital stock.

of the banking system. It is not surprising, then, that the efficiency benefits conferred by heightened competition in a single market have been limited at best and have recently suffered a setback (Box 3.2).

As a result, banking flows to the euro area periphery during the boom years largely took the form of debt rather than equity, which exposed banks in the periphery to rollover risk. By contrast, in emerging Europe, with fewer implicit barriers to bank expansion, most of the bank flows went from parent banks to their local subsidiaries. Although nominally in the form of debt, in practice the flows were more like equity—parent banks could not suddenly withdraw funding from their subsidiaries because such an action would lead to liquidity shortages in the subsidiary and likely intervention by supervisors. The more stable funding structure benefited banks in emerging Europe during the crisis, and may have been one of the reasons that banking crises in the region were largely avoided.

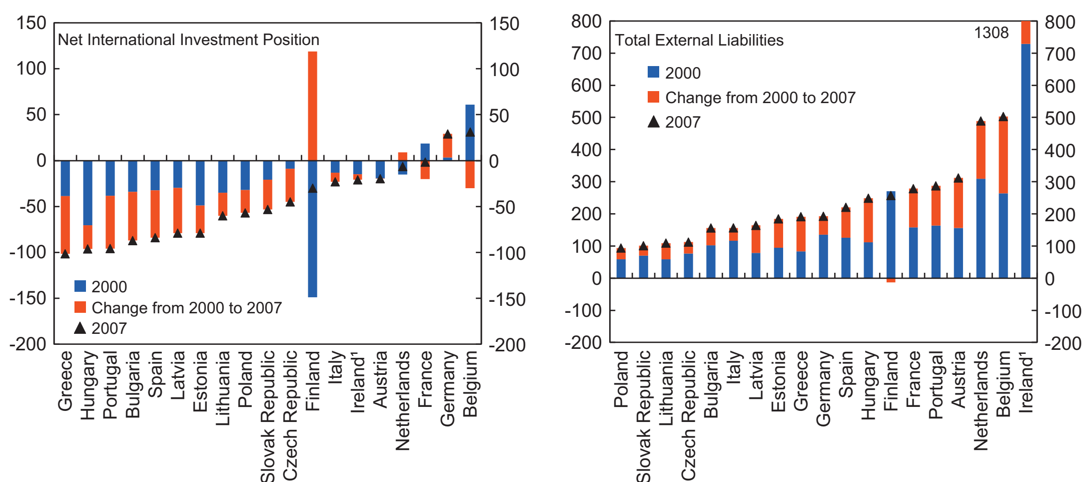
Institutions Supporting the Single Financial Market Are Still Being Built

The EU has fostered financial integration by relaxing constraints (for example, the single passport for cross-border banking) and harmonizing various aspects of the financial system, and by adopting a common currency in the euro area, but this process has been allowed to run

Figure 3.25

Selected EU Countries: International Investment Position, 2000–07

(Percent of GDP)

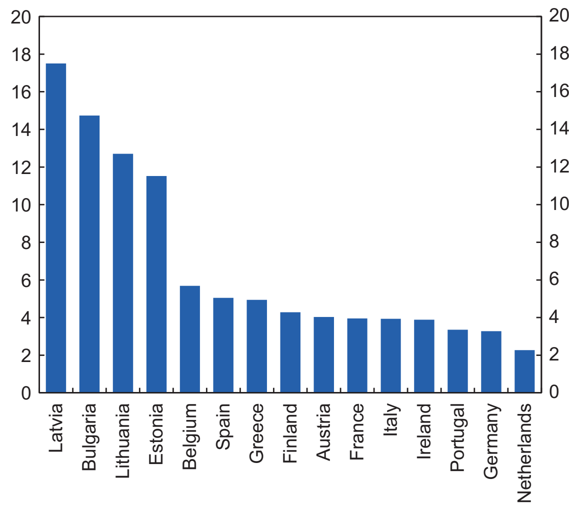


Sources: IMF, *International Financial Statistics*; and IMF, World Economic Outlook database.

Note: Net International Investment Position is defined as the difference between total external assets and total external liabilities.

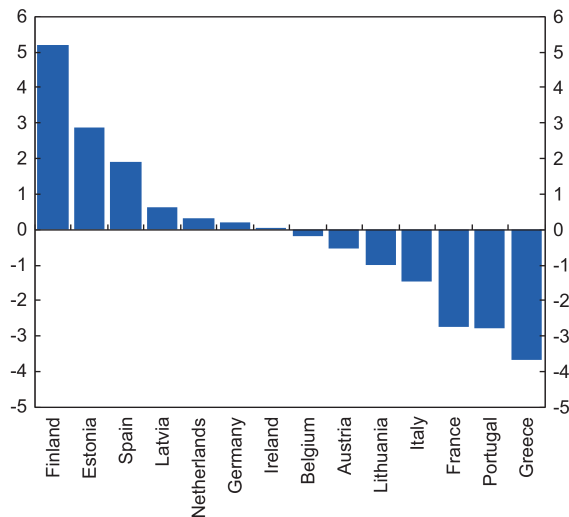
[1] 2001 instead of 2000.

Figure 3.26
Selected EU Countries: Inflation, June 2008
(Year-over-year, percent)



Source: Eurostat.

Figure 3.27
Selected EU Countries: Fiscal Balance, 2007
(Percent of GDP)

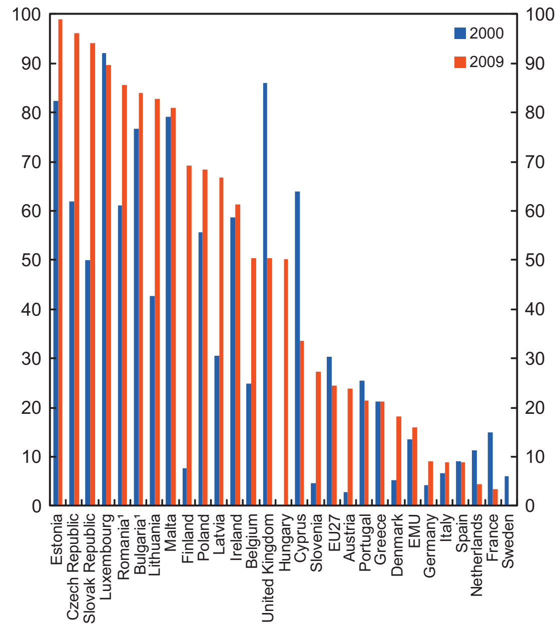


Source: IMF, *International Financial Statistics.*

ahead of the institutions necessary to support the single financial market. No effective instruments were put in place to detect and handle cross-border risks or mitigate the buildup of imbalances financed by cross-border financial flows.

As a result, when the crisis hit, reactions were mostly national, with no regard for the cross-border implications of such policies (for example,

Figure 3.28
Selected EU Countries: Foreign Bank Presence
(Percent of assets)



Source: ECB Report on EU banking structures, consolidated banking data.
Note: Foreign bank presence is the total assets of foreign banks' branches and subsidiaries as a percent of the total assets of the banking sector.
[1] Data from 2005.

guarantees of liabilities, bans on short selling, and proposals for bail-ins). Arrangements to deal with cross-border banks broke down over burden-sharing issues. Throughout the ongoing resolution of the crisis, the approach to banking sector problems has remained national.

EU policymakers have responded to the crisis by setting up new institutions. The European Systemic Risk Board (ESRB) will look into macroprudential risks to spot credit developments before they give lead to unsustainable imbalances, while the new European Supervisory Authorities should strengthen and harmonize regulation and supervision.[13]

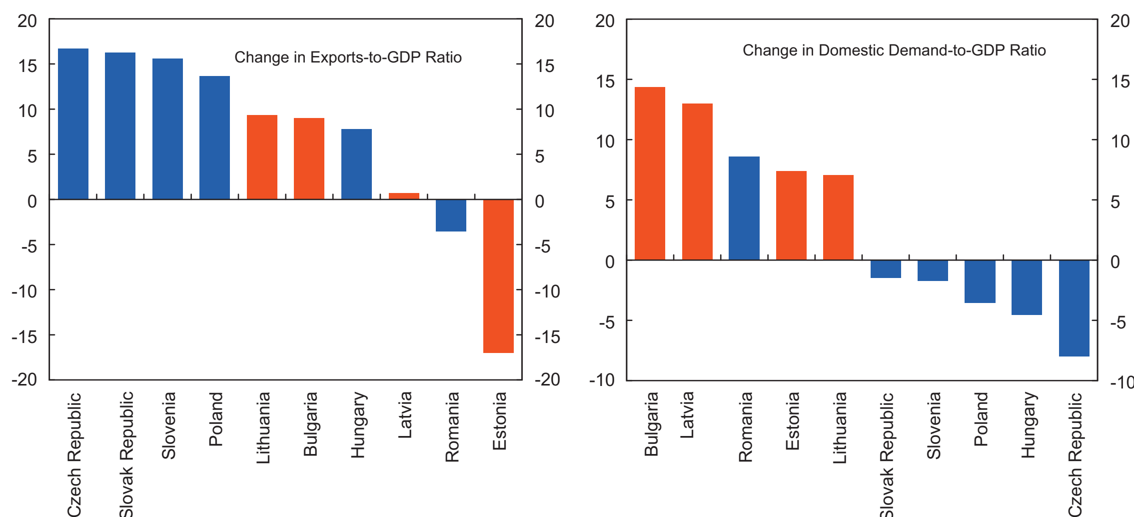
But dealing effectively with interconnected financial institutions operating in a single financial market requires a pan-EU, or at least a euro area-wide, approach, a step beyond the currently

[13] In the international context, various initiatives are under way to make the banking sector safer, and progress is being made in setting up better cross-border tools for crisis management and resolution.

Box 3.1

Why Did the Currency Board Countries in Emerging Europe Have Such Large Imbalances?

Selected EU Countries: Composition of Growth, 2000–07
(Percentage points)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

As discussed in Chapter 3 of the October 2010 *Regional Economic Outlook: Europe* (IMF, 2010b) the large capital flows that went to emerging Europe in the years before the global economic crisis did not affect all countries equally. In some countries, current account deficits widened to over 15 percent of GDP and inflation reached double digits, while in others imbalances remained more contained.

One important factor in these differences was the exchange rate regime. The largest imbalances occurred in new EU member states with hard currency pegs to the euro (Bulgaria, Estonia, Latvia, and Lithuania). In most new member states with more flexible exchange rate regimes, imbalances were milder (the Czech Republic, Hungary, Poland, and the Slovak Republic). Imbalances were also less in countries with fixed exchange rates that were not yet EU members (Bosnia and FYR Macedonia). Capital flows into these countries were lower, probably partly because of the memory and legacy of various conflicts in the region, and partly because they were not yet in the EU).

Why did imbalances in new member states with hard pegs become so much larger than in new member states with more flexible exchange rate regimes?

- From a demand perspective, a boom in domestic demand drove GDP growth in countries with fixed exchange rates (see figure). These countries saw sharp increases in their domestic demand to GDP ratios, while the exports to GDP ratios increased much less. In countries with floating exchange rates, the growth pattern was more balanced.

- From a supply perspective, GDP growth was driven to a large extent by the nontradable sector. Countries with more flexible exchange rates had much stronger growth in manufacturing. These differences reflect differences in capital inflows. In the Baltics and Bulgaria, capital flows largely went to the nontradable sector, whereas in the countries with more flexible exchange rates, a much larger share went to the tradable sector.

Note: The main author of this box is Jeta Menkulasi.

When faced with large capital inflows, the fixed exchange rate regime countries had few instruments at their disposal to stop the credit boom. Indeed, they experienced a vicious circle. As the economy heated up and wage growth and inflation increased, real interest rates dropped, further boosting demand for credit. Sharp wage increases led to a deterioration of the tradable sector's competitiveness, which led to a reduction in the growth of exports. Countries with more flexible exchange rates did not experience the same vicious circle—they could keep real interest rates higher by letting the nominal exchange rate appreciate, which mitigated the credit boom.

planned coordination. There is little alternative to harmonization of regulations and supervisory practices at the EU level and an approach to crisis management and resolution that employs a pan-EU backstop. Only then will location no longer matter for financial institutions' costs of and access to funding, and only then will the financial system be decoupled from the sovereign, a link that in the current crisis has proved to be detrimental in both directions.

More Complete Financial Integration Would Have Helped Resolve the Crisis

How would this deeper integration fortified by proper institutions have helped in resolving the crisis?

- First, banks would have suffered less spillover from sovereign debt trouble. Deposit guarantees or any other implicit guarantees would not have depended on the sovereign signature, which would have kept funding costs for banks in euro area periphery countries in check.
- Second, it would have given the EU more options for dealing with weaknesses in the banking system. If domestic markets had been more open to foreign banks, national public sector policies for supporting and recapitalizing banks—which has perpetuated the adverse feedback between banks and sovereign—would not have been the only viable measures.[14]
- Third, it would have facilitated consolidation of the financial sector typical in the aftermath of a crisis and helped avoid the tendency to ring-fence national systems. Consolidation is now occurring slowly, if at all, and often within borders. In many cases, restructuring has led to refocusing on the domestic market and sales of foreign operations, thus reducing financial integration. Similarly, national authorities, mindful of their taxpayers, are ring-fencing operations under their purview, thus diminishing the benefits of the single market.
- Finally, had a pan-EU supervisory regime been in place, excessive exposures or expansions of banking systems well beyond the fiscal capacity of the sovereign may have been spotted and ill-considered unilateral policy moves avoided.

Experience in the United States illustrates that more centralized crisis resolution mechanisms and more integrated capital markets can make a difference (Box 3.3). The United States also went through a severe boom-bust cycle, with large differences across regions. Although the U.S. fiscal deficit is now higher than that of the euro area countries, and some individual states have come under significant fiscal pressures, the U.S. capital market has not disintegrated along state lines.

In sum, increased financial integration will improve risk sharing and should help stabilize national demand, contributing to the resolution of imbalances and helping prevent their reemergence. But it will need to be accompanied

[14] Achieving these changes would require rapid progress on the single regulatory rulebook for banks and on harmonizing supervisory practices to eliminate multiple reporting requirements. Standardization of products, the establishment of a pan-European approach to securitization, and more uniform consumer protection regimes are also needed.

Box 3.2

Recent Developments in Bank Competition in Europe

Globalization and financial integration have changed the business environment in which banks operate. The impact has been profound in Europe, supported by the introduction of the euro, significant liberalization, and harmonization of financial sector regulation as policymakers pursue the goal of a single market. A fully integrated financial market promotes innovation and competition and ensures efficient provision of financial goods and services. At the same time, the global financial crisis has made clear that harmonized and well-designed regulation and prudent supervision of the banking sector are indispensible for preventing excessive risk taking. The crisis took a heavy toll on European banks and required the introduction of bank support schemes to avoid disorderly bank failures that could have pushed the financial sector into collapse. With advice from the ECB and the European Commission, national authorities implemented support schemes for their domestic banks. The Commission had to balance the need for state aid on the one hand with safeguarding competition and avoiding market segmentation along national borders on the other. Whether this has been achieved is a key question for policymakers. A competitive and sufficiently integrated banking sector should facilitate adjustment and the needed recapitalization, and cross-border restructuring through mergers and acquisitions is an essential element.

The level of bank competition can be measured in various ways. Historically, inferences about the level of competition relied on structural characteristics such as concentration ratios for the largest banks, or overall profitability. However, high capital returns may simply reflect high efficiency instead of monopolistic rents. Moreover, structural features could be less relevant in gauging market competition in very open, globally integrated, and highly contestable markets. Unrestricted entry and exit of firms, including those from abroad, may force banks to act competitively even if their numbers are small. Indeed, Claessens and Laeven (2004) show for a large cross-country sample that being open to new entry is the most important competitive pressure; they find no evidence that banking system concentration is negatively associated with competitiveness.

The H-statistic (H) developed by Panzar and Rosse (1987) is a widely used measure for competitive behavior that relies on market contestability and potential competitors. It focuses on the degree to which changes in the costs of inputs lead to subsequent changes in revenues. Under a monopoly, an increase in input prices will increase marginal costs and reduce equilibrium output and total revenues ($H < 0$). Under perfect competition, an increase in input prices will be fully passed on to the output price ($H = 1$). Positive values less than 1 imply some degree of monopolistic competition. Estimation results for the periods 1995–2000, 2001–07, and 2008–09 show the following:[1]

- In the period shortly after the introduction of the euro (2001–07), competitive bank behavior broadly converged across euro area member countries to a lower overall level and closer to the U.S. level.
- In the aftermath of the financial crisis, several European countries and the euro area as a whole saw a further small but statistically significant deterioration in their levels of banking competition. However, the overall deterioration in competition in Europe appears no worse than the deterioration in the United States.

The finding that large and financially integrated countries or regions tend to exhibit less competitive behavior than smaller regions exhibit is in line with other studies, including Bikker and Spierdijk (2008), who also find

Note: The main author of this box is Thomas Harjes.

[1] Postcrisis estimates only provide preliminary evidence in view of the limited number of observations and the fact that structural changes in the aftermath of the crisis may have distorted the long-term market equilibrium in some countries, which could invalidate the H-statistic.

some deterioration in competitive behavior over time for Europe's banks. They argue that banks in large and integrated financial markets are pushed by rising capital market competition and tend to shift from traditional intermediation to more sophisticated and complex products associated with less price competition. However, the further deterioration in competitive pricing observed in the aftermath of the crisis is unlikely to yet reflect structural market changes and evolving bank business models. Instead, significant bank losses and the subsequent need for recapitalization may have temporarily limited competitive pressures. Finally, little evidence yet suggests that national support schemes in Europe have further hindered competition. Nevertheless, the European Commission and other regulatory agencies should continue to insist on bold restructuring and balance sheet repair in instances in which state aid has been granted with a view toward maintaining a level playing field for healthy and competitive banks with sound business models.

Bank Competition Measured by H-Statistic over Time

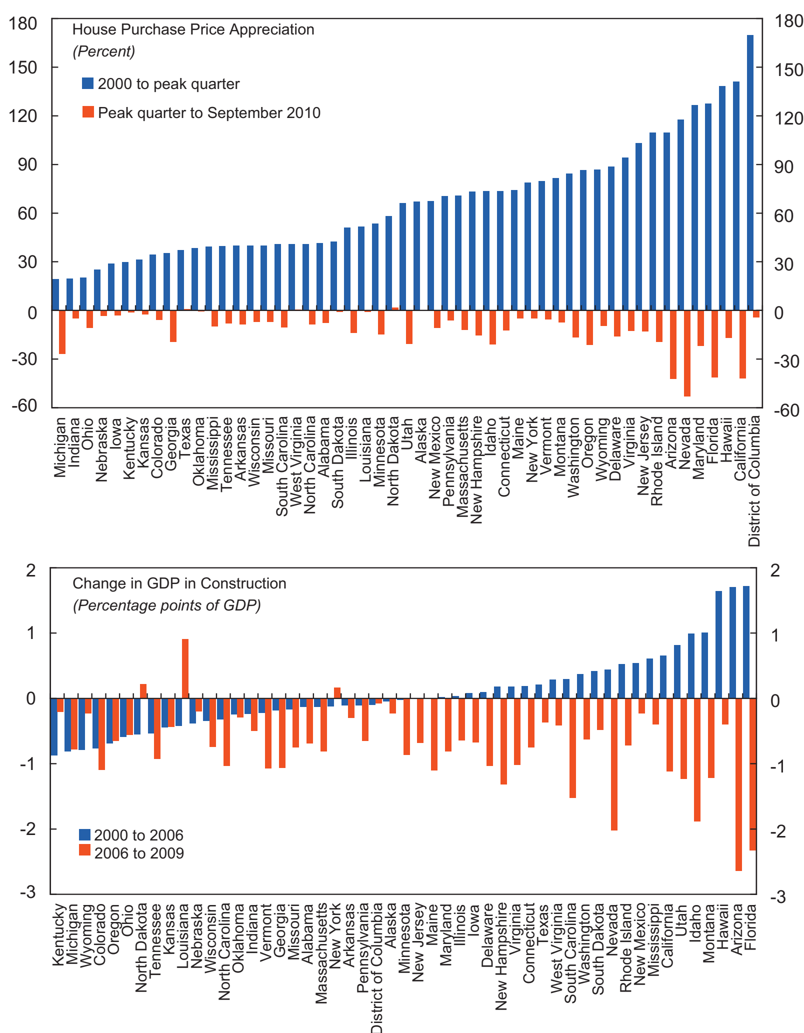
	1995–2000		2001–2007		2008–2009		Change			
							Before and After EMU		Before and After Crisis	
Country/region	H-Statistic	Standard Error	H-Statistic	Standard Error	H-Statistic	Standard Error	ΔH	Standard Error	ΔH	Standard Error
	(1)	(2)	(3)	(4)	(5)	(6)	(7)=(3)–(1)	(8)	(9)=(5)–(3)	(10)
Austria	0.58	0.04	0.60	0.03	0.71	0.10	0.02	0.04	0.10	0.11
Finland	0.80	0.10	0.55	0.06	0.65	0.05	-0.25**	0.12	0.10	0.08
France	0.64	0.01	0.58	0.02	0.63	0.05	-0.05***	0.02	0.04	0.05
Germany	0.43	0.01	0.45	0.01	0.36	0.02	0.02	0.02	-0.09***	0.02
Greece	0.82	0.08	0.52	0.06	0.39	0.10	-0.3***	0.10	-0.13	0.11
Ireland	1.02	0.16	0.75	0.07	0.59	0.13	-0.27	0.17	-0.17	0.14
Italy	0.88	0.01	0.59	0.01	0.50	0.03	-0.29***	0.02	-0.09***	0.03
Netherlands	0.90	0.16	0.41	0.06	0.61	0.08	-0.49***	0.16	0.20**	0.10
Portugal	0.71	0.04	0.68	0.05	0.85	0.17	-0.03	0.07	0.17	0.18
Spain	0.70	0.03	0.80	0.03	0.51	0.05	0.09**	0.04	-0.29***	0.06
United Kingdom	0.51	0.04	0.65	0.03	0.62	0.05	0.14***	0.04	-0.03	0.05
United States	0.31	0.01	0.43	0.00	0.27	0.01	0.12***	0.01	-0.16***	0.01
Euro area	0.70	0.01	0.52	0.01	0.44	0.01	-0.18***	0.01	-0.07***	0.01

Source: IMF staff calculations. For more detail, see Sun (forthcoming).
Note: *** and ** indicate significance at the 1 and 5 percent level, respectively.

Box 3.3

Crisis Resolution and Financial Integration in the United States

Like Europe, the United States experienced large regional differences in the housing boom-bust. California, Florida, Nevada, and Arizona went through the most severe cycles. In these states, housing prices more than doubled from 2000 to their peak, and then declined sharply—in Nevada by more than 50 percent. In other states, the amplitude of the cycle was not as large. These differences in the housing boom-bust were associated with stark differences in the severity of the recession (first three figures). Between late 2006 and late 2010, the unemployment rate rose by 10 percentage point in Nevada, and only ½ percentage point in North Dakota.[1] Differences in unemployment rate levels were similarly stark—ranging from 4 percent in North Dakota to 14½ percent in Nevada.



United States: Housing Boom-Bust, 2000–10

Sources: Bureau of Economic Analysis; Federal Housing Finance Agency; and IMF staff calculations.

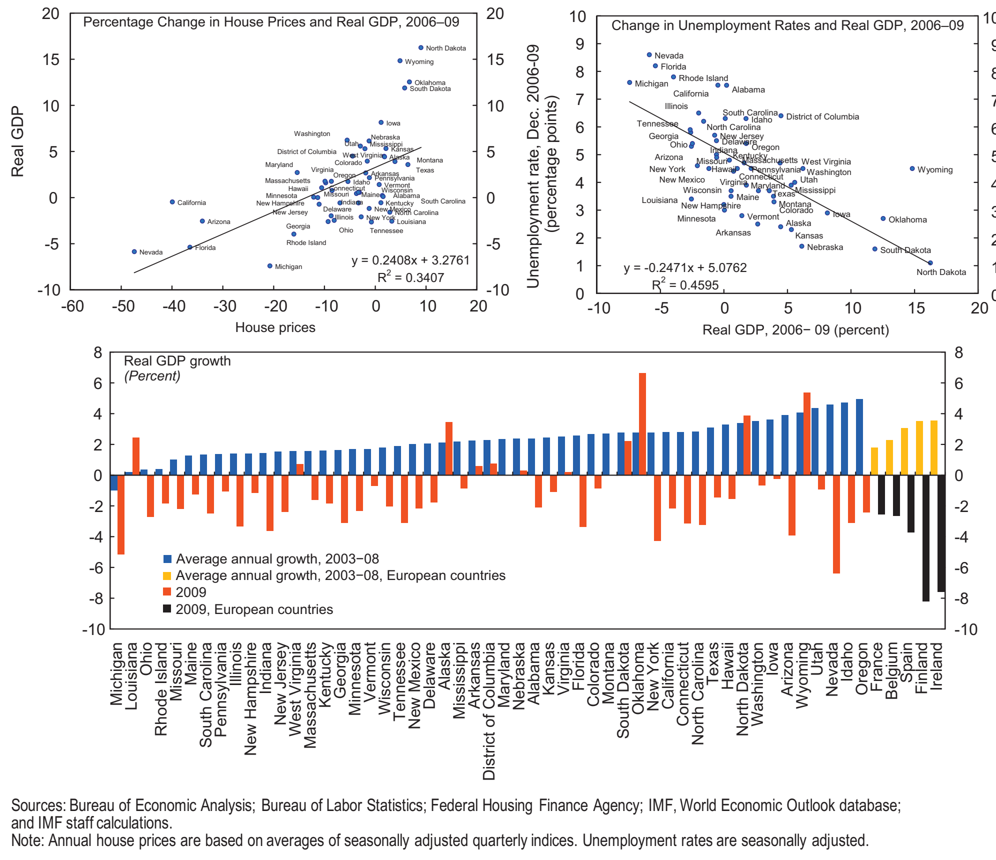
However, unlike in Europe, financial markets in the United States remained fully integrated. Some states experienced sometimes severe fiscal pressures,[2] but there were no concerns that these pressures would affect the financial sector or reduce market access for the private sector, and there was no differentiation in private sector financial market access by state.

Note: The main author of this box is Lone Christiansen.

[1] North Dakota also benefited from an oil industry boom.

[2] In California, the recession's negative effect on revenues together with the strict balanced budget provision led to the issuance of IOUs in lieu of some payments in the summer of 2009. The budget approval process was further complicated by the requirement of a two-thirds super majority of votes to pass the budget bill.

United States and Selected EU Countries: Boom and Bust, 2003–09



Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Housing Finance Agency; IMF, World Economic Outlook database; and IMF staff calculations.
Note: Annual house prices are based on averages of seasonally adjusted quarterly indices. Unemployment rates are seasonally adjusted.

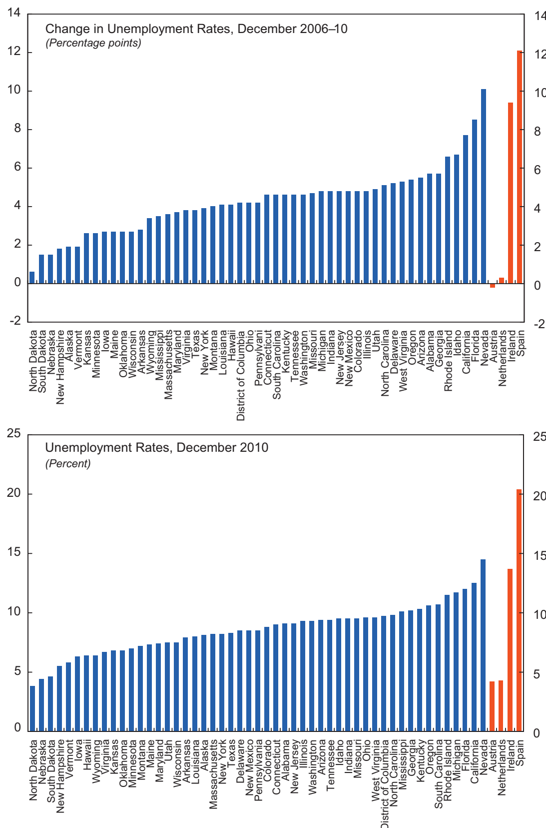
This marked difference between the United States and Europe is likely the result of the different financial sector crisis resolution mechanisms, the better integration of capital markets, and the larger role of the federal government. With much smaller state debts, and with bail-out responsibility assigned to the federal level, concerns about the public finances of individual states do not spill over to the private sector.

- In Europe, individual countries were responsible for rescuing insolvent banks, while in the United States, financial bailouts took place at the federal level.[3] Thus, in Ireland bank support weighed on public finances, while in the United States the bailouts of AIG and investment banks were done at the federal level rather than by the state where the bank was headquartered.
- In the United States, failing banks often are taken over quickly by other banks—including from other states—while in Europe such takeovers of problem banks have been uncommon.

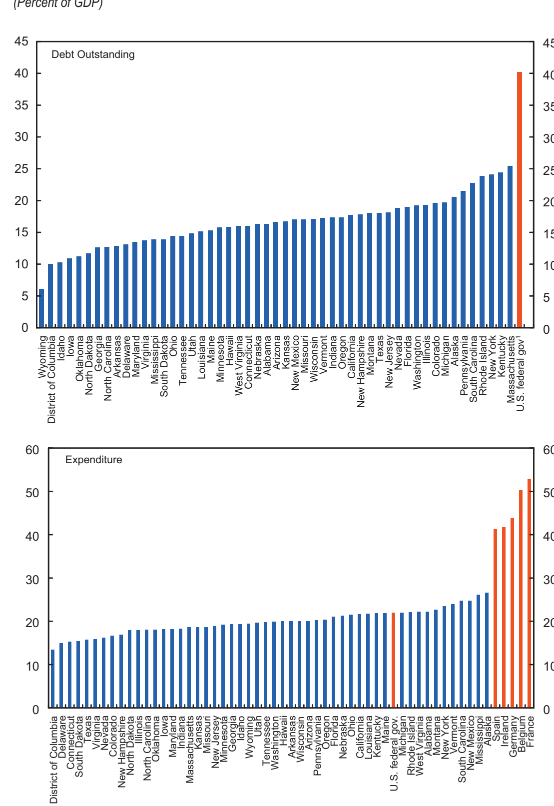
[3] The federal government stepped in to save Bank of America, Wells Fargo, U.S. Bancorp, PNC Financial, and a host of others. In September 2008, the Treasury was given authority to use $700 billion under the Troubled Asset Relief Program to purchase assets, make equity investments and loans, and provide asset guarantees in a range of financial institutions and markets. At the height of the crisis, the Treasury also guaranteed more than $3 trillion in assets to prevent runs on money market mutual funds. The Federal Deposit Insurance Corporation extended the coverage of insured deposits to $250,000, provided an unlimited guarantee of transactions deposits, and guaranteed new bank debt issues. The Federal Reserve provided a range of liquidity support to depository institutions, securities dealers, select foreign central banks, and key markets, and conducted unconventional large-scale asset purchases to support the housing sector and the economy. See IMF (2010c).

Box 3.3 *(concluded)*

- In the United States, state debt is relatively low—in 2008, federal debt held by the public was about 2½ times as large as debt issued by states.[4] Constitutional and statutory provisions in many states limit debt issuance, and most states are governed by balanced budget provisions (last figure, top panel).[5]
- In the United States, the borrowing flexibility and safe haven status of the federal government provides a backstop for the individual states during bad times. A sizable part of the federal stimulus went to states, helping to prevent sharp spending cuts at the state level. More broadly, unlike in Europe, the much larger role of the central fiscal authority in the United States may have a stabilizing effect on individual states. Spending by the federal government is about as large as spending of individual states (last figure, lower panel).



Sources: Bureau of Labor Statistics; Eurostat; and IMF staff calculations.
Note: Unemployment rates are seasonally adjusted.



Sources: Bureau of Economic Analysis; dXdata; IMF, World Economic Outlook database; and IMF staff calculations.
[1] Fiscal year basis. Debt held by the public (IMF, 2010d).

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[4] By 2010, outstanding federal debt had increased to 60 percent of GDP, suggesting that the ratio increased even further. No data on 2010 individual state debt are available yet.

[5] Some of these provisions are implicit rather than explicit: "some balanced budget requirements are based on interpretations of state constitutions and statutes rather than on an explicit statement that the state must have a balanced budget" (National Conference of State Legislatures, 2010).

Box 3.4

How Far Have Current Account Imbalances Adjusted?

To gauge how far rebalancing has come since the onset of the financial crisis, the macroeconomic balance approach is used to compare actual current account balances with "equilibrium" current accounts, which are determined as a function of fundamental factors.[1] This notion of "equilibrium" measures levels of the current account that are consistent with underlying macroeconomic conditions and does not explicitly address the sustainability of current account positions.

A simple empirical model was used, based on the Consultative Group on Exchange Rate Issues methodology.[2] In this model, current accounts as ratios to GDP are determined as a function of the initial net foreign asset position, the fiscal balance, the per capita growth rate, the level of per capita GDP, the oil trade balance, and key demographic features (see Annex for technical details). This approach confirms that current accounts moved away from their equilibrium values in the period immediately before the global crisis (first figure, first and second panels).

During 2001–04, most actual current account balances were not significantly different from their estimated equilibrium values. Reflecting comparatively older populations (and, in some cases, natural resources and importance as financial centers) a number of countries, including Austria, Belgium, Denmark, Germany, and the Netherlands were in surplus, whereas countries in the southern periphery of the euro area (Greece, Portugal, and Spain) were showing a modest deficit, and new EU member states (notably the Baltics, Hungary, Romania, and the Slovak Republic), characterized by much lower GDP levels, displayed somewhat larger deficits. This juxtaposition is consistent with convergence theory, according to which capital should flow downhill to equilibrate its relative return (Abiad, Leigh, and Mody, 2007).

Subsequently, during 2005–08, current accounts moved away from their estimated equilibrium values in a significant number of cases. Deficits in the periphery of the euro area and new member states became larger than could be explained by equilibrium models. In the periphery of the euro area, the gaps between the deficits and their estimated equilibrium intervals ranged from about 1 percent of GDP in Portugal to nearly 5 percent of GDP in Spain. Among the new member states, the gaps ranged from about 1 percent of GDP in Estonia and Lithuania to more than 9 percent of GDP in Bulgaria. Overoptimistic expectations of rapid income convergence together with underestimations of risk and policies that supported the allocation of resources to the nontradable sector, underpinned these developments (see main text). Conversely, in a few countries (notably Germany) surpluses began to exceed equilibrium values. While these diverging current account developments were not mirror images inside the euro area or the EU, they were financed largely by intra-euro area or intra-EU capital flows (Chen, Milesi-Ferretti, and Tressel, forthcoming).

Current accounts began moving back toward equilibrium as a consequence of the global crisis. The return of risk aversion and risk differentiation sharply curbed cross-border capital flows. The resulting contraction in private and public domestic demand led to an acute reduction of current account deficits. Current account balances in surplus countries also narrowed as exports declined and domestic demand held up better than in the deficit countries.

Note: The main author of this box is Irina Tytell.

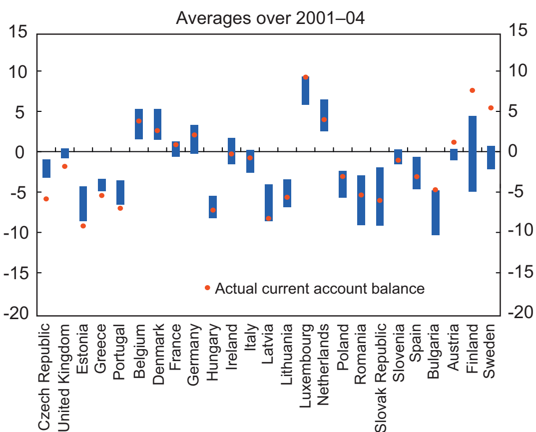
[1] Two other approaches to determining sustainable current account balances exist. One is a reverse "early warning" type exercise that links the probability of a crisis to the degree of imbalance and derives "safe levels" of current account imbalances. This approach is based on historical observations of the association of imbalances with subsequent crises. Another approach is based on evaluating the current account balance that stabilizes the net foreign asset position of the country in question (see Lee and others, 2008).

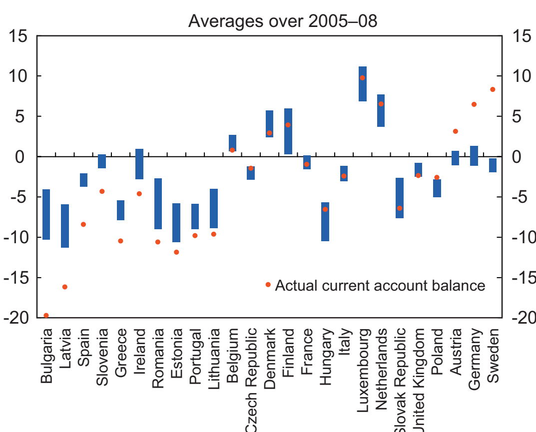
[2] See Lee and others (2008); and also Jaumotte and Sodsriwiboon (2010); Barnes, Lawson, and Radziwill (2010); and Decressin and Stavrev (2009).

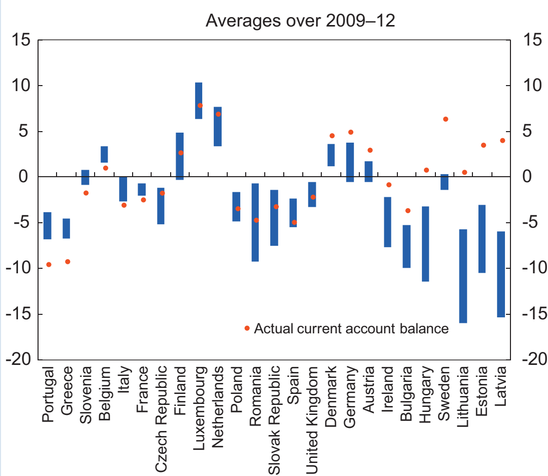
Box 3.4 *(continued)*

Estimated Ranges for Current Account Norms and Actual Current Accounts

(Percent of GDP)



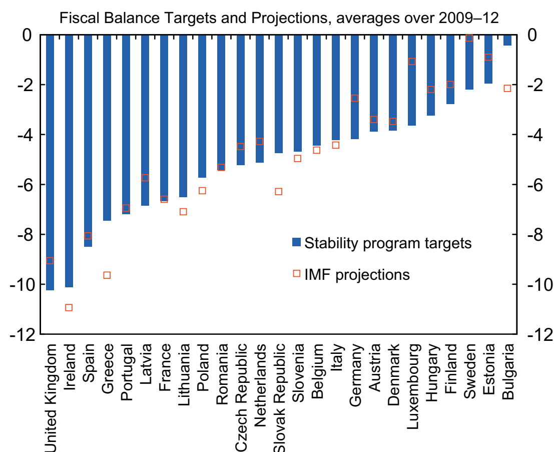


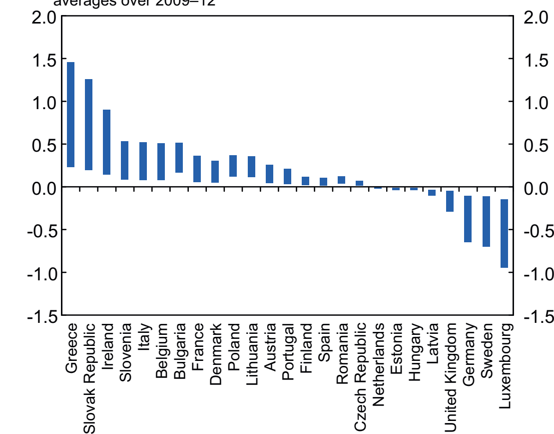


Sources: IMF, World Economic Outlook database; and IMFstaff calculation.

Fiscal Adjustment and Current Account Balances

(Percent of GDP)





Sources: IMF, World Economic Outlook database; and IMF staff calculation.

Looking ahead using IMF *World Economic Outlook* projections of current accounts for 2009–12, with a few notable exceptions (Greece and Portugal), deficits are set to decline to levels compatible with equilibrium values for the current account (first figure, third panel).[3] In Greece, policies are in place to further improve the external accounts under the

[3] Note that for the purpose of computing the equilibrium values for this period it was assumed that countries follow sustainable fiscal policies. For the EU this means adherence to targets of the Stability and Growth Program updates. In addition, to abstract from the potential influence of output gaps on the estimates of the equilibrium current accounts, the European Commission's projections for potential growth were used rather than those for actual growth.

EU- and IMF-supported adjustment programs. For some countries, including Belgium, France, Italy, and Spain, a modest further improvement in the external accounts would be desirable. Strikingly, a number of countries in eastern Europe are set to run current account balances well above what would be consistent with fundamentals. The gaps between the deficits and their estimated equilibrium intervals are projected to range between about 2 percent of GDP in Bulgaria to 10 percent of GDP in Latvia. This possibly reflects a combination of private sector balance sheet repair currently under way, and still-heightened risk aversion toward the region, both of which may temporarily depress domestic demand. A subsequent recovery of domestic demand would likely bring current account balances back in line with equilibrium values. Similarly, a number of surplus countries are set to continue to run surpluses that exceed values justified by fundamentals.

The ongoing fiscal adjustment could have sizable effects on current account balances in a number of countries. Fiscal deficits rose sharply in the aftermath of the global financial crisis and are currently being brought down to preserve sustainability of the public finances across the EU. In some countries (for example, Greece), projected fiscal deficits remain higher than targets stipulated in their most recent Stability and Convergence Programs (SCPs), while in other countries (for example, Germany) the situation is now reversed (second figure, first panel). A simulation based on the model mentioned above shows that additional adjustment to align projected fiscal balances to current SCP targets could be enough to bring Italy's, France's, and Belgium's current account deficits within the normal range (second figure, second panel). In Greece, continued fiscal consolidation would further reduce, although not eliminate, remaining imbalances. At the same time, additional consolidation could further increase the current account balance in Ireland.

by robust institutional arrangements and backstops at the EU or euro area level. Finally, financial integration will remain imperfect for some time, so fiscal and structural policies will also need to be implemented to facilitate adjustment to shocks under a common monetary policy.

Restoring Growth and Preventing Future Excessive Imbalances

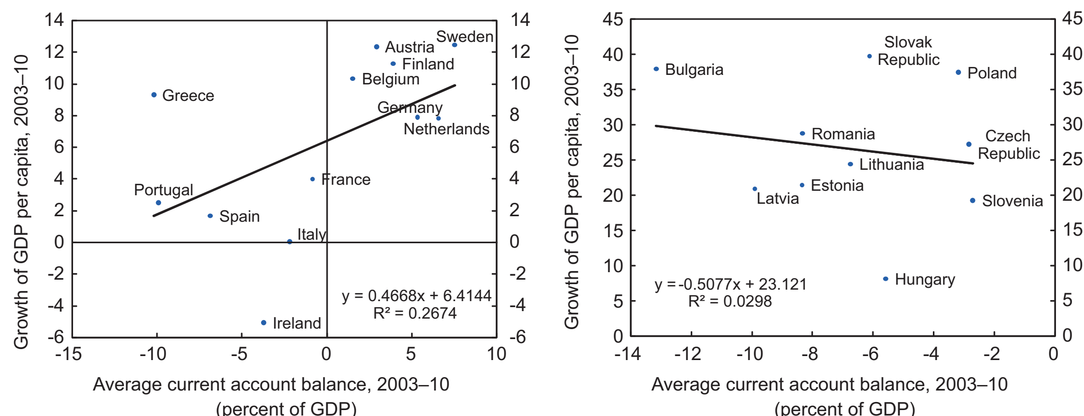
The crisis led to a sharp adjustment of earlier current account imbalances, and current account balances in many countries are now close to "equilibrium" (Box 3.4). Current account deficits in Spain and Ireland declined significantly by 2010, while current account deficits in the Baltics and Bulgaria disappeared or turned into surpluses. Looking ahead, deficits are set to be reduced to levels compatible with equilibrium values of the current account, with a few notable exceptions (Greece and Portugal). In Greece, policies are in place to further improve the external accounts under the EU/IMF-supported adjustment programs.

To overcome the crisis decisively, adjusting imbalances is not enough: the most critical factor in the longer term is restoring GDP growth in the crisis-affected countries to secure lasting prosperity. Strong GDP growth would also make it easier to put public finances on a sustainable footing and improve the health of banking systems.

A sustainable recovery in crisis-affected countries will require a growth pattern different from that of the precrisis years, with a stronger role for the tradable sector and exports, and a less prominent role for the nontradable sector, capital flows, and domestic demand. The previous growth pattern, which relied on large capital inflows, led to pronounced boom-bust cycles. These cycles increased growth volatility but had no appreciable effect on average growth while leaving a legacy of high external indebtedness

Figure 3.29

Selected EU Countries: Capital Inflows and GDP per Capita Growth, 2003–10

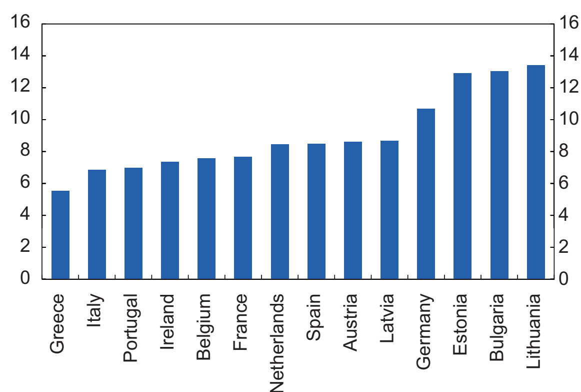


Sources: The Conference Board Total Economy database, January 2011; IMF, World Economic Outlook database; and IMF staff calculations.

Figure 3.30

Selected EU Countries: Growth of Real Exports of Goods and Services, Average 2010–11

(Percent)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

and impaired competitiveness (Figure 3.29). Surplus countries could focus on removing obstacles to the expansion of their nontradable sectors.

After a difficult 2009, such a shift seems to be taking hold in the Baltic countries and Bulgaria. Exports grew rapidly in 2010 and so far in 2011, and competitiveness indicators improved markedly, although the reallocation of resources to the tradable sector is by no means complete (Figures 3.30 and 3.31).[15] In the euro area periphery, Ireland's competitiveness has improved considerably, while Spain has experienced a strong increase in exports. In Greece and Portugal, export growth is still weak, even though Greece has seen an improvement in competitiveness.

Ultimately, growth and convergence will depend on productivity increases. On this front, some countries have performed poorly over the past decade, despite ample access to foreign capital. In Portugal, for example, labor productivity grew by much less than its starting position pointed it toward. Apparently it failed to put the large capital inflows it enjoyed to their best productive uses (Figure 3.32).

Better Policies Are Needed at the National Level

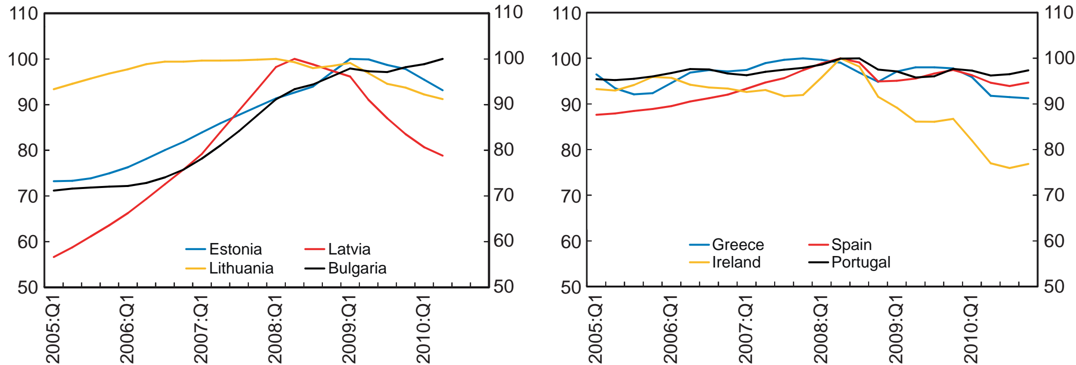
Sustainable convergence in the EU will require better policies at the national level—policies that promote increases in efficiency and productivity and that prevent boom-bust cycles. To a considerable extent, the current crisis arose from a failure to use national policies to manage local conditions. Therefore, policymakers need to rely

[15] See also Chapter 2.

Figure 3.31

REER (ULC Manufacturing Based)

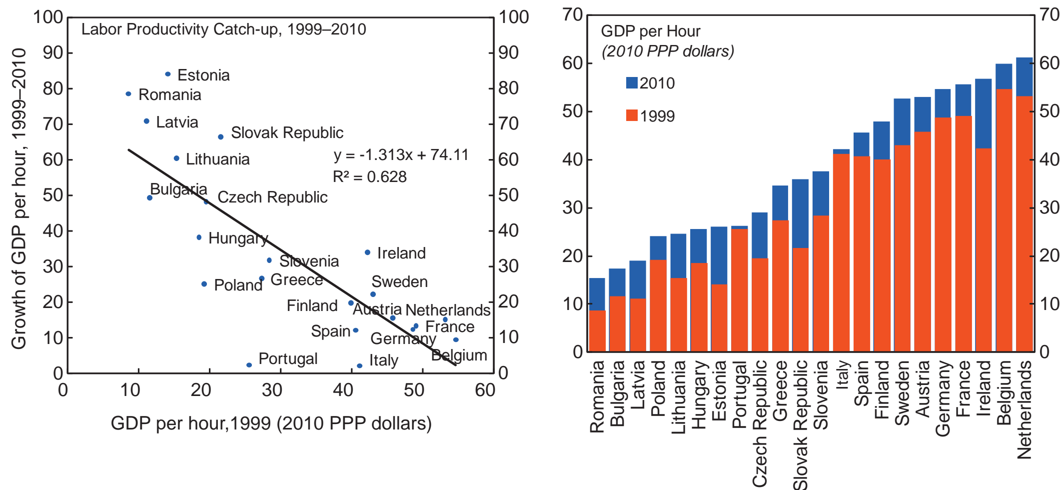
(Peak = 100)



Sources: European Commission, Price and Cost Competitiveness Indicators; IMF, Information Notice System; and IMF staff calculations.

Figure 3.32

Selected EU Countries: Labor Productivity



Sources: The Conference Board Total Economy Database, January 2011; and IMF staff calculations.

more strongly on national fiscal policy, structural reform, and macroprudential tools to manage national developments in demand, credit, prices, and wages relative to developments in the EU as a whole (Box 3.5).

Better Governance at the EU Level Would Help Enforce Strong Policies

Reinforced surveillance of imbalances at the EU level would encourage appropriate and timely national responses and help shield the region from asymmetric developments. Previous work by European Commission staff in the context of the Stability and Growth Pact (SGP), the Lisbon Strategy, and the review of competitiveness developments pointed in the right direction. However, related political discussions (within the Eurogroup, the Economic and Financial Affairs Council, or the European Council) were neither systematic nor binding.

The proposed new surveillance framework for imbalances—the Excessive Imbalances Procedure (EIP)—aims at filling this gap and provides a

Box 3.5

How Can the Reemergence of Excessive Imbalances Be Prevented?

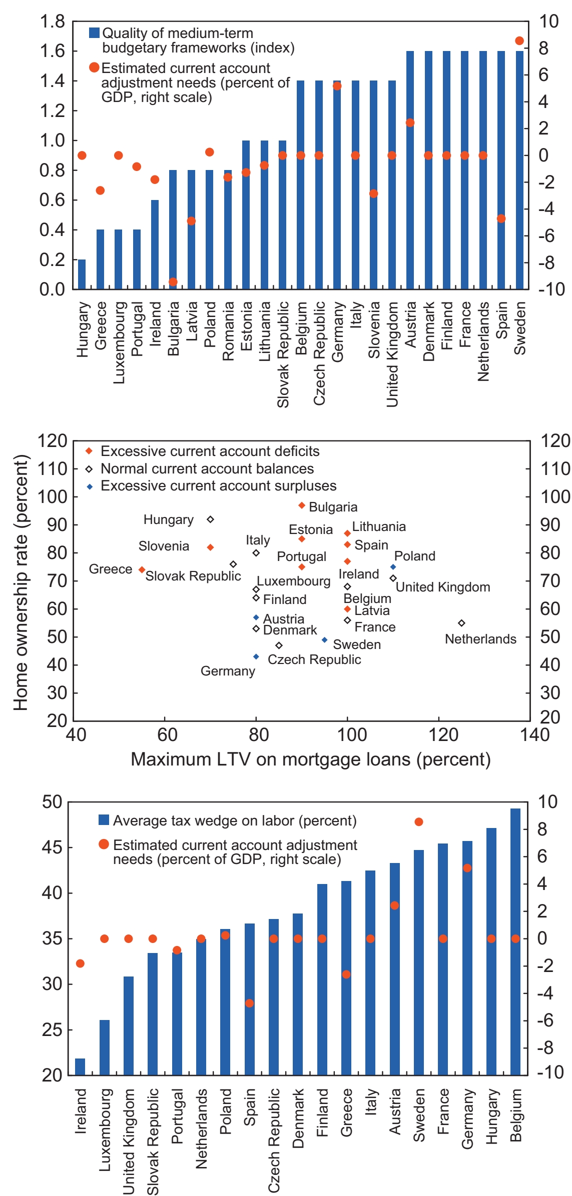
Policies can help prevent a recurrence of imbalances. They could do so, for example, by improving fiscal institutions, helping to channel capital flows to productive uses, and promoting strong private sector balance sheets. In addition, structural reforms could improve domestic price and wage adjustment and stimulate healthy private saving and investment behavior.

Identifying effective policy measures for reducing or preventing excessive current account imbalances is not an easy task. First, many policies may have multiple effects that yield ambiguous overall implications for imbalances, thus requiring a case-by-case analysis to determine their suitability. Second, many policies are difficult to quantify, so that existing indicators often suffer from measurement errors and small-sample biases. For these reasons, the recommendations below are merely suggestive. Actual policies need to be carefully tailored to specific circumstances in every country, and the estimated effects on imbalances should be treated with caution.[1]

Fiscal

Although fiscal adjustment can help reduce excessive imbalances in the near term, over the longer term the quality of budgetary institutions underpins fiscal discipline. Sound public finances, in turn, can help to avoid excessive current account imbalances. The quality of fiscal institutions in a number of EU countries that developed excessive deficits ahead of the global financial crisis— the Baltics, Bulgaria, Greece, Ireland, Portugal, and Romania—ranks relatively low (figure, first panel).[2] Raising the quality of their fiscal institutions to the average level in the EU could have reduced excessive deficits in 2005–08 by about 1 percent of GDP in Greece, Ireland, and Portugal, and by up to ½ percent of GDP in the Baltics, Bulgaria, and Romania.

Imbalances and Policies, 2005–08



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: The main author of this box is Irina Tytell.

[1] The effects of policies are estimated using regressions of estimated current account adjustment needs on policy variables. See Annex for more detail.

[2] The quality of fiscal institutions is measured using an index produced by the European Commission (http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/framework/index_en.htm).

Financial

In the wake of the global financial crisis, effective financial and macroprudential regulation was identified as a key tool for preventing credit and housing bubbles that could cause unsustainable consumption and investment booms. Distortions in mortgage markets are especially damaging in countries where home ownership rates are high. Countries with high loan-to-value ratios (LTVs) on mortgage loans and high home ownership rates include Bulgaria, Estonia, Ireland, Lithuania, and Spain, all of which ran excessive current account deficits ahead of the global financial crisis (figure, second panel).[2] This suggests that measures to keep LTVs in such countries at more reasonable levels could help prevent excessive deficits in the future. Bringing the combination of maximum LTVs on mortgage loans and home ownership rates to the EU average could have reduced excessive deficits in 2005–08 by 1–1½ percent of GDP in Bulgaria, Estonia, Ireland, Lithuania, and Spain.

Structural

Although the link between structural policies in labor and product markets and growth is well established, the evidence on the role of these policies in relation to current account imbalances remains relatively limited (see, for example, Berger and Nitsch, 2010; and Kerdrain, Koske, and Wanner, 2010). The lack of evidence may reflect potentially opposing effects of these policies on imbalances and resulting ambiguities in their overall effects, which make some of the recommendations in this area particularly tenuous.[4]

A high tax wedge on labor raises costs and lowers corporate profitability, thereby reducing investment and pushing the current account balance toward surplus. It could also increase unemployment, raising the need for precautionary saving on the part of households, which would also push the current account into surplus. Reducing the average tax wedge could help lessen excessive surpluses in Austria, Germany, and Sweden (figure, third panel). Bringing it to the EU average could have reduced excessive surpluses in 2005–08 by about ½ percent of GDP in these countries.

The link between the strictness of employment protection legislation (EPL) and the extent of product market regulation (PMR) to current account imbalances is less clear. Although stricter EPL gives workers more job security, it also leads to longer unemployment spells and reduces productivity, with ambiguous overall effects on precautionary saving and the current account. Similarly, more extensive PMR tends to lower productivity, hurting the working population that has a high propensity to save, but it also tends to raise costs and lower corporate profitability, thereby reducing investment, so that the overall effect on the current account is unclear. On the whole, there is no strong evidence suggesting that reducing EPL or PMR would lessen or prevent excessive imbalances in the EU.[5]

In addition, certain labor market practices not directly considered here—for example, collective bargaining systems that lead to excessive wage demands—have likely contributed to the widening of the imbalances. Structural policies that improve wage flexibility could facilitate current account adjustment and help to prevent a resurgence of imbalances in the future. Similarly, further liberalization in nontradable sectors would help in surplus countries by stimulating domestic demand and in deficit countries by moderating prices and improving competitiveness in tradable sectors.

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[3] Maximum LTVs refer to the highest observed LTVs in the mid- to late 2000s. Home ownership rates reflect census data from the early to mid-2000s. See Crowe and others (2011; forthcoming); and IMF (2011).

[4] Indicators of structural policies in labor and product markets come from the Organization for Economic Cooperation and Development (OECD) and Kerdrain, Koske, and Wanner (2010).

[5] In the literature, the evidence on the effects of EPL and PMR on current accounts is mixed. For example, Kerdrain, Koske, and Wanner (2010) do not find any significant effects of EPL on saving rates, a somewhat surprising positive effect on investment rates (possibly reflecting increased substitution of capital for labor), and a negative effect on current accounts in OECD countries; they find no lasting effects of PMR on investment rates and no significant effects on current accounts. In contrast, Berger and Nitsch (2010) find that European countries with higher EPL and PMR exhibit systematically lower trade surpluses or higher trade deficits than do their peers with more flexible labor and product markets.

strong platform for discussing imbalances at the EU level and for handling them at the national level. The EIP will mimic the SGP in that it will have both a preventive and a corrective arm. To be most effective, the procedure should be designed such that it avoids deadlocks in all intermediate steps between diagnostics and sanctions and ensures prompt action to address severe vulnerabilities. The mechanism would encompass all EU27 countries, but more demanding enforcement rules should apply to euro area member states.

Several elements of the proposed EIP could be strengthened to make the process more effective:

- The surveillance process should be kept to the shortest possible time frame. The current proposal to align, under the European semester,[16] the *preventive* arm of the EIP with the surveillance conducted under the SGP, Europe 2020, and the European Systemic Risk Board is a welcome step and should facilitate the identification of relevant linkages between imbalances, fiscal policy, growth-enhancing reforms, and macrofinancial stability. However, weeks rather than months should suffice to identify countries with potential problems, if, as foreseen, the initial screening is based on a mechanistic application of a heat map complemented, as appropriate, with past assessments of individual countries. By nature, the *corrective* arm will be decoupled from the European semester, but the elapsed time from diagnosis to reform implementation should not be more than a year.
- The initiation of the preventive arm should be as automatic as possible. The subsequent in-depth analysis should involve a larger element of judgment.
- The scoreboard should err on the side of caution and leave little margin for countries to escape in-depth analysis, especially because the intent of the alert system is to identify potential imbalances in a timely manner. Ideally, the number of indicators should be small, but broad in scope, and should be based on definitions or accounting relationships to remain immune from influence peddling. A balance between stock and flow indicators would be useful.
- Policy adjustment recommendations should best be subject to reverse majority rules—under which recommendations are adopted unless a majority opposes—as in the proposals for a modified SGP.
- Finally, these policy actions need to be fully integrated with fiscal policy recommendations under the SGP, and with risk warnings and recommendations of the ESRB.

Conclusions

In the run-up to the crisis, countries in the euro area periphery, and countries in emerging Europe with fixed exchange rates, built up large current account imbalances. Although the causes of the imbalances varied across countries, the pattern was similar: strong capital flows into the nontradable sector drove up nontradable prices and wages and eroded competitiveness. Because capital flows boosted demand rather than supply, and imports rather than exports, they contributed to large and ultimately unsustainable changes in net external asset positions.

Financial integration played a critical role in permitting the financing of imbalances, but lack of institutions and a "national" approach to crisis resolution prevented the private sector and markets from playing a larger role. With banking problems addressed at the national level, banking and sovereign problems in euro area periphery countries exacerbated each other; and as financing

[16] The European semester is a six-month period every year during which the member states' budgetary and structural policies will be reviewed to detect any inconsistencies and emerging imbalances. The aim is to reinforce coordination while major budgetary decisions are still under preparation. See http://www.consilium.europa.eu/showFocus.aspx?lang=EN&focusID=504.

costs in the private sector increasingly came to depend on the national origin of the borrower, financial integration reversed.

To overcome the crisis, the crucial factor in the longer run is restoring GDP growth in the crisis-affected countries. Ultimately, growth and convergence will need to be backed by productivity increases, which some countries have struggled with over the past decade, despite ample access to foreign capital. To foster efficiency increases, better national-level policies are needed, while better governance at the EU level would help enforce such policies. Finally, greater vigilance is needed, both nationally and across borders, and better institutions to deal with financial sector problems, and more, rather than less, financial and economic integration.

Annex: Data and Econometric Approaches

Estimating Equilibrium and Excessive Imbalances

To separate excessive imbalances from equilibrium imbalances and thereby understand how much rebalancing is needed, a simple empirical model was used, based on the Consultative Group on Exchange Rate Issues methodology (see Lee and others, 2008; Decressin and Stavrev, 2009; Barnes, Lawson, and Radziwill, 2010; and Jaumotte and Sodsriwiboon, 2010). Specifically, current account balances as ratios to GDP were regressed on their fundamental determinants using an unbalanced panel of observations (averaged over nonoverlapping four-year periods from 1973 to 2008). The data sources are as cited in Lee and others (2008). The table summarizes the results for the sample consisting of countries of the European Union. The fundamental determinants have expected signs and explain about half of the variation in current account balances.

Dependent variable:	Current account balance to GDP
Net foreign assets to GDP (lagged)	0.003 [0.21]
Fiscal balance to GDP (relative to trade partners)	0.221 [3.61]***
Growth of real GDP per capita (relative to trade partners)	-0.163 [0.94]
Level of purchasing power parity GDP per capita (relative to the US)	0.065 [3.86]***
Population growth (relative to trade partners)	-0.929 [1.34]
Current old age dependency ratio (relative to trade partners)	-0.305 [3.11]***
Future old age dependency ratio (relative to trade partners)	0.251 [3.09]***
Oil trade balance to GDP	0.625 [5.10]***
Dummy for financial centers	0.032 [3.71]***
Constant	-0.041 [3.48]***
Observations	176
Adjusted R-squared	0.54

Robust *t*-statistics in brackets.
* significant at 10%; ** significant at 5%; *** significant at 1%

This model was used to estimate equilibrium current account balances, or norms, based on the values of the fundamentals in the past and on their projections for the future. Demographic projections were taken from the United Nations and macroeconomic projections came from the IMF's World Economic Outlook, with two exceptions: (i) in place of actual fiscal balances, targets from the latest Stability and Convergence Programs (SCPs) were used and (ii) the European Commission's projections for potential growth were used instead of those for actual growth. Given some variation in the estimates depending on sample composition, the model was run on eight different samples: the European Union, advanced economies, emerging economies, and the full set of 64 countries, over the full period from 1973 to 2008 and over the recent period from 2001 to 2008. Equilibrium current account balances for each country were then measured using the ranges of predicted values from the model estimated on the various samples. Finally, excessive current account balances, or adjustment needs, for each country were computed as differences between the actual balance and the nearest end of the equilibrium balance range. Adjustment needs were evaluated as zero if the actual balance fell within the equilibrium balance range.

Estimating Effects of Policies on Excessive Imbalances

To assess the role of policies, two somewhat different exercises were conducted. First, potential effects of aligning projected fiscal balances with SCP targets over 2009–12 were simulated by applying the estimated model to the gaps between projected and targeted fiscal balances. Second, the estimated excessive current account balances across the EU over 1997–2008 were regressed on a set of

Dependent Variable: Current Account Adjustment Needs (relative to GDP)			
Index of the quality of medium-term budgetary frameworks	0.016 [1.86]*		
Product of maximum LTVs on mortgage loans and home ownership rates		-0.061 [2.21]**	
Average tax wedge (averaged over two family and three earning situations)			0.001 [2.37]**
Index of employment protection legislation			-0.003 [1.10]
Index of product market regulation			-0.003 [0.61]
Constant	-0.019 [2.32]**	0.036 [1.89]*	-0.025 [2.21]**
Observations	50	48	54
R-squared	0.1	0.1	0.1

Robust *t*-statistics in brackets.
* significant at 10%; ** significant at 5%; *** significant at 1%

selected indicators of fiscal, financial, and structural policies. The data came from the European Commission; the OECD; Kerdrain, Koske, and Wanner (2010); Crowe and others (2011, forthcoming); and IMF (2011). Given the limited availability of the policy indicators, the regressions were run on small samples and the results need to be interpreted with caution. To avoid further reducing sample sizes, separate regressions were run for each policy area. The table summarizes the results.

Appendix. Europe: IMF-Supported Arrangements[1]

(As of April 12, 2011)

Country	IMF Loan Size, Approval Date	Key Objectives and Policy Actions	Additional Information
Ukraine	$16.4 billion Stand-by Arrangement, November 2008	• Help the economy adjust to the new economic environment by allowing the exchange rate to float, aim to achieve a balanced budget in 2009, phase in energy tariff increases, and pursue an income policy that protects the population while slowing price increases. • Restore confidence and financial stability (recapitalizing viable banks and dealing promptly with banks with difficulties). • Protect vulnerable groups in society (an increase in targeted social spending to shield vulnerable groups).	November 2008 stand-by arrangement (SBA) was canceled and replaced by a new SBA with the new government in July 2010. Under the November 2008 SBA, $10.5 billion was disbursed. The first review of the new SBA arrangement was completed in December 2010. The February 2011 mission as part of the second review found that the economy performed better than expected in 2010. (www.imf.org/external/country/UKR/index.htm)
	$15.2 billion Stand-by Arrangement, July 2010	• Restore confidence and fiscal sustainability by reducing the general government deficit to 2.5 percent of GDP by 2012 and setting public debt firmly on a downward path below 35 percent by 2015. • Initiate reforms to modernize the gas sector and phase out Naftogaz's deficit, including through gas tariff increases and a price mechanism that depoliticizes price setting of public utilities. • Restore and safeguard banks' soundness through completion of recapitalization plans by end-2010 and strengthened supervision. • Develop a more robust monetary policy framework focused on domestic price stability with greater exchange rate flexibility under a more independent National Bank of Ukraine.	
Iceland	$2.1 billion Stand-by Arrangement, November 2008	• Contain the negative impact of the crisis by restoring confidence and stabilizing the exchange rate. • Promote a viable domestic banking sector and safeguard international financial relations by developing a comprehensive and collaborative strategy for bank restructuring. • Ensure medium-term fiscal sustainability by limiting the socialization of losses in the collapsed banks and implementing a multi-year fiscal consolidation program.	The fourth review was completed in January 2011. The February 2011 mission as part of the fifth review stated that the economy is recovering in 2011 and financial sector restructuring is moving forward. IMF staff is currently assessing the appropriate pace and timing for lifting capital controls. (www.imf.org/external/country/ISL/index.htm)
Latvia	$2.4 billion (€1.7 billion) Stand-by Arrangement, December 2008	• Take immediate measures to stem the loss of bank deposits and international reserves. • Take steps to restore confidence in the banking system in the medium term and to support private debt restructuring. • Adopt fiscal measures to limit the substantial widening in the budget deficit and prepare for early fulfillment of the Maastricht criteria in view of euro adoption. • Implement income policies and structural reforms that will rebuild competitiveness under the fixed exchange rate regime.	In addition to financial assistance from the IMF, the program is heavily supported by the EU and a number of European countries. On completion of the second review in February 2010, the arrangement was extended to December 22, 2011. The third review of the program was completed in July 2010. (www.imf.org/external/country/LVA/index.htm)
Serbia	$0.5 billion Stand-by Arrangement, January 2009; augmented to $4.0 billion in May 2009	• Tighten the fiscal stance in 2009–10: limit the 2009 general government deficit to 1¾ percent of GDP and adopt further fiscal consolidation in 2010. The tightening involves strict income policies for containing public sector wage and pension growth and a streamlining of non-priority recurrent spending, which helps create fiscal space to expand infrastructure investment. • Strengthen the inflation-targeting framework while maintaining a managed floating exchange rate regime.	Since the original program was designed in late 2008, Serbia's external and financial environment deteriorated substantially. In response, the authorities (1) raised fiscal deficit targets for 2009–10 while taking additional fiscal measures, (2) received commitments from main foreign parent banks that they would roll over their commitments to Serbia and keep their subsidiaries capitalized, and (3) requested additional financial support from international

[1]The main author of this appendix is Phakawa Jeasakul.

Appendix *(continued)*

Country	IMF Loan Size, Approval Date	Key Objectives and Policy Actions	Additional Information
Serbia			financial institutions and the EU. On completion of the first review in May 2009, the arrangement was extended, and the total financing was augmented. The seventh and final review was completed in April 2011. (www.imf.org/external/country/SRB/index.htm)
Romania	$17.1 billion (€12.9 billion) Stand-by Arrangement, May 2009	Cushion the effects of the sharp drop in private capital inflows while implementing policy measures to address the external and fiscal imbalances and to strengthen the financial sector: • Strengthen fiscal policy to reduce the government's financing needs and improve long-term fiscal sustainability. • Maintain adequate capitalization of banks and liquidity in domestic financial markets. • Bring inflation within the central bank's target.	A sizeable financial support is also received from the EU. The seventh and final review was completed in March 2011. The authorities treated the associated tranche as precautionary. With economic activity now stabilizing and the program having successfully ensured macroeconomic and financial stability under very difficult circumstances, the expiring SBA was replaced by a new 24-month precautionary SBA in the amount of $4.9 billion. The EU is also providing funds on a precautionary basis under the new program. (www.imf.org/external/country/ROU/index.htm)
	$4.9 billion (€3.5 billion) Stand-by Arrangement, March 2011	• Designed as a precautionary arrangement. • Focus on promoting growth and employment and maintaining financial and macroeconomic stability.	
Poland	$20.6 billion Flexible Credit Line, May 2009	The Flexible Credit Line (FCL) is an instrument established for IMF member countries with very strong fundamentals, policies, and track records of implementation. Access to the FCL is not conditional on further performance criteria.	The arrangement for Poland, which has been kept precautionary, has helped stabilize financial conditions there, leaving room for accommodative macroeconomic policies and improving access to market financing. (www.imf.org/external/country/POL/index.htm)
	$20.4 billion Flexible Credit Line, July 2010	July 2010 FCL serves as a successor arrangement to May 2009 FCL.	
	$30 billion Flexible Credit Line, January 2011	July 2010 FCL was cancelled and replaced by a new 2-year FCL arrangement approved in January 2011.	
Bosnia and Herzegov-ina	$1.6 billion Stand-by Arrangement, July 2009	Safeguarding the currency board arrangement by a determined implementation of fiscal, income, and financial sector policies: • Reduce the structural fiscal balance and bring public finances on a sustainable medium-term path. • Reestablish public wage restraint. • Support adequate liquidity and capitalization of banks.	The second and third reviews were completed in October 2010. The November 2010 mission as part of the fourth review stated that the program is broadly on track, with all performance criteria and structural benchmarks being observed. Discussions will continue after the formation of a new government to complete this review. (www.imf.org/external/country/BIH/index.htm)
Moldova	$0.6 billion Extended Credit Facility and Extended Fund Facility, January 2010	• Reverse the structural fiscal deterioration that occurred in 2008–09 while safeguarding funds for public investment and priority social spending. • Keep inflation under control while rebuilding foreign reserves to cushion the economy from external shocks. • Ensure financial stability by enabling early detection of problems and strengthening the framework for bank rehabilitation and resolution. • Raise the economy's potential through structural reforms. • To promote poverty reduction, the program sets a floor on priority social spending. Moreover, social assistance spending will be increased by 36 percent in 2010 relative to 2009 to support vulnerable households.	The second review was completed in April 2011. (www.imf.org/external/country/MDA/index.htm)

Country	IMF Loan Size, Approval Date	Key Objectives and Policy Actions	Additional Information
Kosovo	$140 million Stand-by Arrangement, July 2010	Achieving fiscal stabilization, while accommodating large infrastructure investments, and safeguarding financial sector stability: • Limit the overall budget deficits in 2010 to 3.4 percent of GDP by raising select excise taxes and by restraining current primary spending. • Bolster the government's bank balances held with the Central Bank of Kosovo (CBK) to provide scope for emergency liquidity assistance (ELA), and provide the CBK with a mandate for ELA, and further strengthen the banking system. • Improve the financial position of the energy sector to limit its costs to the budget.	Kosovo became the 186th member of the IMF on June 29, 2009. The March 2011 mission as part of the first review found that the economic recovery is on track amid robust growth and private sector credit. However, the review could not be concluded due to disagreement on the draft budget for 2011. (www.imf.org/external/country/UVK/index.htm)
Greece	$39 billion (€30 billion) Stand-by Arrangement, May 2010	• Restoring confidence and fiscal sustainability: substantial front-loaded fiscal effort to bolster confidence, regain market access, and put the debt-to-GDP ratio on a declining path from 2013. • Restoring competitiveness: the nominal wage and benefit cuts and structural reforms to reduce costs and improve price competitiveness. Improved transparency and a reduced role of the state in the economy. • Safeguarding financial sector stability: Establishment of a Financial Stability Fund (FSF) to deal with possible solvency pressures. Extension of government banking liquidity support facilities and ECB's non-standard monetary policy measures.	IMF financial assistance of €30 billion is in parallel with bilateral financial support of €80 billion available from euro area partners. The total amount of €110 billion will cover the expected public financing gap during the program's period. The third review was completed in March 2011. (www.imf.org/external/country/GRC/index.htm)
Ireland	$30.1 billion (€22.5 billion) Extended Fund Facility, December 2010	Targeting vulnerabilities in the banking system and aiming to restore the prospect of growth: • Support banks to maintain higher capital adequacy standards. • Consolidate the fiscal balance in a fair manner. • Address remaining impediments that undermine competitiveness.	IMF financial assistance of €22.5 billion forms part of the substantial financial package amounting to €85 billion, of which the remaining funds comprise of supports from European partners and Ireland's own contributions. The first and second review will be combined and held after the new government has taken office. (www.imf.org/external/country/IRL/index.htm)
Macedonia	$640 million Precautionary Credit Line, January 2011	The Precautionary Credit Line (PCL) is a new IMF instrument established in the context of enhancing its lending tools to help provide effective crisis prevention. This is the first IMF's commitment under PCL. The access to the credit line in the first year is up to $533 million.	In March 2011, changed circumstances brought by the early elections, including a delay in the planned Eurobond issuance, led the authorities to draw $300 million under the PCL arrangement. The PCL arrangement includes indicative targets on the fiscal deficit and on net international reserves. The first review is scheduled in July 2011. (www.imf.org/external/country/MKD/index.htm)

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Europe, May 2011