

Regional Economic Outlook – Strengthening the Recovery

# Europe – Outlook and Policy Priorities

May 2011



Chapter 1

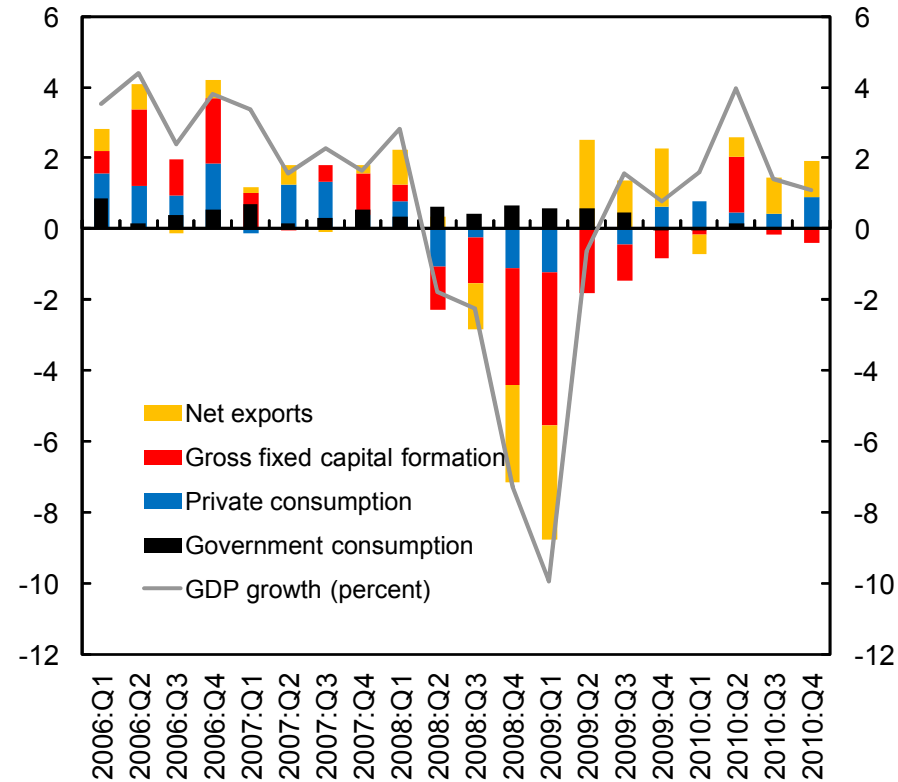
# Advanced Europe – Tackling the Sovereign Crisis



# The recovery is broadening but still moderate

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

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

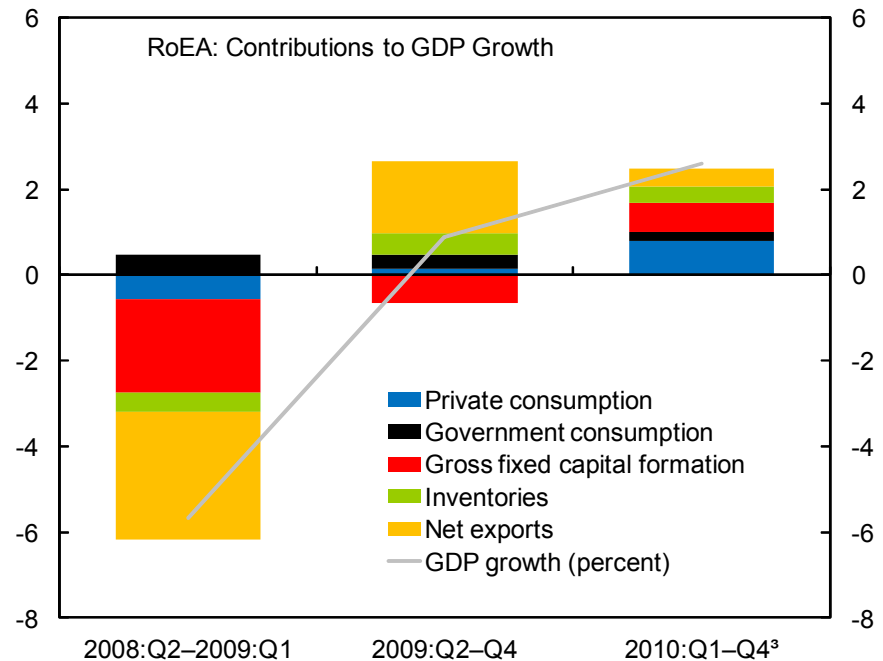
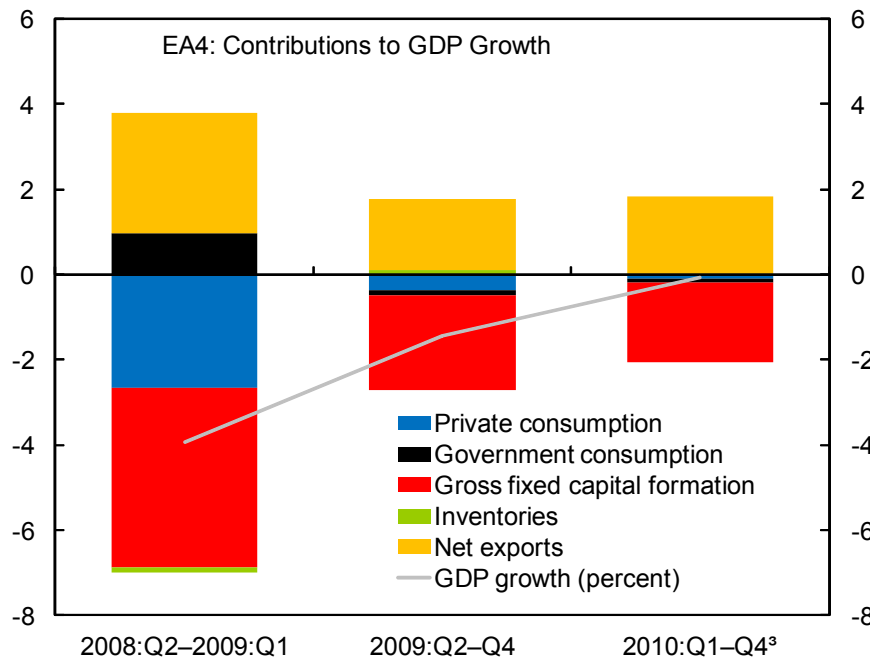


Sources: Eurostat; and IMF staff calculations.

Note: Contributions from inventories and statistical discrepancy not shown.

# But large divergences within the euro area persist...

**EA4 and Rest of Euro Area (RoEA): Contributions to GDP Growth, 2008:Q2–2010:Q4<sup>1 2</sup>**  
*(Cumulative quarter-on-quarter growth rate; percentage points; seasonally adjusted; weighted by real GDP)*



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

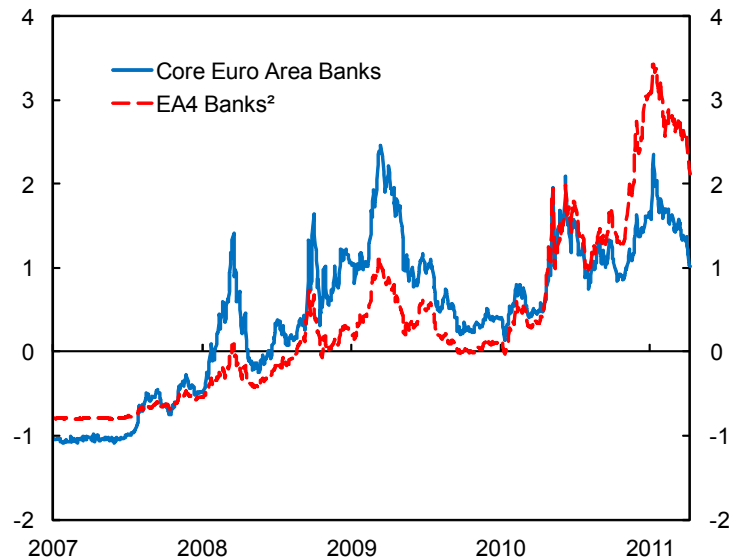
<sup>1</sup> EA4: Greece, Ireland, Portugal, and Spain.

<sup>2</sup> Statistical discrepancy not shown.

<sup>3</sup> Data for Greece and Luxembourg are from 2010:Q1 to 2010:Q3.

# ... as spillovers from financial tensions remained contained

**Euro Area: Banking Sector Risk Index, 2007–11<sup>1</sup>**

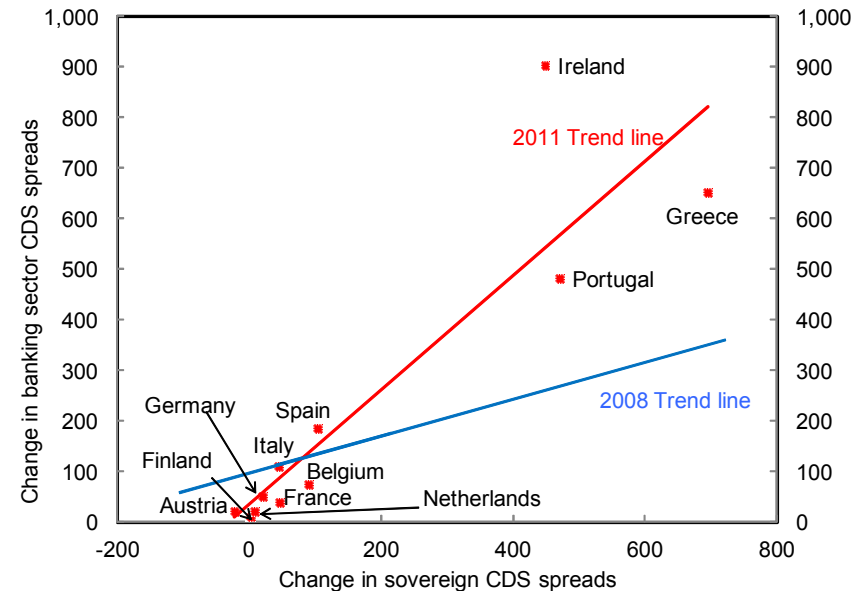


Sources: Bloomberg; and IMF staff calculations.

<sup>1</sup> Normalized score from a principal component analysis on 5-year senior bank credit default swap spreads, estimated using daily data (Jan. 1, 2005–Apr. 8, 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.

<sup>2</sup> EA4: Greece, Ireland, Portugal, Spain.

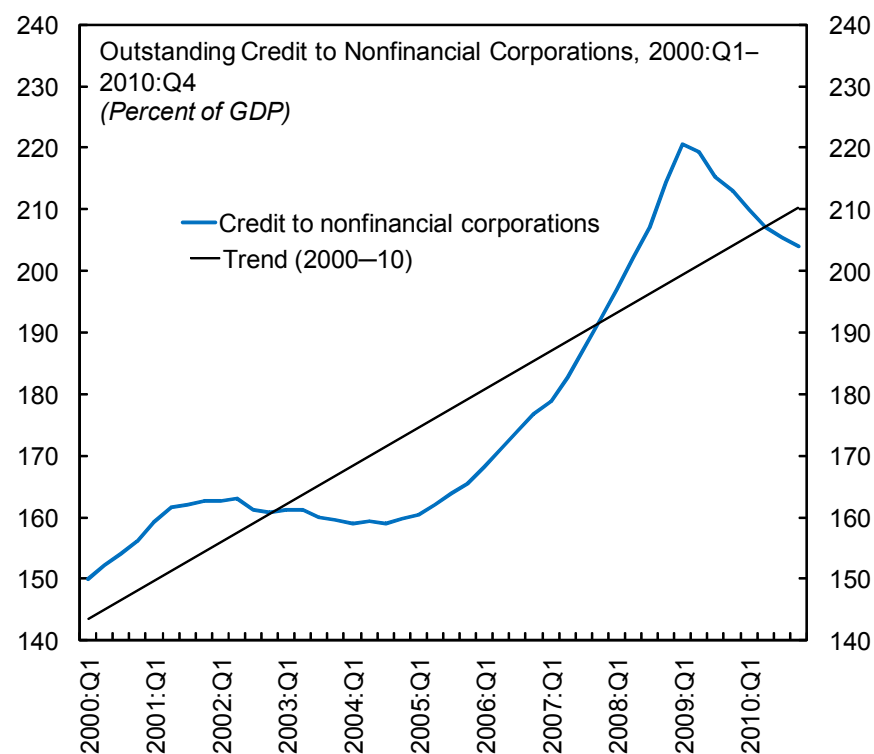
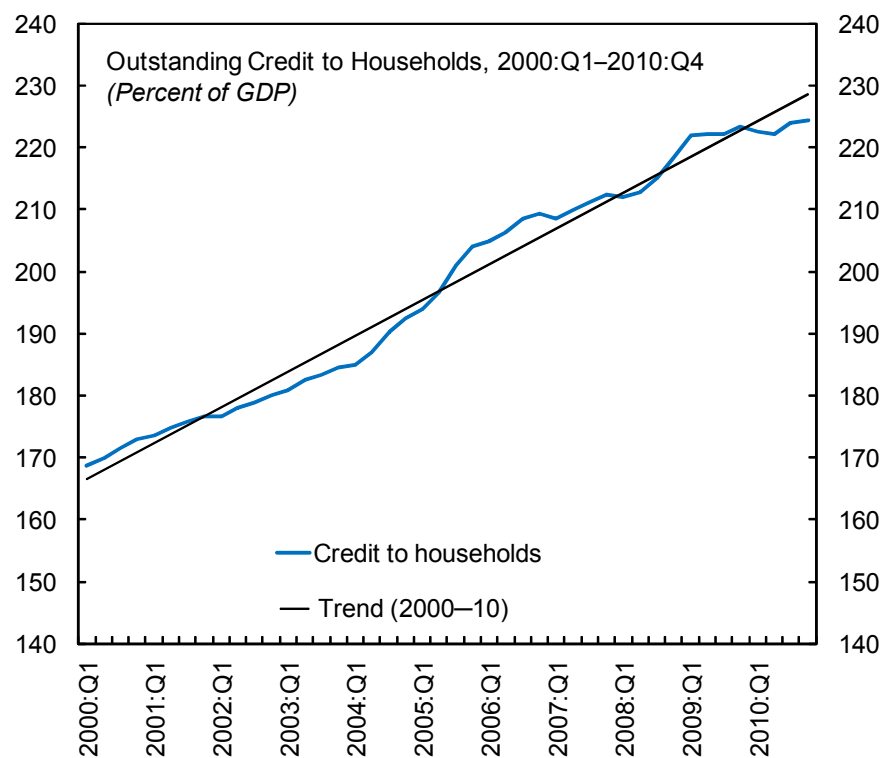
**Selected Euro Area Countries: Change in Sovereign and Bank Credit Default Swap (CDS) Spreads, January 2010–March 2011<sup>1</sup>**  
(Basis points)



Sources: Bloomberg; Datastream; and IMF staff calculations.

<sup>1</sup> Trend lines 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.

# Indeed, credit is not unduly weak



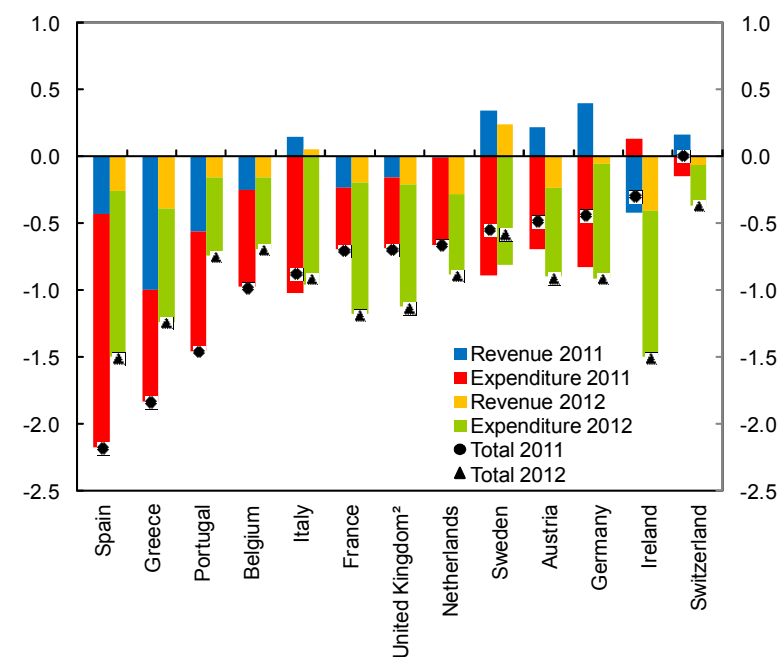
Sources: European Central Bank; and IMF, World Economic Outlook database.

# The outlook remains for a gradual recovery despite fiscal headwinds ...

	GDP Growth	
	2011	2012
Advanced Europe	1.7	1.9
Euro Area	1.6	1.8
France	1.6	1.8
Germany	2.5	2.1
Italy	1.1	1.3
Spain	0.8	1.6
United Kingdom	1.7	2.3
Switzerland	2.4	1.8
Sweden	3.8	3.5

Source: WEO

**Selected European Countries: Impact of Fiscal Policies on GDP Growth, 2011–12<sup>1</sup>**  
(Percentage points)



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

<sup>1</sup> The approach applies 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).

<sup>2</sup> United Kingdom estimates use weighted average of fiscal year numbers.

# ...but substantial downside risks remain

- Euro area sovereign crisis
  - Sizable rollover needs in the periphery
  - Negative feedback loop between banking sector and sovereigns
  - Risk of contagion through large cross-border exposures
- External risks (oil price shock, supply chain disruptions following Japan's earthquake)



# A bold and comprehensive package is needed to turn the page on the crisis

- Restore confidence
  - Strong national policies as first line of defense
  - A credible euro area-wide safety net
  - Accelerate financial sector repair
- Strengthen policies and governance
  - Restore fiscal health
  - Gradual normalization of monetary policy
  - Strengthen preventive governance

Chapter 2

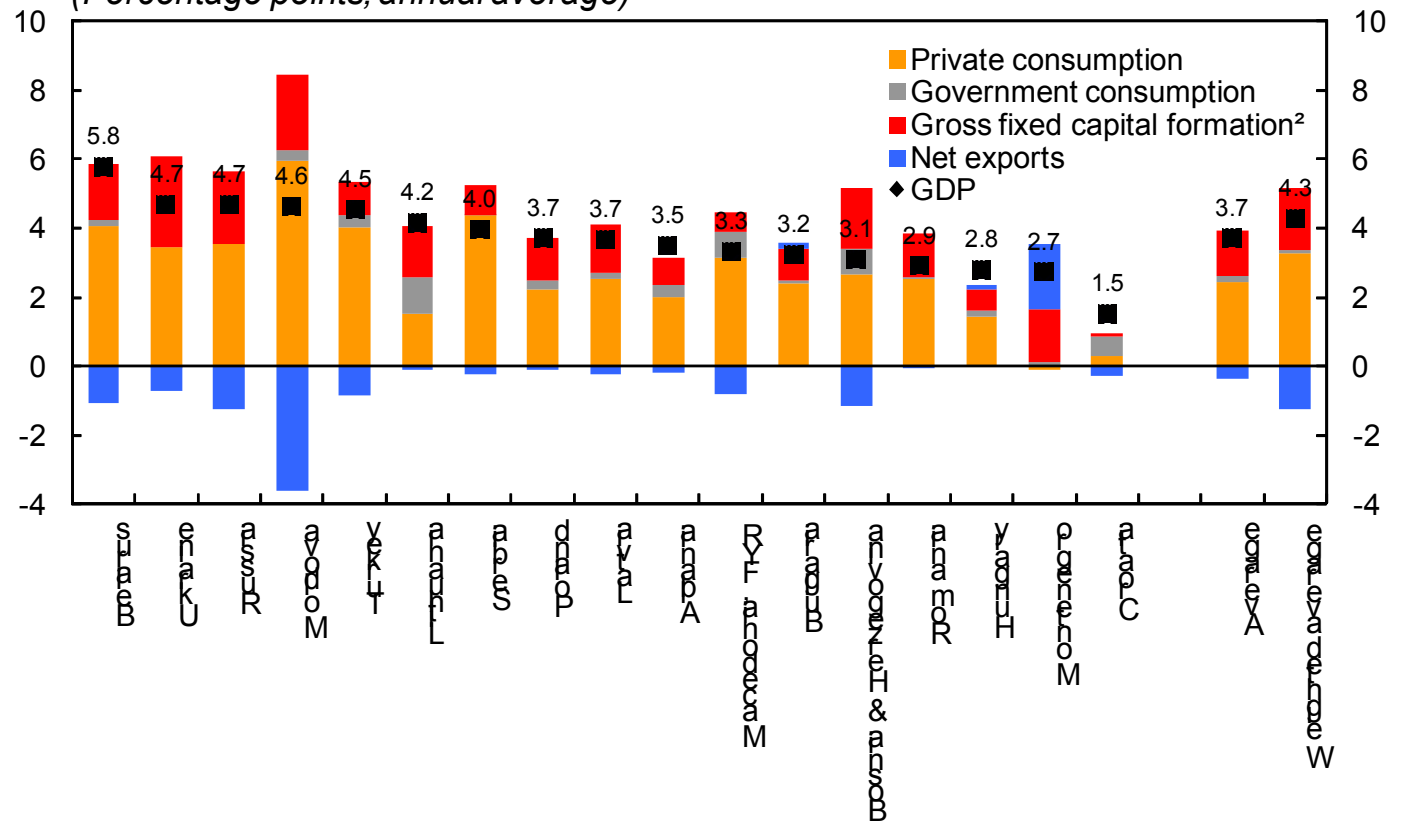
# Emerging Europe – Underwriting a Solid Recovery



# Expansion set to continue in 2011-2012 at pace similar to last year's

- Expansion of 4.3 percent in both years, after 4.2 in 2011
- Domestic demand main pillar of growth
- More evenly distributed across region
- Similar pace to other EMs, except China and India

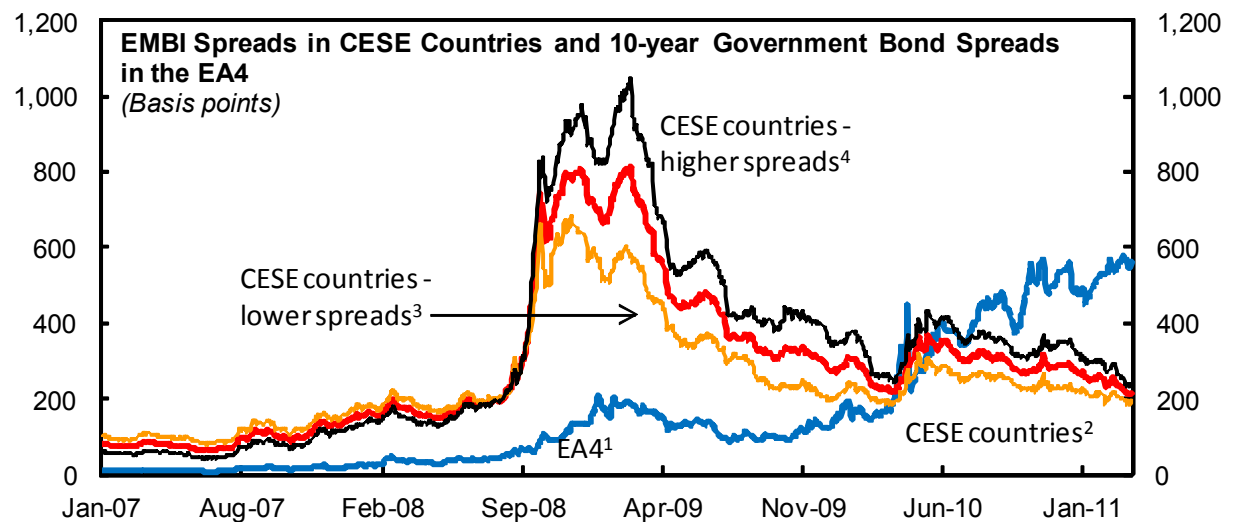
**Emerging Europe: Contributions to GDP Growth, 2011–12<sup>1</sup>**  
(Percentage points, annual average)



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

# Risks to the outlook: (1) contagion

- Little evidence yet that banking linkages at play
- Could change if western parent banks took a hit
- In any event, case for reducing fiscal and financial sector vulnerabilities



Sources: Bloomberg; Datastream; and IMF staff calculations.

<sup>1</sup>Simple average for Greece, Ireland, Portugal, and Spain (the EA4).

<sup>2</sup>Simple average for Bulgaria, Croatia, Hungary, Lithuania, Poland, Romania, Russia, Serbia, Turkey, and Ukraine.

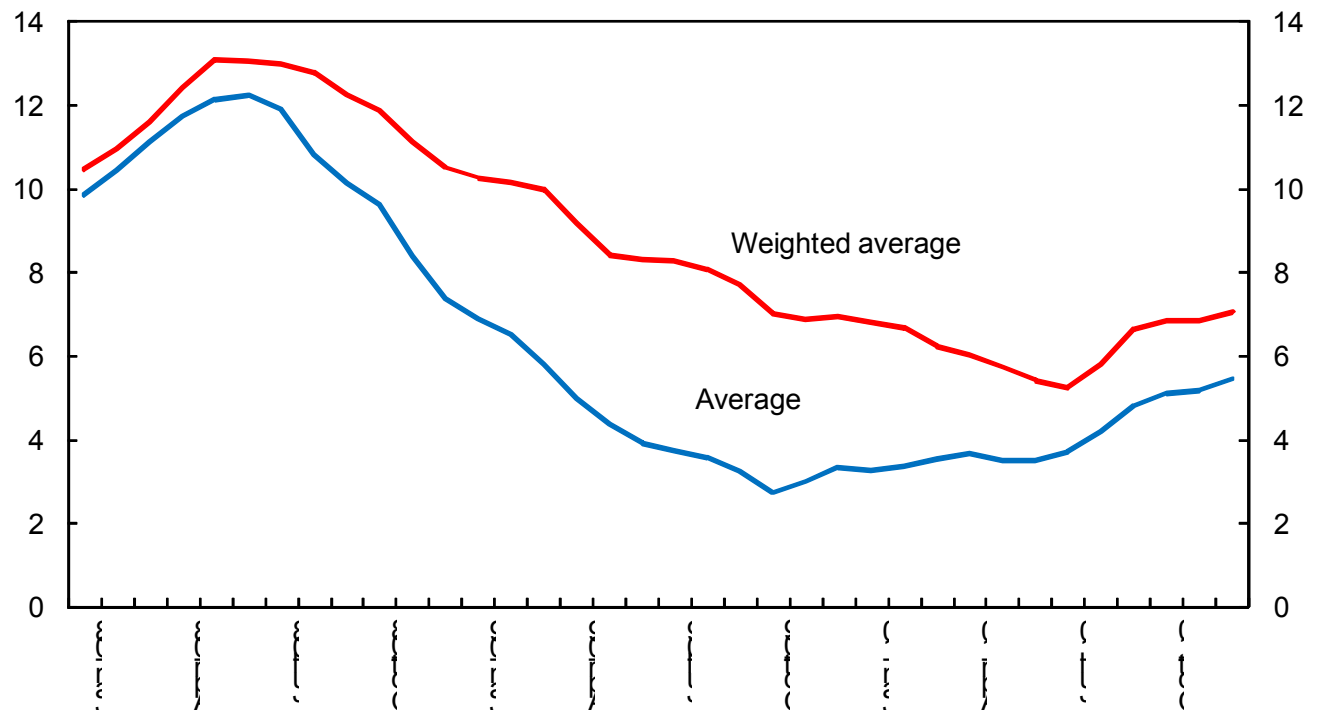
<sup>3</sup>Simple average for Bulgaria, Poland, Russia, Serbia, and Turkey.

<sup>4</sup>Simple average for Croatia, Hungary, Lithuania, Romania, and Ukraine.

# Risks to the outlook: (2) inflation

- Inflation above target in Albania, Belarus, Moldova, Poland, Serbia, Romania, and Russia
- Mainly due to commodity prices
- Monetary tightening underway

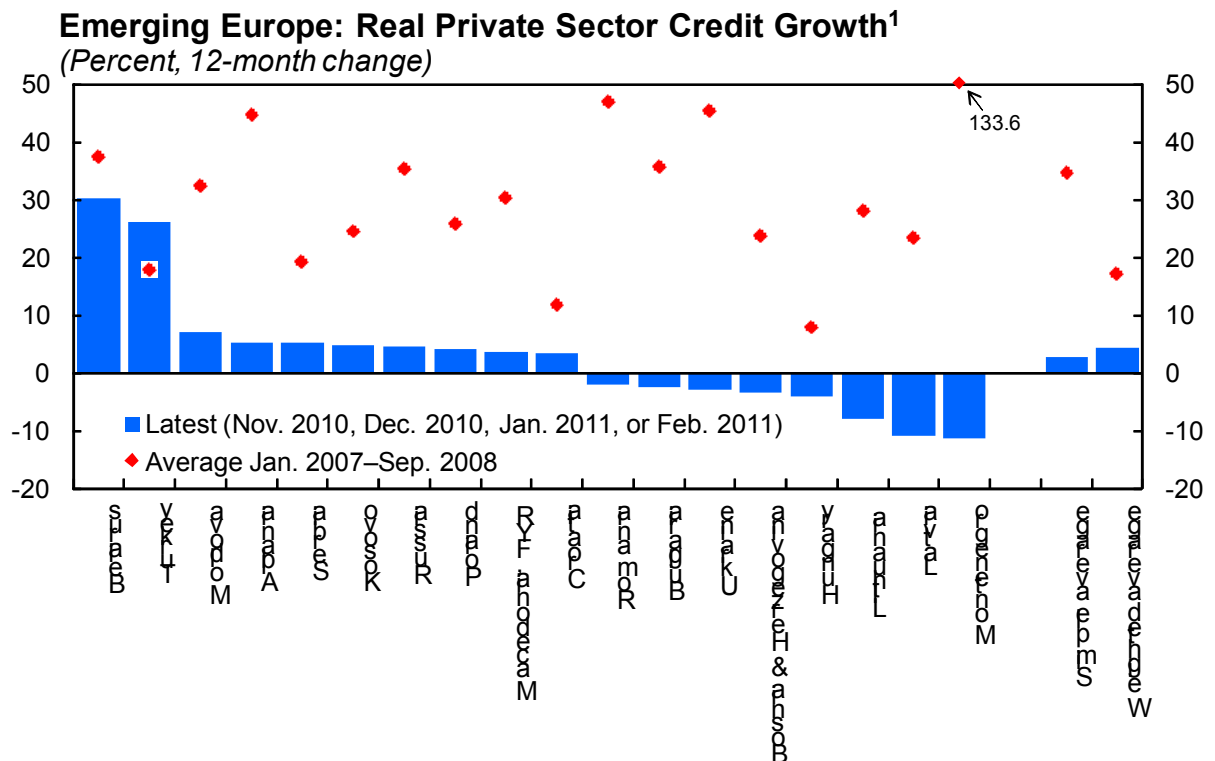
**Emerging Europe: Inflation, 2008–10**  
(Percent, year-on-year)



Source: IMF, Information Notice System.

# Legacies of the crisis: (1) high unemployment in low credit growth environment

- Complicates reduction of unemployment
- High NPL ratios and funding model main reasons; bank capitalization relatively comfortable

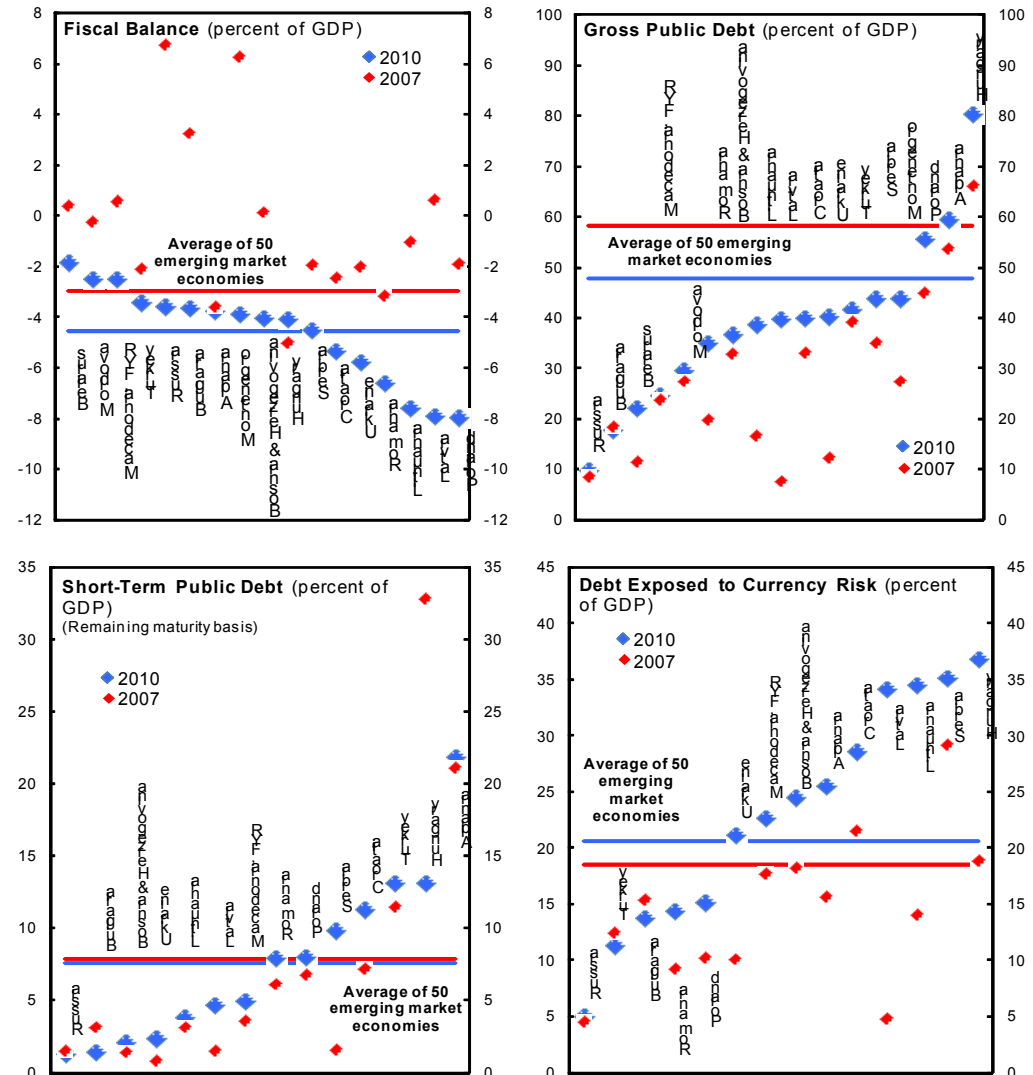


Sources: IMF, *International Financial Statistics*; and IMF staff calculations.

<sup>1</sup> Derived from stock data in domestic currency, adjusted by CPI inflation. May include valuation effects from foreign-currency-denominated loans.

# Legacies of the crisis: (2) depleted fiscal buffers

- From fiscal surplus in 2008 to large deficit in 2010 (+1.8 and -4.5 percent of GDP)
- Increase of public debt ratio from 24 to 30 percent of GDP during 2008-10
- Large cross-country differences



# Policy Priorities for Emerging Europe

- Tightening of fiscal policy
  - to restore fiscal buffers and defuse contagion risks
  - to support monetary policy in demand management
- Monetary policy at the ready to combat inflation
- Structural reform to foster sustainable growth patterns (see Chapter 3)
- Financial sector policy to revive healthy credit growth, supporting domestic demand and structural change
  - leverage ongoing consolidation, Basel III, and emerging cross-boarder supervisory regimes



World Economic and Financial Surveys

# Regional Economic Outlook



**Europe**

**Strengthening the Recovery**



**MAY 11**

INTERNATIONAL MONETARY FUND