

INTERNATIONAL MONETARY FUND

REGIONAL ECONOMIC OUTLOOK

EUROPE

A RECOVERY SHORT OF
EUROPE'S FULL POTENTIAL

2024
OCT



INTERNATIONAL MONETARY FUND

REGIONAL ECONOMIC OUTLOOK

EUROPE

A Recovery Short of
Europe's Full Potential

2024
OCT



©2024 International Monetary Fund

Cataloging-in-Publication Data
IMF Library

Names: International Monetary Fund, publisher.

Title: Regional economic outlook. Europe : a recovery short of Europe's full potential.

Other titles: Europe : a recovery short of Europe's full potential. | A recovery short of Europe's full potential. |
Regional economic outlook : Europe.

Description: Washington, DC : International Monetary Fund, 2024. | Oct. 2024. | Includes bibliographical references.

Identifiers: ISBN:

9798400287312 (paper)

9798400292286 (epub)

9798400292262 (Web PDF)

Subjects: LCSH: Economic forecasting—Europe. | Economic development—Europe. | Economic conditions—Europe.

Classification: LCC HC240.A1 R445 2024

The *Regional Economic Outlook: Europe* is published once a year, in the fall, to review developments in Europe. Both projections and policy considerations are those of the IMF staff and do not necessarily represent the views of the IMF, its Executive Board, or IMF Management.



Publication orders may be placed online, by fax, or through the mail:

International Monetary Fund, Publication Services

P.O. Box 92780, Washington, DC 20090 (USA)

T. +(1) 202.623.7430

F. +(1) 202.623.7201

publications@IMF.org

www.IMFbookstore.org

www.elibrary.IMF.org

Contents

Executive Summary	v
A Recovery Short of Europe’s Full Potential.....	1
Europe Is Slowly Recovering but Uncertainty Is Muting the Rebound	1
Inflation Has Fallen, but Services Inflation Remains Sticky	4
Outlook: A Tepid Recovery.....	5
Absent a Strong Reform Effort, Growth Will Remain below Its Full Potential.....	9
Risks.....	10
Policies: Navigate the Recovery and Push for Growth Reforms.....	11
Monetary Policy: Steady Hands Needed	12
Fiscal Policy: Secure Sustainability, Build Buffers, and Prioritize	13
Financial Sector Policy: A Watchful Eye on Downside Pressures	15
Structural Policies: Single Market Key to Europe’s Full Growth Potential	18
References.....	21

BOXES

Box 1. Europe’s Shift to Electrical Vehicles amid Intensifying Global Competition: Who Will Be Affected?	24
Box 2. Monetary Policy and Uncertain Neutral Rate Estimates	26
Box 3. What Is Constraining Europe’s Productivity Growth? Evidence from a Firm-Level Study.....	27
Box 4. How Large Are Europe’s Convergence Effect and What Are Their Main Drivers?.....	28
Box 5. Ukraine: Heightened Risks, Longer War, and Continued Resilience.....	30

FIGURES

Figure 1. A Slow Recovery despite Healthy Income Rebound	2
Figure 2. Uncertainty, Near-Term Sentiment, and Long-Term Growth Expectations.....	3
Figure 3. Demand and Supply Conditions.....	3
Figure 4. Incomes and Productivity	4
Figure 5. Inflation Developments.....	5
Figure 6. Sticky Core Inflation	6
Figure 7. Baseline Macroeconomic Forecast and Consumption.....	7
Figure 8. Baseline Macroeconomic Forecast and Investment	8
Figure 9. Long-Term Growth Forecast.....	10
Figure 10. Risk to Growth and Inflation.....	11
Figure 11. Monetary Policy.....	12
Figure 12. Public Debt and Fiscal Policy.....	14
Figure 13. Expenditure Pressures	16
Figure 14. Financial Sector.....	17
Figure 15. European Economic Integration and Scope for Deepening the Single Market	19
Box Figure 1.1. Battery Electric Vehicle Sales	24
Box Figure 1.2. Short-Term GDP Impact of Electric Vehicle Shock with Tariffs.....	25
Box Figure 2.1. Real Natural Rates of Interest in the Euro Area	26

Box Figure 2.2. Illustrative European Central Bank Monetary Policy	26
Box Figure 3.1. Listed Firms' R&D Intensity over Sales	27
Box Figure 3.2. Nonfinancial Corporations Funding Structure, 2023	27
Box Figure 3.3. Share of Young Firms	27
Box Figure 4.1. Per Capita Convergence across Regions (95-24)	29
Box Figure 4.2. European Union Integration and Returns from Enlargement: Cumulative per Capita Increase	29
Box Figure 4.3. Integration in European Union Global Value Chains	29
Box Figure 4.4. Structural Reforms pre- and post-Accession	29
Box Figure 5.1. Real GDP	30

TABLES

Annex Table 1.1 Real GDP Growth	32
Annex Table 1.2. Headline Inflation	34

Executive Summary

Europe's economic recovery continues, benefiting from a strong response to crises. Yet, the recovery is falling well short of Europe's full potential. Uncertainty about persistent core inflation, the direction of economic policies, and geopolitical conflicts are weighing down the outlook in the short term. In the longer term, perennially weak productivity growth and new headwinds from the uncertainty of the effects of fragmentation, climate change, and other structural shifts are holding back potential growth. Addressing key policy uncertainties and removing structural barriers would strengthen growth in both the short term and the long term.

The outlook for 2024 and 2025 remains for a modest increase in growth. In advanced European economies and the Central, Eastern, and Southeastern Europe (CESEE) region, the projected growth rate for 2024 is 1.0 and 2.3 percent, and for 2025, it is 1.4 and 3.1 percent, respectively, broadly unchanged since our previous forecast. Gradually strengthening private domestic demand, supported by further disinflation and progressively easing financial conditions, is expected to more than offset the effects of necessary fiscal consolidation. However, Europe's recovery path is more protracted compared to previous crises, and the risks to the outlook are on the downside. Given high core inflation persistence, inflation targets will only be reached in 2025 in advanced European economies and in 2026 in most CESEE countries.

In this context, policymakers need steady macroeconomic policies to help firms and households navigate an uncertain environment. Over the near term, this means transitioning to a neutral monetary policy stance while reducing deficits without jeopardizing a smooth landing.

Central banks have appropriately started to ease. In advanced European economies, rate reductions should continue steadily. Since policy rates are closer to targets and the effects of monetary policy better understood, policy decisions can become more forecast-driven, although central banks should respond flexibly to any large data surprises or developments. Central banks in the CESEE region, where inflation is further above targets and stickier, should pursue a more data-dependent and meeting-by-meeting approach. Here, monetary policy still needs to internalize the asymmetric (high) costs of inflation overshooting and avoid premature or too rapid easing. Given the uncertainties around the level of neutral rates, central banks will have to approach the end of the easing cycle with care and be ready to adjust the terminal rate with an eye on economic and inflation outcomes.

The time has come for fiscal policy to rebuild buffers and secure debt sustainability. Public debt has risen substantially since 2020 as governments provided necessary policy support during the crises. With inflation closer to target and moderate levels of growth, high debt would become a vulnerability if not addressed through medium-term adjustment efforts. A welcome fiscal policy pivot is now under way. The new European fiscal governance framework presents a crucial step to reduce debt and strengthen sustainability, and should be implemented as planned. Managing the needed fiscal adjustment, while addressing rising expenditure needs, will require spending prioritization and structural fiscal reforms. In high-debt countries, fiscal adjustment should be front-loaded to demonstrate resolve, secure market confidence, and create room for addressing future spending needs.

In light of elevated uncertainty, financial sector policymakers and supervisors need to keep a watchful eye on downside risks. Banks have substantial capital buffers; however, vulnerabilities such as exposure to commercial real estate could be exacerbated by a potential downturn. Rebuilding macroprudential buffers could provide protection against such an eventuality. In addition, it is important to prevent the migration of risks to nonbank financial intermediaries, especially those with high portfolio concentration, elevated leverage, and liquidity mismatches.

Finally, policymakers need to provide a clear direction on how to raise potential growth. An in-depth analysis of Europe's productivity growth and convergence process accompanying this report (see October 2024 *Regional Economic Outlook: Europe* Note 1 Europe's Declining Productivity Growth: Diagnoses and Remedies and October 2024 *Regional Economic Outlook: Europe* Note 2 Accelerating Europe's Income Convergence through Integration) sheds light on the underlying issues. Consistent with the two recent reports on the long-term outlook for the European Union (EU) by Enrico Letta and Mario Draghi,¹ the analysis reveals that, in advanced European economies, a lack of market scale and access to capital and skilled labor constrain firms from operating at the global technology and innovation frontier. In CESEE countries, lagging structural reforms and low investment rates are slowing the convergence process. For Europe to achieve its full growth potential, a larger and more integrated single market—especially for goods, services, and capital—is needed. A fully developed single market will provide firms and entrepreneurs with the room to innovate and sustainably raise growth; it will also facilitate structural reforms and raise investment incentives in converging countries. CESEE countries also need to upgrade infrastructure, enhance worker skills, and improve institutions to resume their income growth catch-up.

Deepening European integration is also the best response to accumulating uncertainties. By insulating businesses and labor markets from global fragmentation pressures, a more complete single market would strengthen economic resilience in a shock-prone world. These are formidable policy challenges, but Europe can overcome them with steady macroeconomic policies and a strong commitment to economic integration and continued multilateral collaboration.

¹ Letta (2024); and Draghi (2024).

A Recovery Short of Europe's Full Potential

Europe's economic recovery is gradually gathering strength, benefiting from a strong response to crises. Yet, the recovery is falling short of Europe's full potential. Uncertainty about the persistence of core inflation, the direction of economic policies, and geopolitical conflicts are dampening the domestic demand and weighing on potential growth.

Europe Is Slowly Recovering but Uncertainty Is Muting the Rebound

Europe's economy is slowly recovering. Growth strengthened in the first half of 2024 to 1.7 percent broadly in line with the April 2024 World Economic Outlook (Figure 1, panel 1), driven by a moderate pickup in private consumption—underpinned by real income growth and high levels of employment (Figure 1, panels 3 and 4). While the service sector has maintained its robust recovery, industrial production has been lagging, reflecting weakening external demand, including from China. Investment has been slow to turn around amid still tight financial conditions despite the start of the monetary easing cycle (Figure 1, panel 2). Economic outcomes have differed along this path, with some countries benefiting from strong services (Spain, France, Poland, and United Kingdom) and some manufacturing-intensive countries (Germany and Austria) being weighed down by weak goods demand.

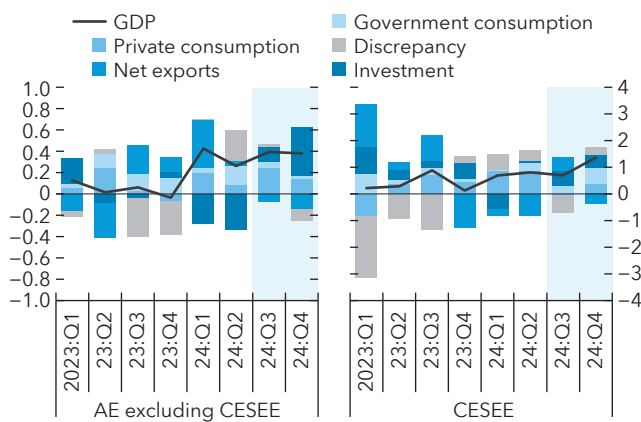
High uncertainty is muting the rebound and Europe's medium-term outlook. Risks from an intensification of the war in Ukraine and an escalation of armed conflicts in the Middle East have raised concerns about commodity price volatility (Figure 2, panel 1). Uncertainty about the direction of economic policies has also risen in this year due to recent and impending elections in the EU and the United States (Figure 2, panel 2; Hong, Ke, and Nguyen 2024). Policy uncertainty pertains to Europe's resolve on rebuilding fiscal space, its commitment to EU-wide competitiveness reforms, adherence to climate goals, and the direction of trade policies. Banks have remained cautious throughout the second quarter despite a gradual easing of credit standards in some countries and notwithstanding healthy profits and capital buffers. Furthermore, recent financial market turbulence (such as the equity market rout and reversal in early August) signals concerns about global financial conditions, the strength of US growth, and the impact of global fragmentation. All this uncertainty has weighed on the recovery momentum and expectations for longer-term growth:

- **Slow recovery momentum.** Private consumption has remained moderate when compared with households' income growth. Low consumer confidence and uncertainty about future income shocks (Figure 3, panel 1) have raised precautionary savings, and as a result, saving rates have stayed above pre-crisis levels (Figure 3, panel 2). This has come on top of the effects of high interest rates (Figure 3, panel 4) on consumer spending and investments, with investment also affected by declining real estate prices in some countries and widening capacity-underutilization from low domestic demand. Concerns about permanently higher energy prices and a delayed global manufacturing recovery (Figure 3, panel 3) have additionally weighed on business activity. The recent decoupling of wholesale electricity between the CESEE and Western European countries as a result of unanticipated higher demand from Ukraine is just one example of such effects.
- **Muted long-term growth expectations.** Forecasters have increasingly become pessimistic about Europe's longer-term outlook (Figure 4, panel 1). Uncertainty is high whether Europe can adopt policies that reverse a decade-long productivity decline and narrow the 30-percent income per capita gap with the United States (Figure 4, panels 2 and 3). Such policies would have to be far-reaching. Europe's productivity slump

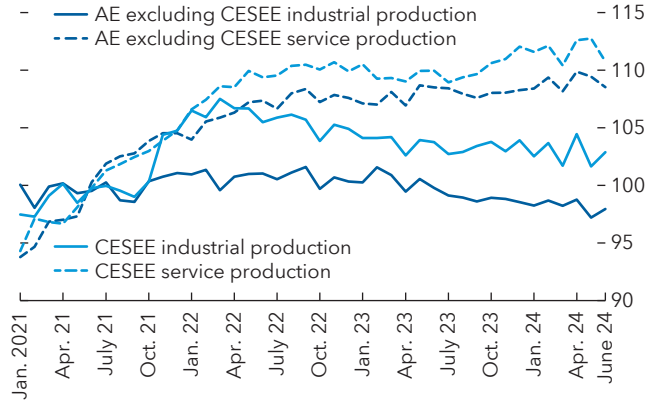
This report was prepared by Tianxiao Zheng (lead) and Ben Park, under the guidance and supervision of Helge Berger and Stephan Danninger. It includes contributions from Oyun Adilbish, Robert Beyer, Diego Cerdeiro, Francesca Caselli, Allan Dizioli, Philipp Engler, Gianluigi Ferrucci, Shakill Hassan, Gee Hee Hong, Chris Jackson, Goesta Ljungman, Giacomo Magistretti, Alexander Pitt, Igljka Vassileva, and Sebastian Weber. Agnesa Zalezakova was expertly in charge of administrative and editorial support.

Figure 1. A Slow Recovery despite Healthy Income Rebound¹**1. Growth Decomposition**

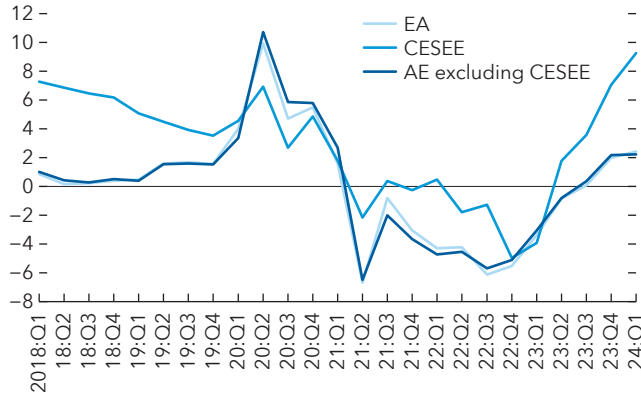
(Percent change, quarter over quarter)

**2. Industry and Services Production**

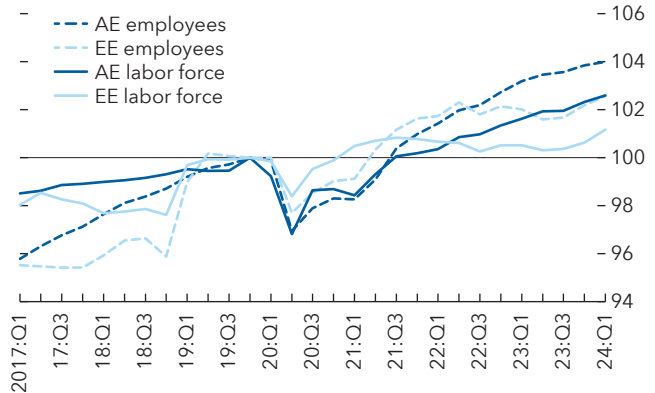
(Index, 2021 = 100)

**3. Real Income Growth**

(Percent change, year over year)

**4. Employment**

(Index, 2019:Q4 = 100)



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

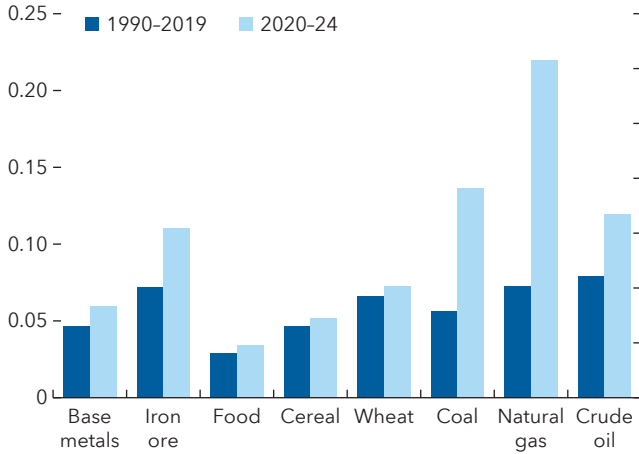
Note: In panel 1, investment is gross fixed capital formation. Data on 2024:Q3 and 2024:Q4 are based on projections. In panel 3, real income is defined as compensation per employee adjusted for consumer price index. AE excluding CESEE includes Andorra, Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Luxembourg, Malta, The Netherlands, Norway, Portugal, San Marino, Spain, Switzerland, and the United Kingdom. CESEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Serbia, Slovak Republic, and Slovenia. Belarus, Russia, Ukraine, and Türkiye are included in CESEE if otherwise specified. AE = advanced economies; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area; EE = emerging Europe.

spans all sectors—tech and non-tech (Figure 4, panel 4)—driven by low business start-up rates and slow firm growth (October 2024 *Regional Economic Outlook: Europe* Note 1 Europe's Declining Productivity Growth: Diagnoses and Remedies), and extends across the entire region, with CESEE countries no longer converging to advanced European productivity and income levels (October 2024 *Regional Economic Outlook: Europe* Note 2 Accelerating Europe's Income Convergence through Integration). At the same time, economic fragmentation and energy security are adding new headwinds to growth on top of population aging and climate change.

Figure 2. Uncertainty, Near-Term Sentiment, and Long-Term Growth Expectations

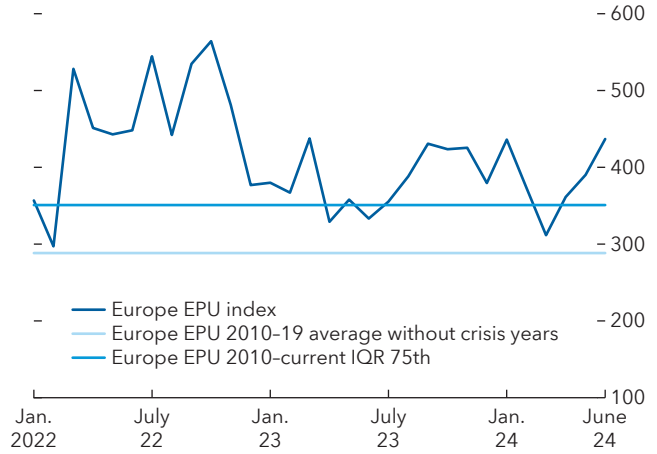
1. Volatility of Commodity Prices

(Standard deviation of log differences)



2. European Economic Policy Uncertainty Index

(Index)

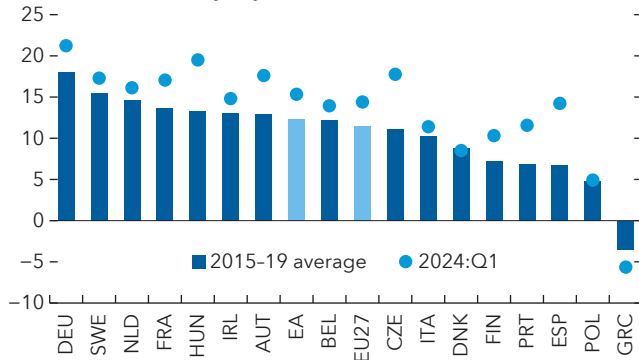


Sources: Baker, Bloom, and Davis (2016); IMF, Primary Commodity Price System; and IMF staff calculations. Note: In panel 2, crisis years denote 2013 and the period 2020-22. EPU = economic policy uncertainty; IQR = interquartile range.

Figure 3. Demand and Supply Conditions

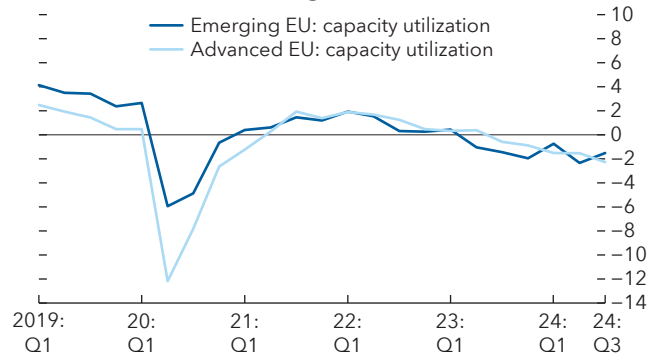
1. Household Savings Rate

(Percent, seasonally adjusted)



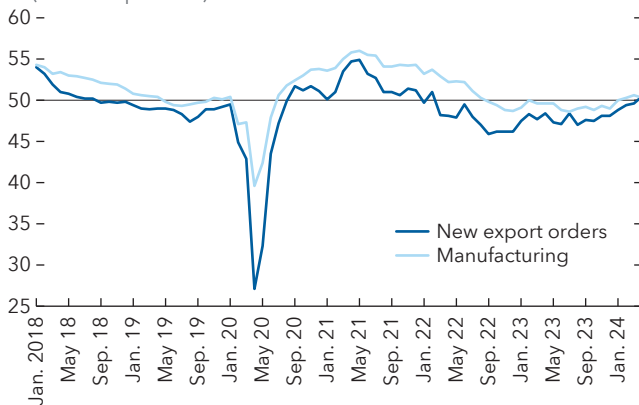
2. Capacity Utilization Rate

(Percent, deviation from long-term trend)



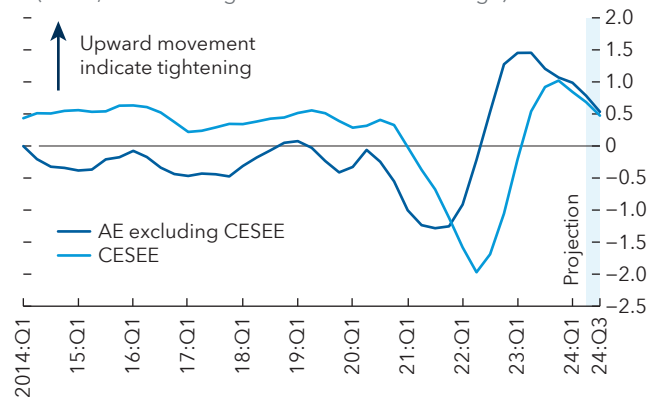
3. Global PMI for New Export Orders and Manufacturing

(50+ = expansion)



4. Financial Conditions

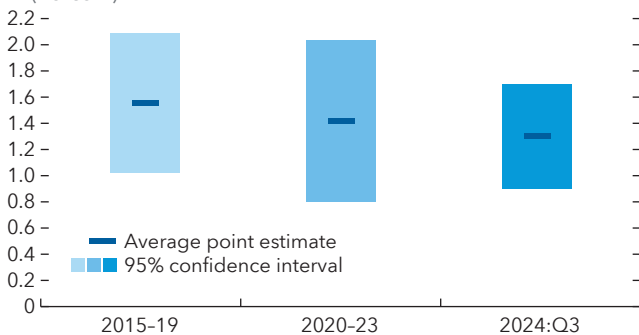
(Index, above 0 = tighter than historical average)



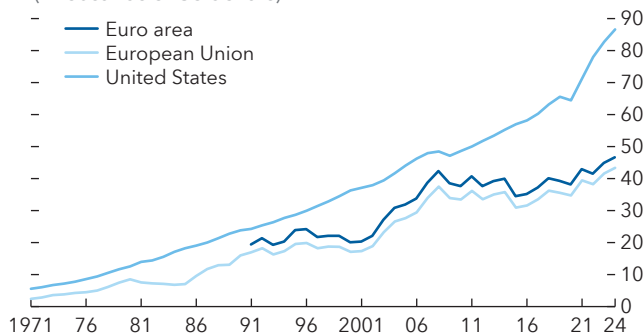
Sources: Borraiccia and others (2023); Eurostat; Haver Analytics; Statista; and IMF staff calculations. Note: In panel 1, household savings rate is calculated as gross saving/(gross disposable income + the adjustment for the change in pension entitlements). The bar for Finland shows average of 2023:Q1-Q3 value because of data unavailability. In panel 2, long-term trend is the average from 2000 to 2023. Capacity utilization is based on the survey of manufacturing industry. In panel 4, the financial conditions indexes show change in the index from previous quarter. The financial conditions indexes are aggregated using liability-weighted average. Countries that do not have a full range of data are excluded from the figures. CESEE excludes Belarus, Russia, Türkiye, and Ukraine. Data labels in the figure use International Organization for Standardization (ISO) country codes. CESEE = Central, Eastern, and Southeastern Europe; EA = euro area; EU27 includes Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, and Sweden.; PMI = purchasing managers' index.

Figure 4. Incomes and Productivity**1. Five-Year Real GDP Growth Expectations**

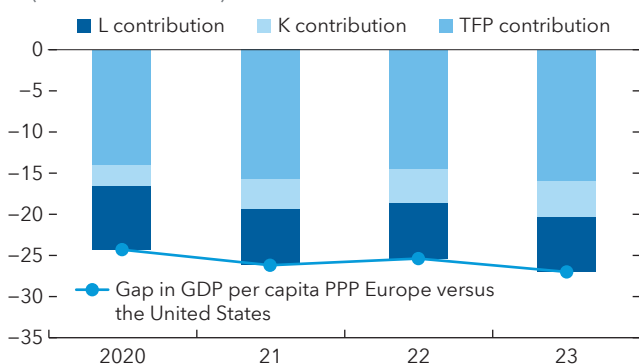
(Percent)

**2. GDP per Capita in Europe and United States**

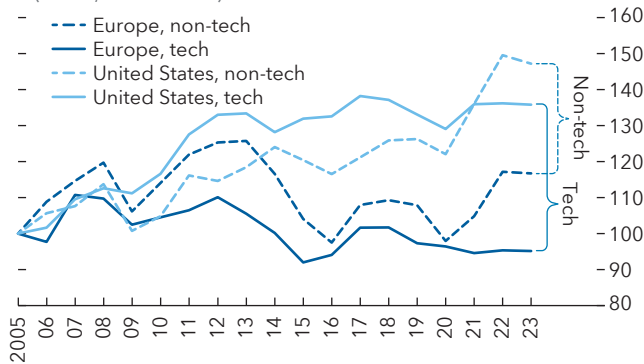
(Thousands of US dollars)

**3. GDP per Capita Gap between Europe and United States**

(Percent of US level)

**4. Productivity of Listed Firms**

(Index, 2005 = 100)



Sources: AMECO database; Compustat; IMF, World Economic Outlook database; European Central Bank; European Commission; Eurostat; Haver Analytics; and IMF staff calculations.

Note: In panel 3, Europe excludes Albania, Belarus, Bosnia and Herzegovina, Iceland, Israel, Kosovo, Moldova, Montenegro, North Macedonia, Norway, Romania, Russia, San Marino, Serbia, Switzerland, Türkiye, and Ukraine. PPP = purchasing power parity; TFP = total factor productivity.

Inflation Has Fallen, but Services Inflation Remains Sticky

Headline inflation is approaching targets, if not smoothly (Figure 5, panel 1). In about 60 percent of advanced European countries, headline inflation has declined to within 1 percentage point or less of central banks' targets. In 22 percent of countries inflation has fallen below it. In the CESEE region,³ the disinflation process has been slower and only 33 percent of countries are within 1 percentage point of the target, whereas more than 40 percent of countries are still above it (Figure 5, panel 2). Lower energy and food inflation were responsible for about three-quarters of the euro areas' disinflation since its peak in 2023, and about half in the CESEE region (Figure 5, panel 3). The effects of past monetary tightening also continued to feed through. In the euro area, about 80 to 90 percent of the transmission to growth occurred up to 2023:Q4/2024:Q1 (IMF 2024). The path toward the inflation target has, however, been bumpy in many countries across Europe, as base effects and staggered reversal of support measures are affecting the inflation path (Figure 5, panel 4). The attacks on Red Sea shipping lanes have increased shipping costs and created upward price pressures.

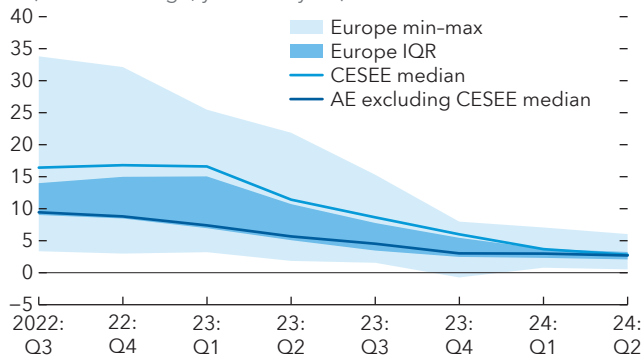
Underlying inflation, especially in services, appears sticky, with cross-country differences driven by wage and profit dynamics. Core inflation has slowed more gradually than headline because of strong second-round effects from wage inflation in labor-intensive services sectors (Figure 6, panels 3 and 4). As of August, services inflation in the euro area is still 2 percentage points above its 2015-19 average (Figure 6, panel 1), whereas

³ CESEE refers to the CESEE excluding Belarus, Russia, Türkiye, and Ukraine unless otherwise specified.

Figure 5. Inflation Developments

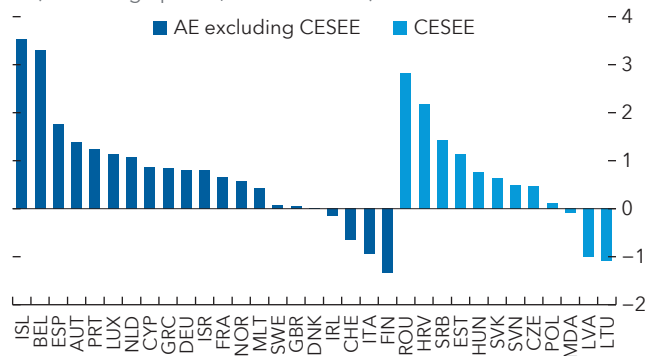
1. Headline Inflation

(Percent change, year over year)



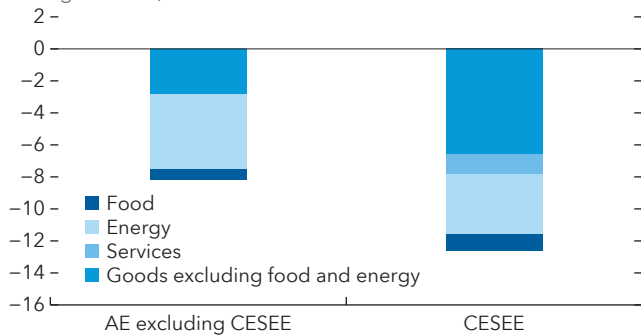
2. Headline Inflation Deviation from Target

(Percentage points, as of 2024:Q2)



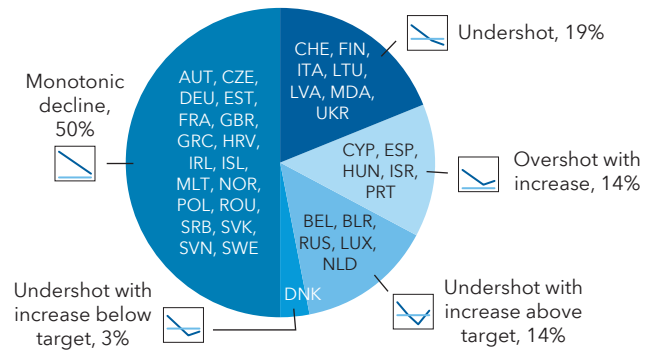
3. Decomposition of Headline Inflation

(Percentage points, decrease from October 2022 to August 2024)



4. Disinflation Paths by Type

(Percent of European countries)



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

Note: In panel 4, countries with inflation target range use average between the upper and lower bound. Each country's path is calculated using quarterly data from the peak inflation, between 2022:Q2 and 2023:Q1, until 2024:Q2. Monotonic decline represents countries with less than two consecutive quarters of increase in inflation rate. For Switzerland, the inflation has been within the price stability range since mid-2023. Countries that do not have a full range of data are excluded from the figures. CESEE excludes Belarus, Russia, Türkiye, and Ukraine. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economies; CESEE = Central, Eastern, and Southeastern Europe; IQR = interquartile range.

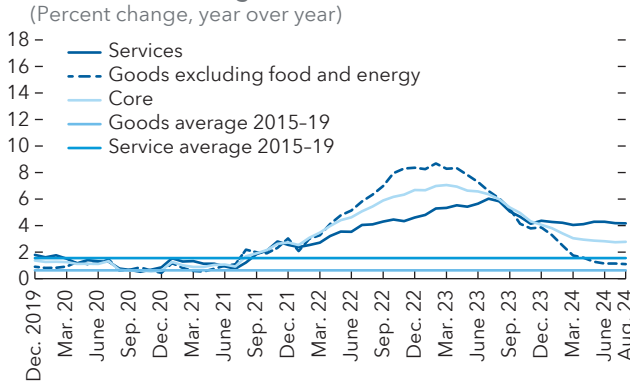
in CESEE countries, it is 5 percentage points higher (Figure 6, panel 2). In Romania, Hungary, and Poland, wage growth has remained near or above double digits this year (Figure 6, panel 5). In advanced European economies, however, wages have grown less rapidly, and real wages have only now recovered to pre-war levels (Figure 6, panel 6). In several countries, declining corporate profit margins have helped absorb some of the cost pressures.

Outlook: A Tepid Recovery

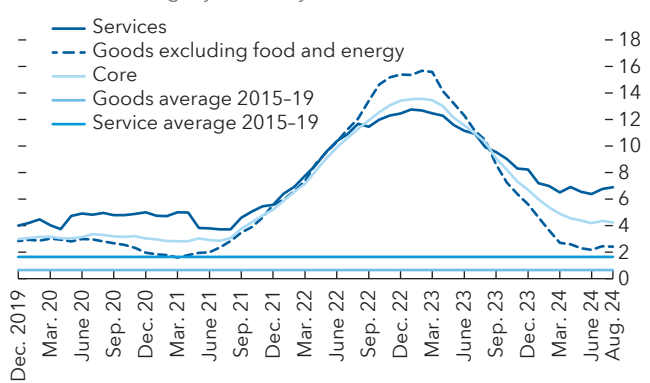
The baseline outlook for 2024 and 2025 indicates a modest increase in growth. In advanced European economies and the CESEE region, the projected growth rate for 2024 is 1.0 and 2.3 percent, and for 2025 1.4 and 3.1 percent, respectively (Figure 7, panel 1), broadly unchanged since our previous forecast. Inflation will return to target in 2025 in advanced European economies and in 2026 for most CESEE countries (Figure 7, panel 2). Gradually strengthening private domestic demand, supported by further disinflation and progressively easing financial conditions, more than offsets the effects of necessary fiscal consolidation. However,

Figure 6. Sticky Core Inflation

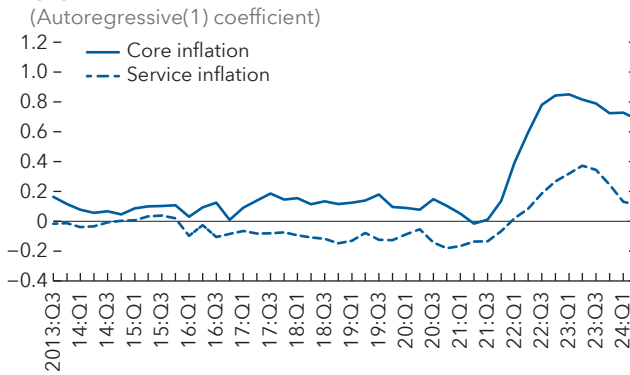
1. Core and Goods and Service Inflation in Advanced Economies excluding CESEE



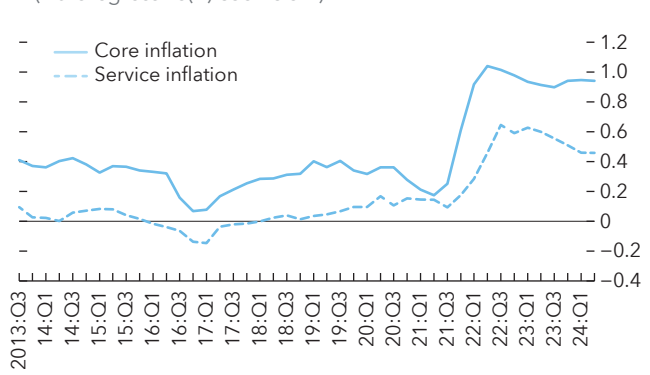
2. Core and Goods and Service Inflation in CESEE



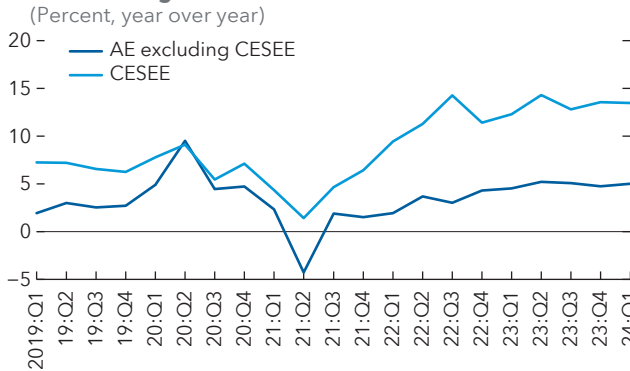
3. Inflation Persistence in Advanced Economies excluding CESEE



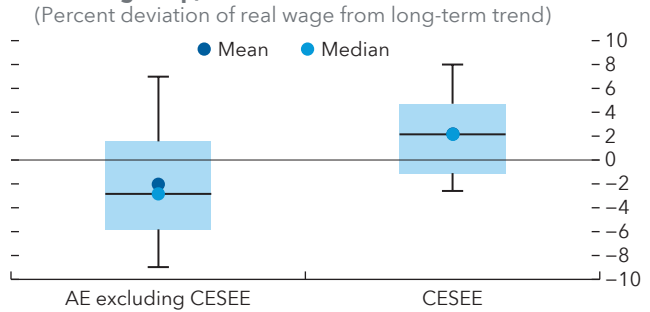
4. Inflation Persistence in CESEE



5. Nominal Wages



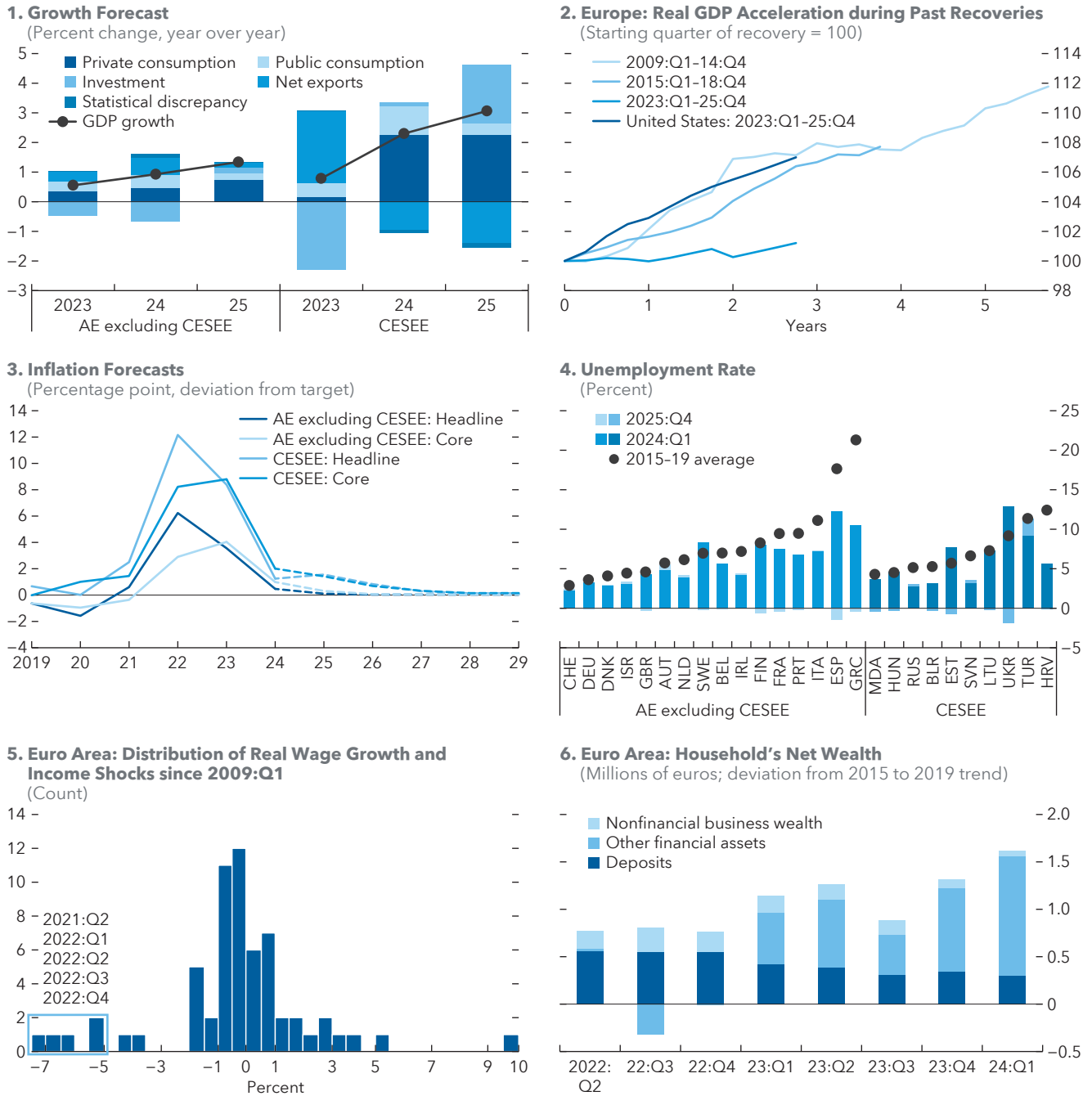
6. Real Wage Gap, 2024:Q1



Sources: Eurostat; Federal Reserve Economic Data; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.

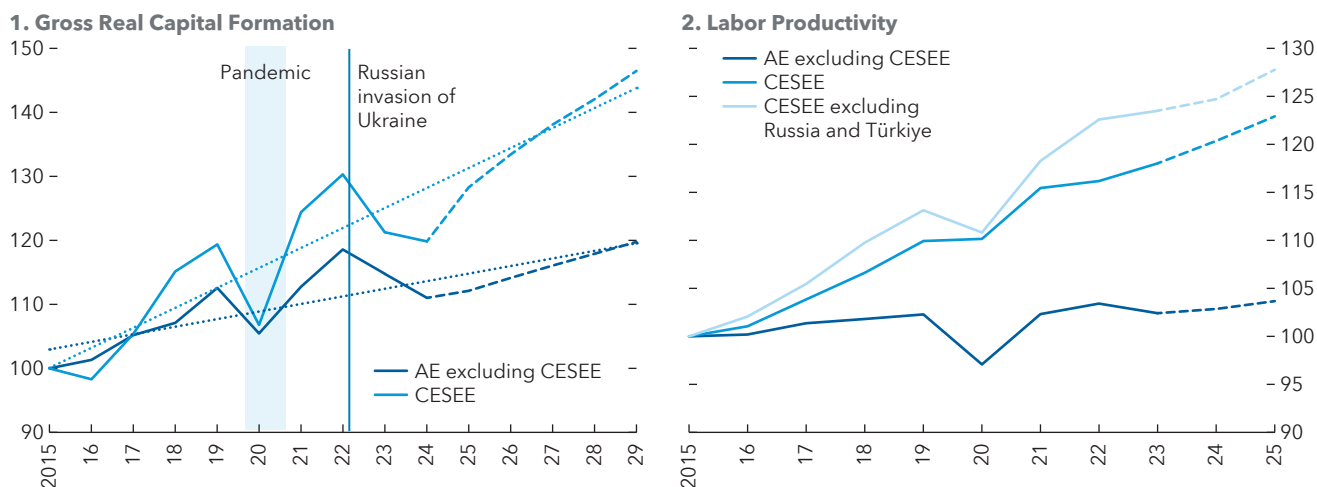
Note: Countries that do not have a full range of data are excluded from the figures. Panels 3 and 4 present the estimated results for the period from 2010:Q1 to 2024:Q1, using rolling windows of 16 quarters from a pooled autoregressive(1) analysis of 22 and 14 countries for the AE excluding CESEE and CESEE samples, respectively. CESEE excludes Belarus, Russia, Türkiye, and Ukraine. AE = advanced economies; CESEE = Central, Eastern, and Southeastern Europe.

Figure 7. Baseline Macroeconomic Forecast and Consumption



Sources: European Central Bank; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
 Note: CESEE excludes Belarus, Russia, Türkiye, and Ukraine. In panel 5, the figure represents the histogram of real wage growth using data between 2009:Q1 and 2024:Q1. In panel 6, household net wealth is calculated as the sum of median values from different wealth decile groups. This includes the median value of the combined 1st to 5th deciles, as well as the median values of each individual deciles from the 6th to the 10th. Other financial assets represent debt securities, listed and unlisted shares, other equity, investment fund shares, and life insurance and annuity entitlements. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economies; CESEE = Central, Eastern, and Southeastern Europe.

Figure 8. Baseline Macroeconomic Forecast and Investment
(Index, 2015 = 100)



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

Note: In panel 1, CESEE excludes Belarus, Russia, Türkiye, and Ukraine. In panel 2, CESEE includes Belarus, Russia, Türkiye, and Ukraine. AE = advanced economies; CESEE = Central, Eastern, and Southeastern Europe.

Europe's recovery path is protracted when compared with the rebound following the global financial crisis and the euro area crisis (Figure 7, panel 2). The main reasons include a slow normalization of household saving rates, subdued investment levels, and a slow rebound in labor productivity.

Rising household purchasing power is expected to only gradually feed into higher consumer spending. Although labor markets are expected to cool, they will remain sufficiently tight, especially in services, to support robust wage growth (Figure 7, panel 4). The resulting real income gains will, however, only slowly translate into higher spending. Heightened uncertainty is expected to keep saving rates elevated for precautionary reasons as the memory of the large 2020- and 2023-income shocks fades. In addition, the slow decline of interest rates under the baseline will keep investment in low-risk savings products attractive while disincentivizing debt-financed consumption. In addition, as savings are increasingly invested in less liquid financial assets, they are less quickly tapped for consumption going forward (Figure 7, panel 6). Overall, savings rates and consumption will only gradually return to prepandemic levels.

The strength of the private investment recovery is dampened by a slow easing of financial conditions and lingering uncertainty. Compared to previous recoveries, lending conditions under the baseline will improve more slowly and start from tighter conditions, leading to a drawn-out investment recovery. This effect is compounded by uncertainty about the timing and strength of a global manufacturing recovery, regional conflicts and geoeconomic fragmentation, economic policies, and the level and volatility of energy costs. The strength of these adverse developments varies across countries. Manufacturing-intensive advanced economies (for example, Germany) will see slower investment recoveries with spillovers to neighboring CESEE countries with significant trade and production ties (for example, Czech Republic, Hungary, Poland, and Slovakia). Economies with more energy-intensive production, larger construction sectors, or slower monetary easing cycles (because of high wage growth and inflation persistence) will also see more sluggish investment recoveries (Figure 8, panel 1). However, some offset is expected for 2025 from a catch-up in spending related to the Next Generation EU recovery plan, which will support government infrastructure and climate investments.

Demand spillovers from outside of Europe provide limited support. Cooling growth in the United States to about 2 percent in 2025 and weak demand for manufacturing inputs—driven by strong competition from China and other emerging market economies, along with sluggish domestic demand in China and import substitution—will provide only a limited demand impetus in the near term (October 2024 *World Economic Outlook*).

Disinflation is expected to continue, if at different speeds. Services inflation is set to steadily slow over the forecast horizon as labor markets and wage growth cools amid a cyclical uptick in labor productivity and a decline in profit margins. Overall, core price pressures are receding gradually leaving core inflation broadly stable through the end of the year, before declining materially in 2025 as wage inflation recedes. In the CESEE region where wage and services inflation are more persistent, the disinflation process is more drawn out. Along this path, inflation developments are unlikely to be smooth. Expiring subsidies or tax relief measures can lift user prices and temporarily also inflation.

Absent a Strong Reform Effort, Growth Will Remain below Its Full Potential

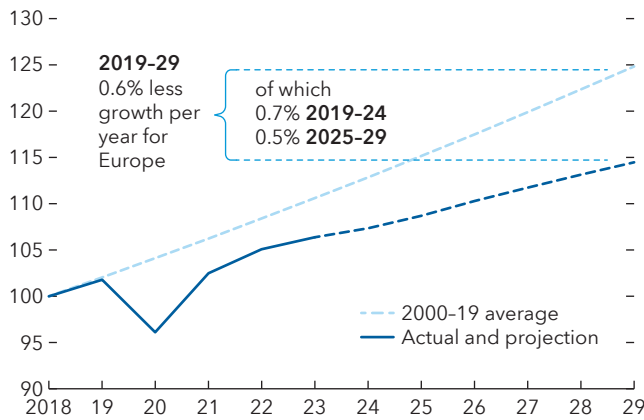
Europe's medium-term growth is projected to remain below the pre-COVID-19 forecast levels. Compared to the prepandemic period 2000-19, Europe's annual real GDP growth in the decade from 2019 to 2029 is projected to be about 0.6 percentage points lower (Figure 9, panel 1). During the crisis period 2019-24, this gap widened to 0.7 percentage points slower per year and remains substantial in the forecast—at 0.5 percentage points—for the coming five years.

A combination of structural shifts, growth impediments, and lingering uncertainties will keep growth below Europe's full potential. Across Europe, the main headwinds are as follows:

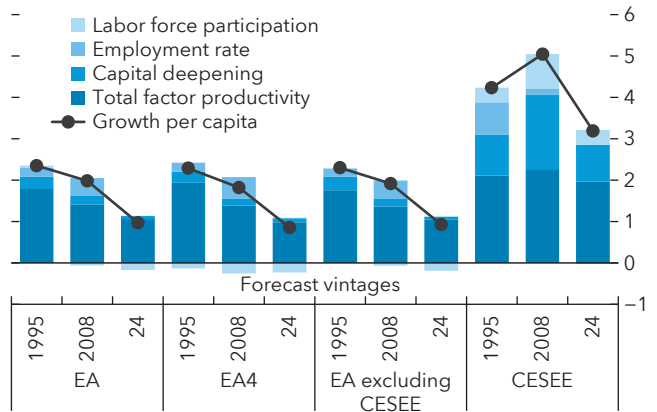
1. *Slowing labor force growth resulting from accelerating population aging* (Figure 9, panel 3). Europe's aging population constrains growth, especially in countries with a higher share of labor-intensive services (for example, Greece and Italy), but is also slowing the supply of skilled labor needed in high-productive-growth sectors (for example, tech sectors, research and development [R&D]). Steady outmigration from lower-income countries in the CESEE region could aggravate shortages of skilled labor in countries affected.
2. *Low investment rate relative to capital stock*. Uncertainties about the effects of global fragmentation and trade policies will weigh down business expectations across Europe, reducing expected returns to capital and investment. In the CESEE region, where the average capital stock remains at only about 30 percent of advanced economy levels (Figure 9, panel 4), investment will also remain constrained by bottlenecks in public infrastructure, including utilities and road transportation, and concerns about energy price volatility given higher energy intensity. Among non-EU members, weak governance and inefficient public institutions are an additional brake on inward investments. Absent further reforms, investment rates relative to GDP from domestic or foreign sources are unlikely to exceed the levels needed to reignite economic convergence, which is the catch-up effect of lower-income countries to higher-income ones (October 2024 *Regional Economic Outlook: Europe Note 2*).
3. *Low productivity growth*. Notwithstanding a temporary recovery from the very low levels seen during the COVID-19 and 2022-23 energy shock, sluggish labor productivity growth is a perennial constraint on growth. In advanced European economies, a main driver is low total factor productivity growth. Limiting factors are a small market size, less capital market funding, and an over-abundance of small and stagnating firms that are less innovative than in the United States and face less competition because of segmentation of national markets (October 2024 *Regional Economic Outlook: Europe Note 1*). Prospects for scaling-up are also hampered by uncertainty about the resilience of global supply chains, access to critical commodities, and new protectionist measures. In the CESEE region, the persistent low capital intensity of production and skill gaps further curtail productivity growth.

Figure 9. Long-Term Growth Forecast

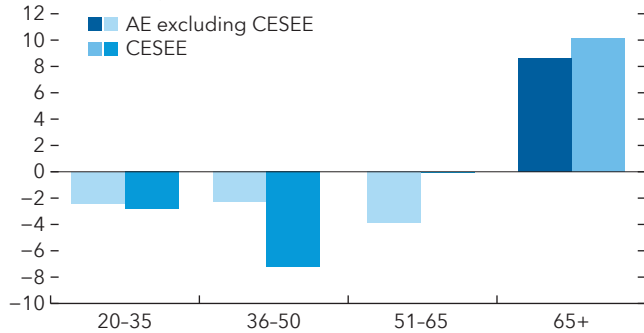
1. Real GDP in Europe
(Index, 2018 = 100)



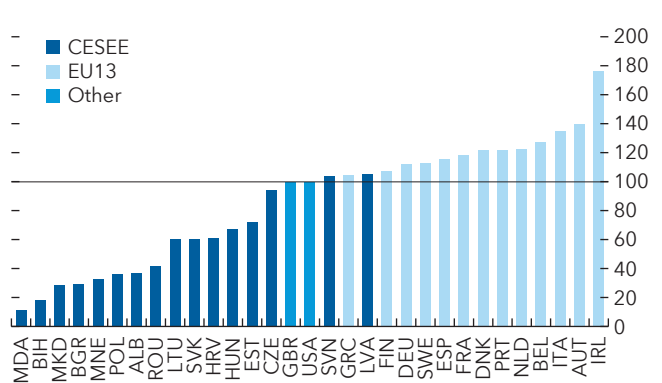
2. Five-Year-Ahead per Capita Growth Forecast Decomposition
(Percent)



3. Change in Adult Population Composition by Age Group between 2022 and 2050
(Percentage points)



4. Per Capita Capital Stock in 2023 of Selected Countries
(Percent of United States)

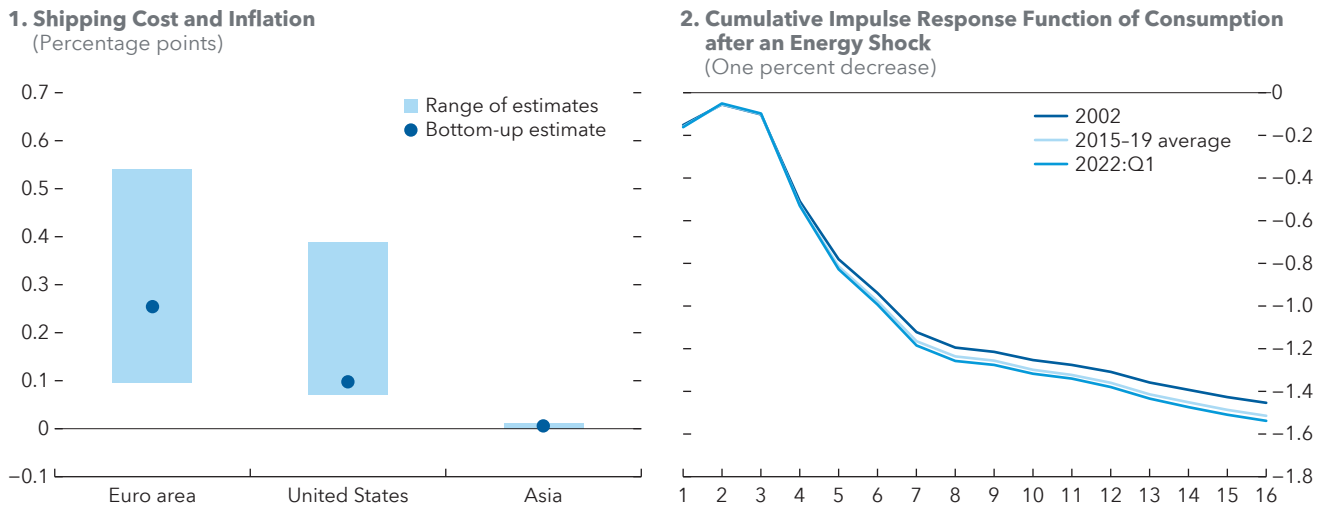


Sources: European Central Bank; Eurostat; IMF, World Economic Outlook database; Penn World Table, version 10.01; and IMF staff calculations.

Note: Countries that do not have a full range of data are excluded from the figures. CESEE excludes Belarus, Russia, Türkiye, and Ukraine. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economies; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area; EA4 = France, Germany, Italy, Spain.

Risks

Risks to the near-term outlook are biased downward. Consumers could remain more cautious and retain more of their savings than anticipated. Similarly, the effects of past monetary policy tightening could be stronger than expected—for example, through mortgage rate resets that add pressure to household budgets. Demand could also be suppressed by greater-than-expected core inflation persistence or renewed spikes in shipping costs or commodity prices—for example, due to escalation of regional conflicts, rising geopolitical tensions, or intensifying trade conflicts (Figure 10, panel 1). As such, risks materialize; they could be amplified by financial institutions—banks and nonbanks—as they adjust to rising risk premia, further declines in property prices, or crowded trades (for example, carry trades funded by short positions in low yielding currencies). On the upside, household spending and investment could pick up sooner or by a larger amount, if uncertainty about economic policies and trade tensions wanes and consumer sentiment and financial conditions improve faster than anticipated.

Figure 10. Risk to Growth and Inflation

Sources: Bloomberg Finance L.P.; Drewry; Goldman Sachs; Haver Analytics; Korea Ocean Business Corporation; and IMF staff calculations.
Note: In panel 1, estimated impact is on core inflation of changes in shipping costs in 2024 relative to 2023, assuming that shipping costs fall gradually over the remainder of 2024. Shipping costs by region are calculated by weighting the change in shipping costs on different routes by import shares using Drewry and Korea Container Composite Indices. The range of estimates uses multipliers of shipping costs to inflation from Carriere-Swallow and others (2022), Sly and others (2016), and OECD (2021). The bottom-up estimate is calculated using information on the share of shipping costs in goods prices from the World Input-Output Tables.

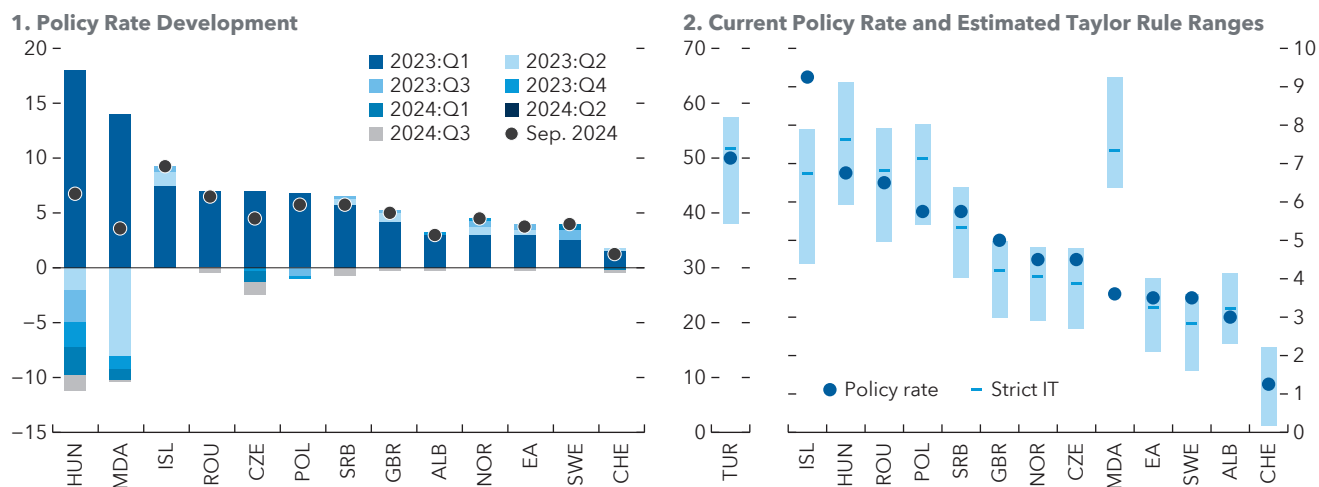
Inflation could plausibly exceed or fall below the baseline forecasts. More persistent services inflation and renewed spikes in commodity and global shipping costs could slow or reverse disinflation. Such risks are elevated in countries with higher energy intensity and where wage growth is more persistent (mainly CESEE). In most countries, firms' profit margins have declined to pre-COVID-19 levels and would be unlikely to absorb rising costs. On the other side, disinflation could happen faster, especially if the recovery is weaker (see the previous section), trade tensions ease reducing supply constraints, and short-term inflation expectations continue to decline, allowing central banks to ease sooner.

Potential growth could be even weaker if fragmentation and climate change remain untackled, although effects could vary across countries. Geopolitical tensions and an intensification of protectionist policies could lead to sharper trade and value chain decoupling than currently anticipated. Such a retrenchment would lead to less efficient production and forgone gains from trade. Similarly, deepening skepticism about advancing the single market or the pursuit of climate goals—entrenching uncertainty about the outlook—could curtail private investments, especially in R&D and new and cleaner technologies. While Europe's growth potential would be dampened in aggregate growth, individual countries could still benefit. An analysis of Europe's electrical vehicle sector dispute with China finds substantial efficiency losses notwithstanding the fact that individual countries could benefit from the relocation of some production (Hungary and Slovakia) (Box 1).

Policies: Navigate the Recovery and Push for Growth Reforms

Policymakers will need steady macro policies to help firms and households navigate a more uncertain environment. Over the near term, this means transitioning to a neutral monetary policy stance while reducing fiscal deficits without jeopardizing a smooth landing. At the same time, policymakers need to act decisively to lift Europe's growth potential.

Figure 11. Monetary Policy
(Percent)



Sources: Consensus Economics; Haver Analytics; IMF, World Economic Outlook database; national central banks; and IMF staff calculations. Note: In panel 1, for Hungary, the policy rate shows overnight interbank offer rate (BUBOR). Panel 2 compares the current nominal policy rate to an estimated range of rates consistent with a Taylor-type rule, allowing for uncertainty about the neutral rate of interest, and different central bank reaction functions (April 2023 *Regional Economic Outlook: Europe*). For illustrative purposes, the “Strict IT” lines indicate a Taylor rule rate for the hypothetical case where the central bank responds to inflation deviations from target, but not to changes in the output gap. This rule does not necessarily reflect the optimal simple policy rule or central bank mandates. The Central Bank of the Republic of Türkiye uses various quantitative and macroprudential rules as part of its monetary policy regime that are not taken into account here. Moldova absorbs liquidity by high reserve requirements, rendering the monetary policy stance tighter than suggested by the policy rate. Euro area policy rate refers to refinancing operations rate. Data labels in the figure use International Organization for Standardization (ISO) country codes. EA = euro area; IT = inflation targeting.

Monetary Policy: Steady Hands Needed

Monetary policy has appropriately started to ease (Figure 11, panel 1). However, current real rates in some countries remain above their neutral levels (Figure 11, panel 2). A still-restrictive stance is warranted, given our forecast of gradually receding inflationary pressure—and in the CESEE region high inflation persistence—and expectations of a bumpy “last mile.” In countries where inflation is expected to soon be close to the target, a smooth loosening path through 2025 that will lower real rates toward neutral levels would strike a balance between keeping expectations anchored and avoiding an inflation undershoot (for example, euro area). Some countries, where inflation is already back to target and output gap are negative, have appropriately started to ease earlier than others and should continue to ease their monetary policy stance balancing risks to inflation and output (for example, Sweden and Switzerland). In countries where inflation is still further above target or approaching it slowly, there is limited scope for further rate reductions in 2024 (for example, Hungary, Romania, Serbia, and Russia). Maintaining a tight monetary stance can be consistent with a gradual reduction in nominal policy rates if inflation and expectations are declining toward the target, implying a rise in the real interest rate.

Policy decisions can gradually become more inflation-forecast driven. In many countries, inflation is approaching its target and uncertainties surrounding the disinflation path are receding. In this context, policy decisions should transition from closing observed inflation gaps to calibrating rate paths that deliver a timely and successful return to target, relying increasingly on forecasts rather than current data (ECB 2024b). That said, central banks should remain on the lookout for significant surprises in the course of inflation or its drivers—such as wage growth, size of profits buffers, strength of monetary transmission, and inflation expectation—and adjust the monetary stance accordingly.

- In many advanced economies, downward policy rate paths should be calibrated to provide sufficient flexibility, allowing for a slower pace of rate cuts in response to significant upside inflation developments or shocks, while

also providing protection against large deflation shocks through quicker rate reductions if growth and inflation slow materially. Management of risks remains essential during the current period of uncertainty, with scenario analysis and contingent action plans serving as useful analytical and communication tools (for example, Bank of England; Bernanke 2024). In the euro area and the United Kingdom, normalization of central banks' balance sheets should continue while minimizing its distortion on the intended monetary policy stance.

- In CESEE, a data-dependent and meeting-by-meeting approach remains appropriate, especially where inflation is still further away from targets. Given higher inflation persistence, monetary policy needs to internalize still-asymmetric risks to inflation, especially where wage growth remains strong and could feed into services prices (Hungary, Poland, Romania, Serbia, and Russia). A premature or rapid easing in such an environment could de-anchor inflation expectations. This calls for a cautious risk-management approach to monetary easing to avoid further tightening and a sharper economic downturn later (Gopinath 2024; Gudmundsson, Jackson, and Portillo 2024). In Türkiye, a tight monetary policy stance remains appropriate to facilitate a faster re-anchoring of inflation expectations and prevent possible disinflation derailing.

Central banks will have to approach the end of the easing cycle with care. Under the baseline, real interest rates in many countries should approach the real neutral rate— r^* , the rate consistent with the economy maintaining full employment with associated price stability—in 2025 or 2026. However, estimates of the neutral rate are even more uncertain than usual (Box 2). Some of the downside risks to r^* are an upward shift in saving rates and low productivity levels. Conversely, higher long-term public spending needs, including on defense and climate change, could imply higher neutral rates. In addition, lingering effects of the COVID-19 pandemic and energy crises and the uncertain effects of fragmentation have made structural relationships among macroeconomic variables less stable, possibly affecting monetary policy transmission. As a consequence, central banks will have to be ready to adjust the terminal rate of the current easing cycle with an eye on economic and inflation outcomes.

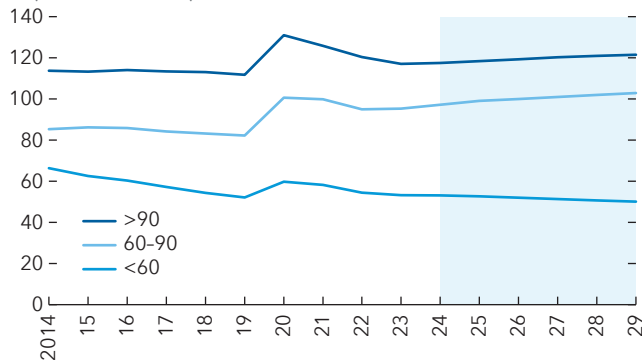
Fiscal Policy: Secure Sustainability, Build Buffers, and Prioritize

Public debt has risen substantially since 2020 as governments stepped up to meet the needs of consecutive crises. In advanced European economies, the debt-to-GDP ratio in 2023 reached 84 percent, about 5 percentage points of GDP higher than in 2019, with the largest increases observed in medium-debt countries (United Kingdom, Austria, and Finland) (Figure 12, panel 1). Debt-to-GDP ratios also increased substantially in CESEE countries by 7 percentage points, with the largest increase in medium-debt-level countries (Slovakia and Poland) (Figure 12, panel 2). Over the medium term, while debt levels are expected to level off slowly, the number of CESEE countries classified within the high-debt group is increasing (Figure 12, panels 3 and 4). Sustained high levels of debt pose risks to fiscal sustainability particularly as nominal growth remains weak under the baseline.

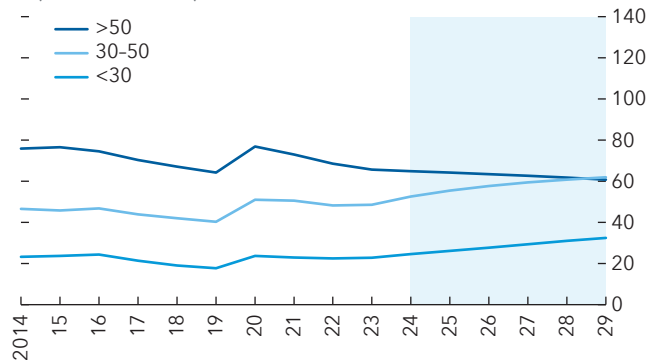
A fiscal policy pivot is under way. Fiscal policy is projected to appropriately tighten in 2024; although consolidation is proceeding more slowly among CESEE countries with elections in many, high interest bills, and high inflation-linked spendings. In advanced economies, the cyclically adjusted primary balance (CAPB)—a measure of the underlying fiscal adjustment effort after excluding interest payments—is expected to improve by 0.8 percentage point this year, up from a deterioration of 0.4 percentage point in 2023. Around two-thirds of euro area countries are implementing discretionary fiscal tightening, including all high-debt countries. In CESEE, the CAPB is slightly deteriorating in 2024 before improving from 2025 (Figure 12, panel 5). In Romania, the deficit is projected to reach almost 8 percent of GDP in 2024 due to spending slippages, despite solid GDP growth. Under current fiscal plans, the deficit ratio in CESEE countries would remain above the debt stabilizing level over the medium term. Lower fiscal cost of energy measures create some savings, but are offset by other spending needs such as defense-, aging population-, and climate change-related expenditures (for example, Poland, Romania, Czech Republic, Slovakia, Albania, and Baltics).

Figure 12. Public Debt and Fiscal Policy

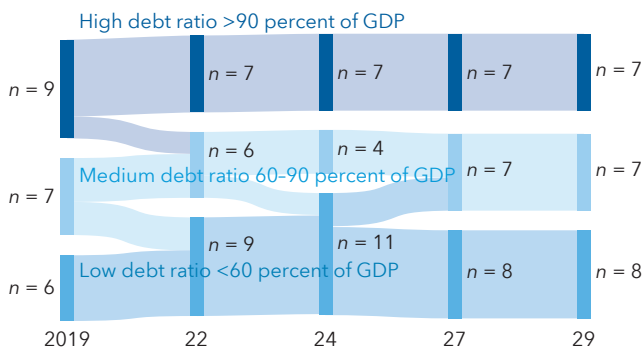
1. Public Debt of Advanced Economies
(Percent of GDP)



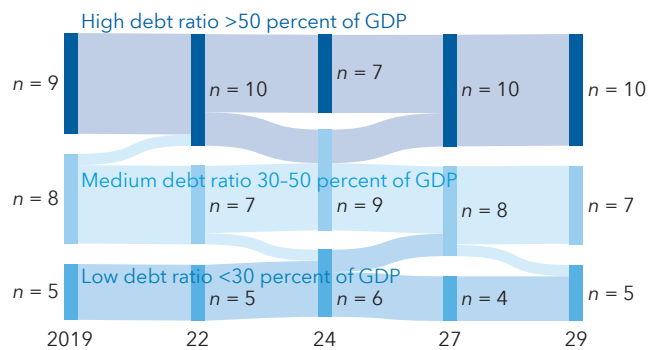
2. Public Debt of CESEE
(Percent of GDP)



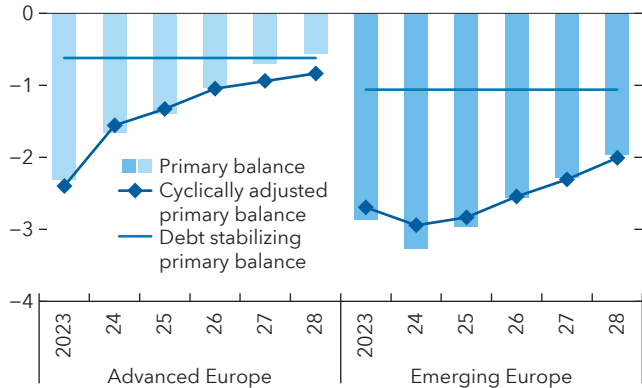
3. Debt Groupings in Advanced Economies 2019-29
(Number of countries)



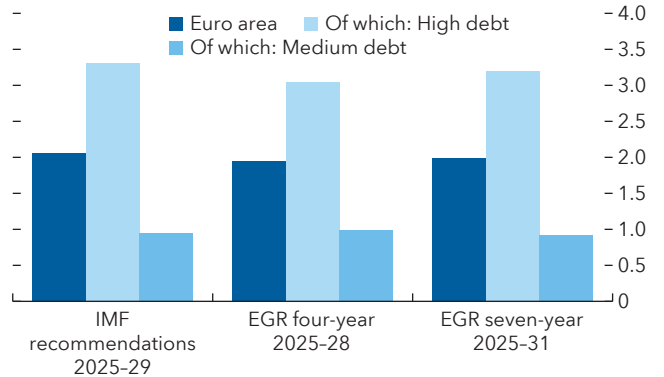
4. Debt Groupings in CESEE 2019-29
(Number of countries)



5. Fiscal Balance
(Percent of GDP)



6. Cumulative Fiscal Adjustment
(Percent of potential GDP)



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

Note: In panels 1 and 2, the debt-level range group is identified by the 2019 general government debt-to-GDP ratio. The aggregate of each group is calculated using purchasing power parity GDP weights. Panel 5 shows aggregate using purchasing power parity weights. Debt stabilizing primary balance is calculated using 2026 projections. Emerging Europe excludes Belarus, Moldova, Montenegro, Russia, Türkiye, and Ukraine. Data labels use International Organization for Standardization (ISO) country codes. CESEE = Central, Eastern, and Southeastern Europe; EGR = European Governance Review.

The EU's new fiscal framework should be implemented as intended. The framework serves as a fiscal anchor for the EU and if effectively implemented by member states, will ensure long-term sustainability while balancing debt reduction and investment needs. With 17 of 27 member states currently exceeding the framework's debt and deficit benchmarks, significant fiscal adjustments are likely required (Figure 12, panel 6), particularly for high-debt nations (for example, Italy, France, Spain, and Belgium). Adherence to the new rules is critical to establish the framework's credibility and reduce economically costly uncertainty about debt sustainability concerns, which will lower sovereign risk premia, and enhance ability to deal with future economic shocks and spending needs. Effective implementation relies on strong domestic medium-term budgetary frameworks and public financial management systems that align with the EU's fiscal rules.

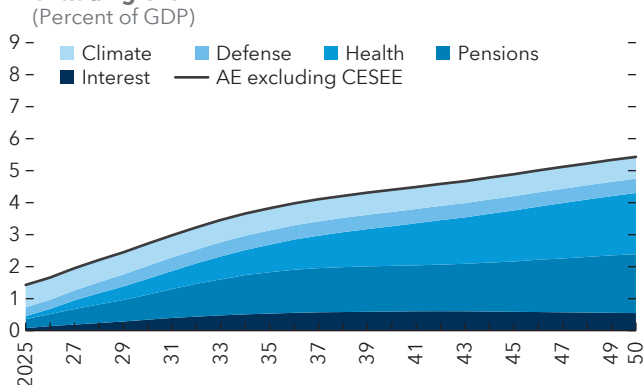
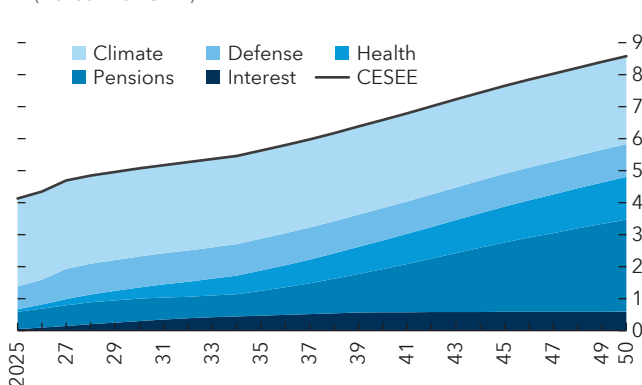
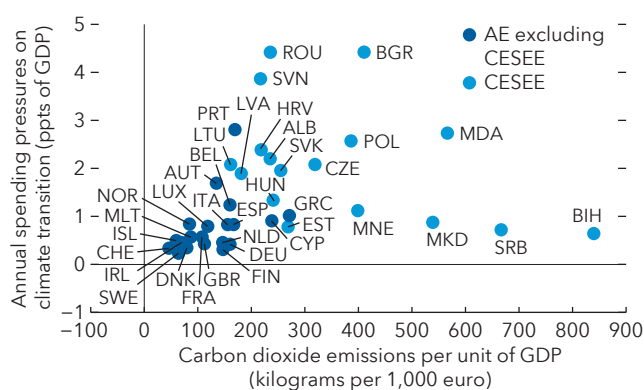
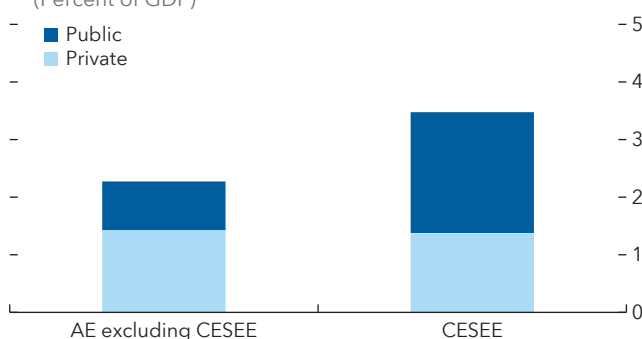
Fiscal consolidation should be more front-loaded. For EU countries with high debt, and where output gaps are small, faster consolidation than the linear adjustment assumed under the EU's governance framework would help strengthen market confidence and reduce the risks of slippages due to waning political will. For countries outside the EU—especially in some Western Balkan states—ambitious near-term fiscal adjustment would lower fiscal risks given weaker institutions and often less well-established fiscal policy track records. Adjustment plans should be embedded in a medium-term fiscal framework with concrete fiscal objectives, to strengthen policy credibility and minimize negative growth effects of fiscal adjustment.

The fiscal paths should take into account large and increasing spending pressures (Figure 13, panels 1 and 2). The new EU fiscal rules internalize long-term aging-related health care and pension costs, and require countries to take those into account when formulating medium-term fiscal strategies. In addition, policymakers have identified increasing defense spending needs. Substantial upfront investments are also necessary to fulfill climate transition goals. In the CESEE region, climate spending needs are particularly large, given a higher carbon intensity and a larger share of public ownership in electricity generation (Figure 13, panels 3 and 4). By 2050, these expenditures are estimated to constitute 5.7 percent of GDP in advanced European economies and 8.1 percent of GDP in CESEEs. These new long-term costs are in addition and not explicitly accounted in the EU-wide fiscal rule. Countries should assess the size of emerging expenditure pressure and plan how to address them through policy adjustments now or in the future.

Managing the necessary fiscal adjustment while addressing rising expenditure needs requires spending prioritization and structural fiscal reforms. In the near term, to protect the recovery, fiscal adjustment should prioritize low fiscal multiplier items—for example, removal of hiring subsidies and tax measures benefiting high-income households. However, over time fiscal reforms need to promote active reallocations of existing spending programs to reflect current policy priorities, as well as create savings from higher spending efficiency, better targeting, and enhance revenue mobilization by broadening the tax base, closing tax gaps, and improving digitization in revenue administration. Many countries could benefit from strengthening the budget preparation process to balance difficult priority trade-offs among competing spending objectives. Improved expenditure efficiency could be achieved through results-based management, incentives for administrative efficiency, and better budget prioritization of transfer programs. For instance, transforming broad-based support measures (such as blanket energy crisis support measures) into needs-based program would free up resources that could be used for deficit reduction and priority spendings such as infrastructure investment and labor upskilling and reskilling. In CESEE countries—especially those outside the EU—fiscal room could be created through broadening of tax bases, a more balanced tax structure, and improved tax policy design (Albania, Bosnia and Herzegovina, Serbia, and Moldova).

Financial Sector Policy: A Watchful Eye on Downside Pressures

Risks to financial stability have improved, but credit and market risks are likely to remain elevated even under the baseline recovery. The recovery in incomes and activity is relieving the pressure on businesses and households. Nonetheless, the only gradually easing financial conditions will keep debt service costs elevated, as existing debt is rolled over at higher rates. This creates challenges for corporations, especially for those with lower

Figure 13. Expenditure Pressures**1. Additional Spending Pressures: Advanced Economies excluding CESEE**
(Percent of GDP)**2. Additional Spending Pressures: CESEE**
(Percent of GDP)**3. Spending Pressures and Fossil Fuel Dependence****4. Climate Spending Pressures by 2050**
(Percent of GDP)

Sources: European Commission; European Investment Bank; Eurostat; IMF, World Economic Outlook database; and IMF staff estimates and projections.

Note: Annual spending pressures are beyond baseline. Baseline level: defense spending 2021–22, health and pensions 2023, and interest at constant interest rate. Climate transition is at 2011–20 levels. Weighted by GDP. CESEE excludes Belarus, Israel, Kosovo, Russia, Türkiye, and Ukraine. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economies; CESEE = Central, Eastern, and Southeastern Europe.

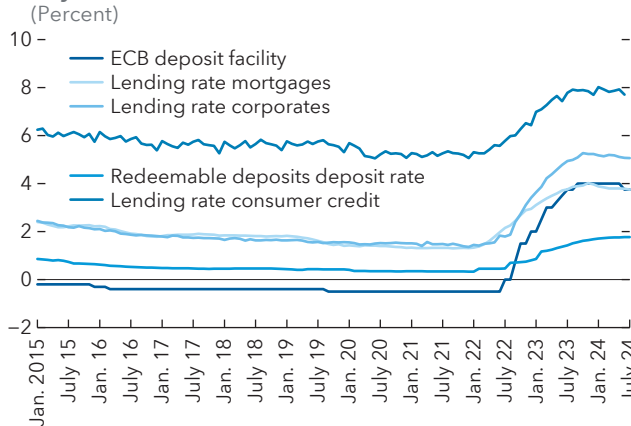
credit ratings. Vulnerable households—particularly those with lower incomes or in regions predominantly using floating-rate mortgage lending (Figure 14, panel 1)—are also at risk (ECB 2024a). Furthermore, the downturn in property markets, especially in commercial real estate, could lower the asset quality of some banks (Figure 14, panel 2).

Banks have ample capital buffers but should nonetheless prepare for vulnerabilities in a downside scenario. Large profits in the past year have bolstered bank reserves and resilience to credit risks. Buffers are unlikely to grow further as this process, typical during a tightening period, has passed its peak. In addition to exposures to private credit and real estate (October 2023 *Regional Economic Outlook: Europe*), banks have significant direct exposures to their home sovereigns' debt, particularly in central and eastern Europe. Such exposures could turn into vulnerabilities in a scenario where growth moderates, corporate defaults rise, and sovereign risk premia rise (Figure 14, panel 4).

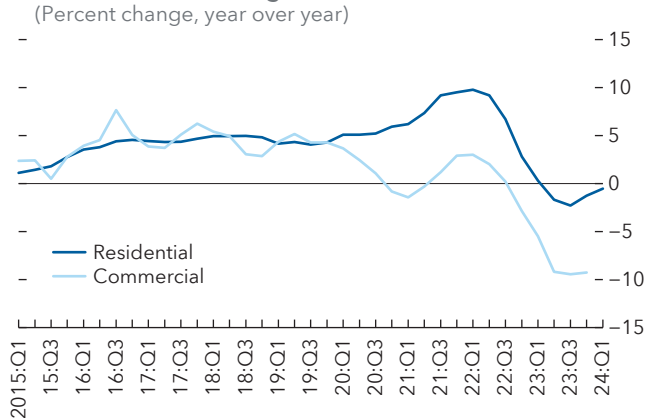
Nonbank financial intermediaries (NBFIs) can amplify market stress and need attention. The significant interconnectedness of NBFIs—predominantly investment funds exposed to high liquidity risk from potential investor redemptions—is a potential source of contagion. In addition to common exposures on the investment side including from commercial real estate, banks' non-core funding is highly reliant on NBFIs, which account for

Figure 14. Financial Sector

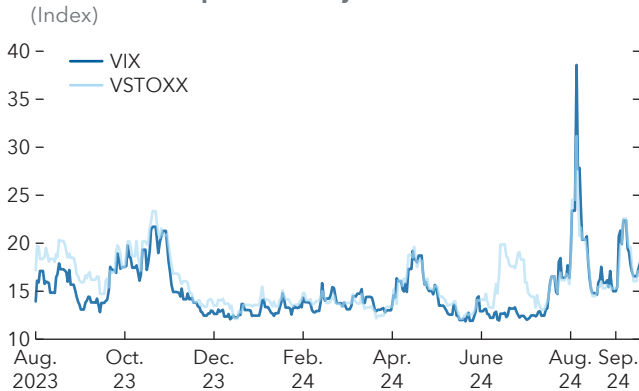
1. Key Interest Rates



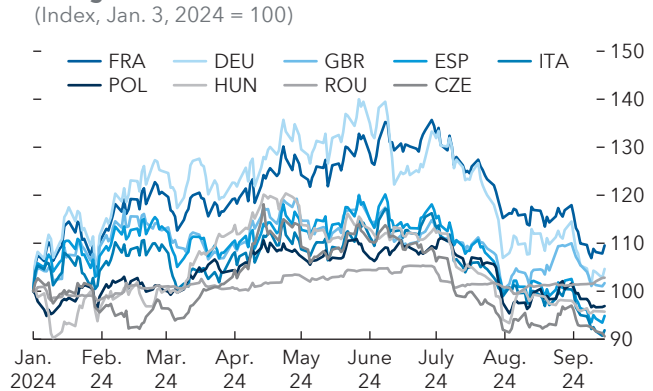
2. Real Estate Price Change



3. Stock Market Implied Volatility



4. Change in Five-Year Government Bond Yields



Sources: Bloomberg Finance L.P.; European Central Bank; Haver Analytics; and IMF staff calculations.
 Note: Data labels in the figure use International Organization for Standardization (ISO) country codes. ECB = European Central Bank ; VIX = Chicago Board Options Exchange Volatility Index; VSTOXX = EURO STOXX 50® Volatility Index.

roughly half of the repo funding to banks in the euro area, most of it short term (largely overnight) and backed by government bonds. Substantial interest-rate derivative exposures can also amplify adverse shocks through collateral and margin calls, triggering feedback loops which lead to market-wide stress (for example, UK pension funds in 2022). Nonbank-oriented macroprudential tools, such as restrictions on leverage and the ability of funds or regulators to suspend investor withdrawals, should be further developed. In addition, policymakers should tackle data gaps and enhance data sharing among financial oversight agencies. This would significantly strengthen the capacity to monitor and assess risks throughout the financial sector. Other priorities remain to incentivize risk management by NBFIs, set appropriate regulation, and intensify supervision, with a framework for central bank liquidity support subject to carefully laid guardrails (April 2023 *Global Financial Stability Report* Chapter 2).

Macroprudential policy can preempt potential pressures in the banking sector. Although the overall level of capital requirements is adequate under the baseline outlook, continued tight macroprudential policy can strengthen the capacity of the banking sector to deal with rising credit defaults or a repricing of assets. Implementing positive neutral countercyclical capital buffers is not expected to restrict credit supply given bank profitability at the current juncture. However, higher buffers would help banks maintain the flow of lending if profits moderate and non-performing loans rise more than expected later in the credit cycle. In addition, a tightening of macroprudential policy could lower downside risks to growth as financial conditions loosen, especially during periods

of macro-market disconnect (October 2024 *Global Financial Stability Report*). Banks' substantial commercial real estate portfolios need continued monitoring. Where appropriate, supervisors should deploy sectoral systemic risk buffers or adjust risk weights to mitigate stress from the segment, while containing migration of risks to NBFIs (October 2023 *Regional Economic Outlook: Europe*).

Structural Policies: Single Market Key to Europe's Full Growth Potential

Europe's productivity gap with the global frontier can be traced back to a more limited market size, capital market constraints, skilled labor shortages, and stalled structural reforms. Firm-data analysis (Box 3) shows that Europe's segmented good and services markets are keeping businesses from becoming larger, spending more on R&D, and exploiting economies of scale. Moreover, fragmented capital markets mean that firms do not draw enough on equity financing. As a result, business dynamics are dampened especially in the services sector where start-ups tend to operate with large intangible capital. Business formation is also hampered by shortages of skilled labor. Another headwind to productivity growth is stalled structural reforms. Emerging European countries which have benefited from an opening of factor and product markets in the past have undertaken fewer reforms post-2004 EU accession which likely contributed to the slowing of convergence in the last decade (Box 4).

There is widespread agreement on the sources of Europe's growth weakness. Recently released expert studies (Letta 2024; Draghi 2024) come to a similar conclusion that Europe's low productivity is related to lack of market depth and scale. Both reports link Europe's lack of competitiveness to Europe's incomplete single market in the trade of goods, services, and factors of production (capital, labor). Remaining barriers are considered to be still substantial and have resulted in less investment and innovation than necessary to accelerate growth and productivity to levels seen in other advanced regions.

A deeper and larger single market offers the potential for a resurgence in productivity growth. European integration delivered tangible growth benefits in the past and could do so again. Following the two EU enlargement waves in 1995 and 2004, EU member countries began trading more with each other (Figure 15, panel 1). As a consequence, in the decade following accession, regions in new member states saw on average GDP per capita rise by more than 30 percent relative to comparable non-accession regions and existing member states gained too.

It is important to note that regions within Europe that were better integrated through value chains and transport networks registered higher gains. However, value chain integration has stalled since the last decade (Figure 15, panels 2 and 3), and substantial barriers to goods and trade flows remain (Figure 15, panel 4). New IMF analysis finds that in 2020 trade costs within Europe were equivalent to a sizable ad-valorem tariff of 44 percent for the average manufacturing sector compared to 15 percent between US states, and as high as 110 percent in the case of services sectors (October 2024 *Regional Economic Outlook: Europe Note 1*). A particular problem is the substantial domestic barriers to entry in services in several countries (Figure 15, panel 5).

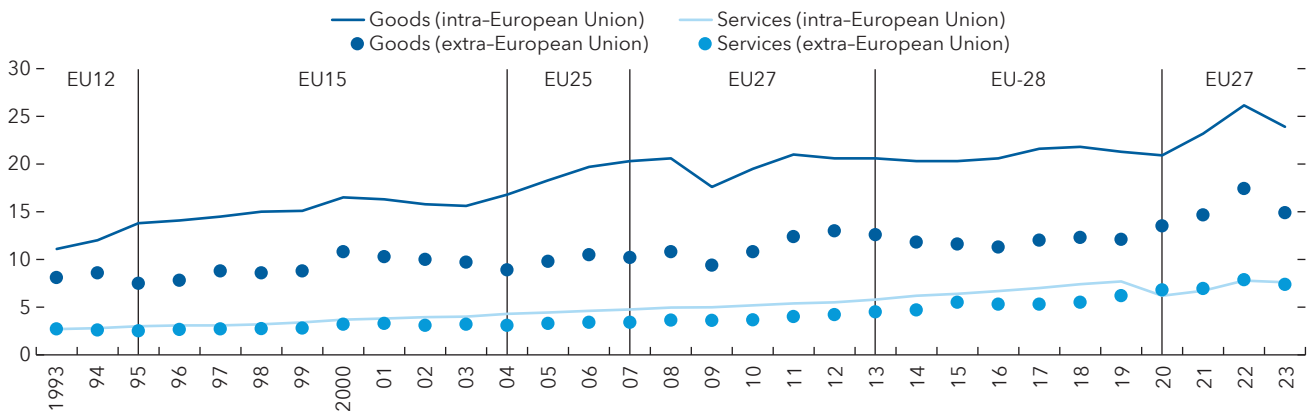
Reform priorities at the European level include removing barriers and advancing the capital market and banking union.

- *Leveling all remaining barriers to a fully functioning single market for goods and services:* Key measures are opening up protected sectors, such as financial services, telecommunications, and electricity to more foreign competitors; improvements in border infrastructure; and harmonized rules for businesses operating in different jurisdictions such as a common 28th corporate regime. These measures would reduce trade costs and increase the benefits of scale.
- *Advancing capital markets and banking union:* Developing a single market for financial services is particularly important to help increase financing for riskier but potentially high-productive investments while lowering costs of cross-border lending and foreign investment. Concrete measures include completing the European Single Access Point, an online repository for corporate financial information, reviewing

Figure 15. European Economic Integration and Scope for Deepening the Simple Market

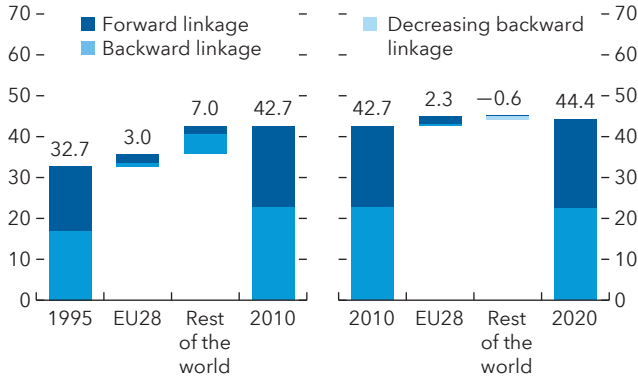
1. Intra- and Extra-EU Trade in the European Union

(Average of exports and imports as share of total EU GDP)



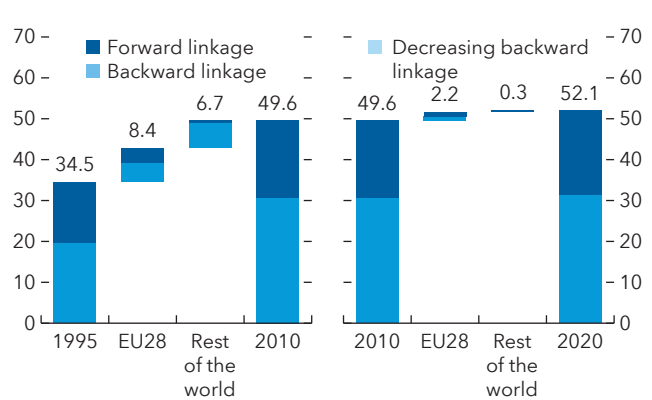
2. Value Chain Linkages in Advanced Economies excluding CESEE

(Percent of total economy gross exports)



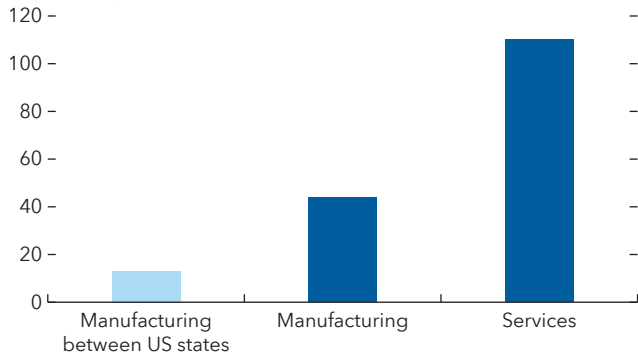
3. Value Chain Linkages in CESEE

(Percent of total economy gross exports)



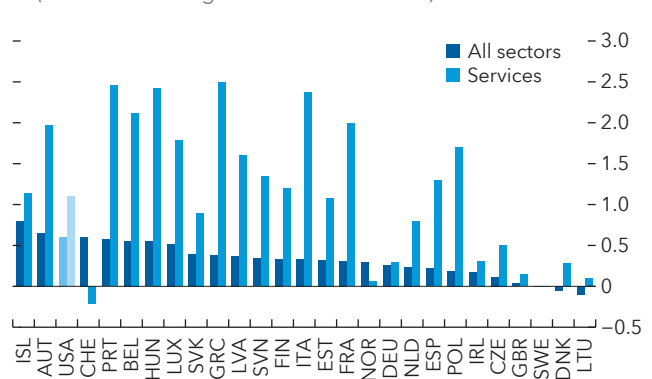
4. Remaining Barriers to EU Internal Trade: 2020 Tariff Equivalent

(Percent)



5. Barriers to Entry

(Relative to average of five best in OECD)



Sources: European Central Bank; European Commission (2024); Eurostat; Head and Mayer (2021); OECD; TiVA; and IMF staff calculations. Note: In panel 1, the vertical lines represent the changing composition of EU countries. In panel 5, estimates are based on a gravity model of bilateral and internal trade flows. CESEE excludes Belarus, Russia, Türkiye, and Ukraine. Data labels in the figure use International Organization for Standardization (ISO) country codes. CESEE = Central, Eastern, and Southeastern Europe; EU12 = Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, and the United Kingdom; EU15 = EU12, Austria, Finland, and Sweden; EU25 = EU15, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, and Slovenia; EU27 = EU25, Bulgaria, and Romania; EU28 = EU27 and Croatia; EU27 after 2020 = EU28 excluding the United Kingdom. OECD = Organisation for Economic Co-operation and Development.

Solvency II with the aims to enhancing long-term and equity financing from insurance companies, harmonization of insolvency procedures, greater portability of pension products, streamlining cross-border withholding taxes procedures, fostering supervisory convergence, and centralizing oversight of systemic financial market infrastructures (Bhatia and others 2019). The Common Market Deposit Insurance reform proposed by the Commission in April 2023 will further enhance crisis preparedness, and its successful implementation will improve the efficiency of the bank resolution process and harmonize the framework across the EU.

In addition, EU Funds should boost public investment and support structural change. Support for non-EU countries should aim at boosting economic growth and accelerating convergence:

- *The fiscal capacity at the EU level should be more strategically aligned to support the provision of common public goods.* About 60 percent of the current EU budget goes to the Common Agricultural Policy and cohesion funds, which finance a broad array of investments in poorer regions in EU countries that contributed to fast growth convergence. Looking ahead, the next EU budget should focus on shared challenges. Examples are investments in connectivity infrastructure for transportation, energy and digital communication, and climate adaptation and R&D spending, which could create substantial cost savings and the generation of positive externalities. An EU Climate and Energy Security Facility could help deliver the EU's climate and energy security goals in a cost effective manner and help accelerate the green transition by pooling resources and coordinating investments at the European level (Dolphin and others 2024).
- *Actions are needed to overcome implementation bottlenecks and delayed reforms under Next Generation EU and Recovery and Resilience Facility.* Despite initial rapid disbursement, the pace of Recovery and Resilience Facility funding has decelerated, with only 40 percent of its resources deployed as of May 2024. At the EU level, addressing the issues would require improving absorptive capacity through better coordination at all government levels, streamlining administrative processes, while maintaining the highest standards of using the funds for growth-enhancing reforms and investments. At the recipient country level, tackling political challenges related to reform implementation and improving administrative capacity would enhance policy predictability and unlock EU financing. Clear communication, raising awareness for the necessity of reforms, and thorough consultations with all stakeholders are essential for successful reform implementation (October 2024 *World Economic Outlook*). The use of EU funds could also be used to catalyze structural reforms, which in the past have generated strong growth benefits in CESEE countries (Box 4).

Measures at the European level must be complemented by strong domestic reform efforts. Market entry costs are still high. Firms that manage to enter markets in other European countries are typically larger than entrants in US markets, pointing to higher barriers to entry and scope for easing administrative barriers. Addressing skill shortages through more fluid labor markets is another priority item. Labor market regulations should protect workers and move away from protecting specific jobs. During unemployment spells, workers should receive adequate benefits, training, and job search support. Such a system has been successfully implemented in Denmark. Finally, to incentivize firm growth and attract private investment, firm size-based tax and regulatory incentives should be made temporary, governance reforms accelerated—where institutions are weak—and education spending raised.

Targeted industrial policies have some role to play in certain circumstances, such as R&D and development of green technologies. While the heightened geoeconomic fragmentation and geopolitical tensions have raised concerns about the resilience of supply chains and economic security, it is important to get industry policy right. For example, subsidies can be desirable when they address a clearly identified market failure and less-distortionary interventions do not deliver the desired outcome. This can be the case for basic R&D, adoption of early-stage green technologies, supply-chain resilience, and strategic public goods such as defense. As a general rule, within a strengthened single market, reliance on industrial policies should be restricted to addressing market failures, narrowly targeted, well-designed and time bound, and avoid negative cross-border spillovers. Preserving a level playing field in the single market and remaining consistent with the World Trade Organization's rules must be key priorities.

The EU should be particularly wary of national policies that could fray the single market. State aid may benefit some firms only at the expense of other businesses (Brandao-Marques and Toprak forthcoming) and potentially all consumers. There is also evidence that subsidies implemented by EU members distort trade within the EU. In particular, to the extent that subsidies lift exports, this effect predominantly stems from exports to other EU countries (Rotunno and Ruta 2024). These findings underscore the need to design state aid in a coordinated manner at the EU level. Relaxed state aid rules should not distort the single market in favor of certain countries that can spend larger sums on state aid, and it is important to consider the potential spillover effect on both EU and non-EU countries.

Engagement on pressing global issues should be sustained. The EU has increased its *climate mitigation* ambitions and should continue progressing toward its climate objectives, to enhance energy security. Europe has set ambitious climate goals that will help prevent the most severe global warming outcomes. Latest estimates of the macroeconomic impact of climate change are six times larger than previously documented (Bilal and Känzig 2024). In this context, maintaining these ambitious goals seems crucial. The transition to a greener economy may, at the same time, require short- to medium-term adjustments. Protecting globally maturing technologies from foreign competition, as in the case of electric vehicles, can be detrimental to growth while also undermining the climate goals. Europe should instead rely on policies that ease growth-climate trade-offs. A pro-competition package should continue to uphold a strong commitment to carbon pricing, and support the development and adoption of *early-stage* clean technologies. Clarity on the path toward decarbonization, including around interim objectives and associated regulations, would strengthen firms' incentives to invest and innovate (Kalantzis, Revoltella, and Gatti 2024). Finally, the EU should also lend its voice to reforms by the World Trade Organization to strengthen international collaboration and to settle trade disputes within a robust multilateral trade system.

References

- Amendolagine, Vito, Francesco Prota, and Laura Serlenga. 2024. "The Impact of European Cohesion Policy: A Spatial Perspective." *Journal of Economic Geography* 24 (4): 477-94.
- Arnold, Nathaniel G., Guillaume Claveres, and Jan Frie. 2024. "Stepping Up Venture Capital to Finance Innovation in Europe." IMF Working Paper No. 2024/146, International Monetary Fund, Washington, DC.
- Baker, Scott R., Nicholas Bloom, and Steven J. Davis. 2016. "Measuring Economic Policy Uncertainty." *The Quarterly Journal of Economics* 131 (4): 1593-636.
- Bernanke, B. S. 2024. "Forecasting for Monetary Policy Making and Communication at the Bank of England: A Review." Review Report for Bank of England, London, United Kingdom.
- Bhatia, Ashok Vir, Srobona Mitra, Anke Weber, Shekhar Aiyar, Luiza Antoun de Almeida, Cristina Cuervo, Andre O Santos, and Tryggvi Gudmundsson. 2019. "A Capital Market Union for Europe." IMF Staff Discussion Notes No. 2019/007, International Monetary Fund, Washington, DC.
- Bilal, Adrien, and Diego R. Känzig. 2024. "The Macroeconomic Impact of Climate Change: Global vs. Local Temperature." NBER Working Paper No. 32450, National Bureau of Economic Research, Cambridge, MA.
- Borraccia, Giovanni, Raphael A. Espinoza, Vincenzo Guzzo, Romain Lafarguette, Fuda Jiang, Vina Nguyen, Miguel A. Segoviano, and Philippe Wingender. 2023. "Financial Conditions in Europe: Dynamics, Drivers, and Macroeconomic Implications." IMF Working Paper 2023/2019, International Monetary Fund, Washington, DC.
- Brand, Claus, Noémie Lisack, and Falk Mazelis. 2024. "Estimates of the Natural Interest Rate for the Euro Area: An Update." ECB Bulletin 2024/1, European Central Bank, Frankfurt am Main, Germany.

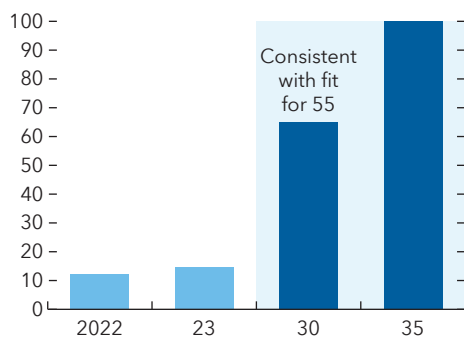
- Brandao-Marques, Luis and Hasan Halit Toprak. Forthcoming. "Impact of State Aid on Firm Performance and the Single Market in the European Union." IMF Working Paper, International Monetary Fund, Washington, DC. Carriere-Swallow, Yan, Pragyan Deb, Davide Furceri, Daniel Jimenez, and Jonathan David Ostry. 2022. "Shipping Costs and Inflation." IMF Working Paper No. 2022/061, International Monetary Fund, Washington, DC.
- Dolphin, Geoffroy, Romain A. Duval, Hugo Rojas-Romagosa, and Galen Sher. 2024. "The Energy Security Gains from Strengthening Europe's Climate Action." IMF Departmental Paper No 2024/005, International Monetary Fund, Washington, DC.
- Draghi, Mario. 2024. "The Future of European Competitiveness." European Commission Report.
- Engbom, Niklas. 2019. "Firm and Worker Dynamics in an Aging Labor Market." Working Paper 756, Federal Reserve Bank of Minneapolis, Minneapolis, MN.
- European Central Bank (ECB). 2024a. "Financial Stability Review." Frankfurt, May.
- European Central Bank (ECB). 2024b. "Monetary Policy in an Unusual Cycle: The Risks, the Path and the Costs." Speech by Christine Lagarde. Frankfurt, May.
- European Central Bank (ECB). 2024c. "Update on Economic, Financial and Monetary Developments." Economic Bulletin Issue 1, Frankfurt, May.
- European Commission. 2024. "The 2024 Annual Single Market and Competitiveness Report." Brussels, Belgium.
- Gopinath, Gita. 2024. "Navigating Fragmentation, Conflict, and Large Shocks." Speech delivered at the NBU-NBP Annual Research Conference, Kyiv, Ukraine. .
- Gudmundsson, Tryggvi, Chris Jackson, and Rafael A. Portillo. 2024. "The Shifting and Steepening of Phillips Curves during the Pandemic Recovery: International Evidence and Some Theory." International Monetary Fund Working Paper No. 2024/007, International Monetary Fund, Washington, DC.
- Head, Keith, and Thierry Mayer. 2021. "The United States of Europe: A Gravity Model Evaluation of the Four Freedoms." *Journal of Economic Perspectives* 35 (2): 23–48.
- Hong, Gee Hee, Shikun (Barry) Ke, and Anh D. M. Nguyen. 2024. "The Economic Impact of Fiscal Policy Uncertainty: Evidence from a New Cross-Country Database." IMF Working Paper, International Monetary Fund, Washington, DC.
- Hopenhayn, Hugo, Julian Neira, and Rish Singhanian. 2022. "From Population Growth to Firm Demographics: Implications for Concentration, Entrepreneurship and the Labor Share." *Econometrica* 90: 1879–914.
- International Monetary Fund (IMF). 2024. "Euro Area Policies: 2024 Article IV Consultation—Press Release; Staff Report; And Statement by the Executive Director for Euro Area." IMF Country Report No. 2024/248, International Monetary Fund, Washington, DC.
- Kalantzis, Fotios, Debora Revoltella, and Matteo Gatti. 2024. "How Do EU Firms Cope with the Energy Transition in Times of Uncertainty and High Energy Prices?" Evidence from EIBIS. EIB Working Paper Series (forthcoming).
- Letta, Enrico. 2024. "Much More Than a Market." Report presented to the European Council on 18 April 2024, Séverine Waterbley.
- Lundberg, Scott and Su-In Lee. 2017. "A unified approach to interpreting model predictions." NIPS'17: Proceedings of the 31st International Conference on Neural Information Processing Systems, Pages 4768 – 4777.

- Magistretti, Giacomo, and Igljka Vassileva. 2024. "Bulgaria in Global Value Chains: Leveraging Integration with the EU: Bulgaria." IMF Selected Issues Paper No. 2024/023, International Monetary Fund, Washington, DC.
- The Organization for Economic Co-operation and Development (OECD), 2021. "2021 OECD Economic Outlook." Volume 2021 Issue 2, Paris, France.
- Rotunno, Lorenzo, and Michele Ruta. 2024. "Trade Spillovers of Domestic Subsidies." IMF Working Paper No. 2024/041, International Monetary Fund, Washington, DC.
- Sly, Nicholas, A. Lee Smith, Elizabeth Johnson, and Trenton Herriford. 2016. "How Does a Rise in International Shipping Costs Affect U.S. Inflation?" Economic Bulletin, Federal Reserve Bank of Kansas City, Kansas, MO.
- Wingender, Philippe, Jiexiong Yao, Robert Zymek, Benjamin Carton, Diego Cerdeiro, and Anke Weber. 2024. "Europe's Shift to Electric Vehicles Amid More Intense Global Competition." IMF Working Paper, International Monetary Fund, Washington, DC.

Box 1. Europe’s Shift to Electrical Vehicles amid Intensifying Global Competition: Who Will Be Affected?

Box Figure 1.1. Battery Electric Vehicle Sales

(Percent of total car sales)



Sources: European Commission; International Energy Agency; and IMF staff calculations.

The EU’s climate goals include a steep transition toward the electrical vehicle (EV) sector. Considering that only 15 percent of total car sales in Europe are currently fully electric (Box Figure 1.1), such a transition represents a large change affecting a sector that accounts for a significant share of GDP in many economies (4 to 5 percent in Czechia, Slovakia, Hungary, and Germany). Meanwhile, the EV sector is increasingly dominated by Chinese producers, which have rapidly gained market share.

Model simulations can shed light on the growth implications of different scenarios. Forthcoming analysis (Wingender and others 2024) assumes that the Chinese market share in Europe increases by 15 percentage points within five years—a situation that parallels the Japanese experience in the United States in the 1970s, albeit at a relatively faster pace—and is labeled as “EV-shock scenario.” This is compared with the outcomes of trade restrictions imposed

in the form of 25- or 100-percentage-point additional tariffs on Chinese EV imports into Europe.

The impact of the “EV shock” on GDP for Europe is small in the aggregate but significantly heterogeneous across countries. Large countries such as Germany, France, and Italy would experience a cumulative output loss of about 0.15 percent of GDP after five years under such a shock. By contrast, the Central, Eastern, and Southeastern Europe countries that are highly dependent on the automotive sector such as Czechia and Hungary would see much larger losses of 1.2 and 1.6 percent of their respective GDP after five years including sizable employment losses (of up to 2½ percent of the total workforce in Czechia) (Box Figure 1.2). At the other end, European countries that do not have a large car manufacturing base benefit from cheaper EVs.

The imposition of tariffs results in worse GDP outcomes. European economies with large car manufacturing sectors lose because of higher input costs. In the combined region of Germany, France, and Italy, GDP losses for five years are of 0.15 percent under no tariffs, of 0.18 percent under 25-percent additional tariffs, and of 0.46 percent under 100 percent additional tariffs. Importantly, higher tariffs also erase most of the gains of European economies that do not have significant car manufacturing bases.

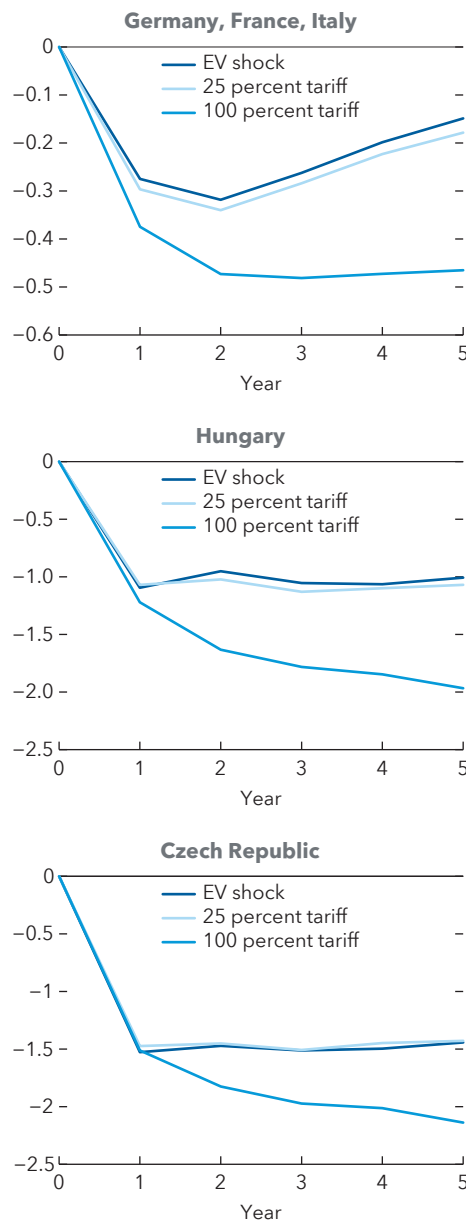
An increase in foreign direct investment inflows that results in a significant share of Chinese EVs being produced in Europe can help smaller economies. The foreign direct investment scenario undoes some of the economic losses from the baseline scenario in the worst-affected EU economies proportionally. In practice, the distribution of gains compared with the baseline scenario (averted losses) may depend on whether some individual economies are more successful in attracting Chinese foreign direct investment than others.

The authors of this Box are Diego Cerdeiro, Anke Weber, and Jiaxiong Yao.

Box 1. (Continued)

Box Figure 1.2. Short-Term GDP Impact of Electric Vehicle Shock with Tariffs

(Percent, deviation from steady state)



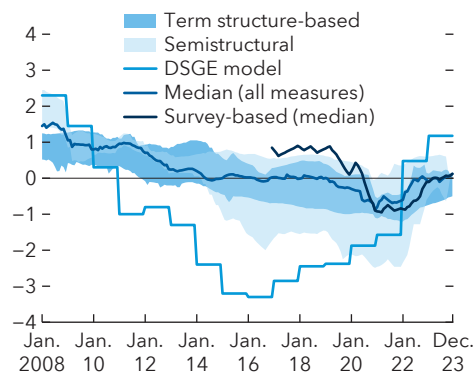
Sources: European Commission; International Energy Agency; and IMF staff calculations.
 Note: EV = electric vehicle.

Box 2. Monetary Policy and Uncertain Neutral Rate Estimates

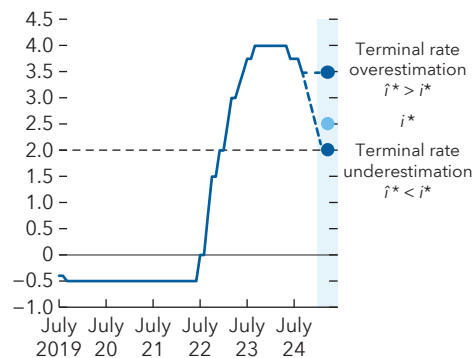
With long-term implications of recent shocks (for example, pandemic, energy supply, fragmentation) only gradually unfolding, estimates of neutral real interest rates have become more uncertain. For example, the IMF staff estimates that the euro area r^* has risen modestly from before the pandemic to about 0.5 percent, consistent with a neutral policy rate of 2.5 percent (IMF 2024). Other model estimates of r^* for the euro area differ by ± 1 percentage point depending on model and approach (ECB 2024c; Box Figure 2.1).

Uncertainty about the “true” r^* and, by extension, the nominal terminal rate i^* poses challenges for policymakers (Box Figure 2.2). An overestimated nominal terminal rate might lead central banks to keep a restrictive monetary stance for longer period than is consistent with durable price stability, dampening the economic outlook in the short term, and possibly affecting potential growth over the medium term. In such a case, the central banks may need to ease more aggressively to avoid a sustained inflation undershoot. Conversely, an underestimated terminal rate poses the risk of premature loosening. This could push inflation expectations up and make inflation more persistent. As a consequence, central banks may have to tighten more aggressively to ensure price stability at high economic costs.

Box Figure 2.1. Real Natural Rates of Interest in the Euro Area
(Percent)



Box Figure 2.2. Illustrative European Central Bank Monetary Policy
(Percent)



Sources: Brand, Lisack, and Mazelis (2024); and European Central Bank (2024c).

Note: Terminal rate overestimation refers to an estimated nominal terminal rate \hat{i}^* above i^* , which implies an overestimated \hat{r}^* , that is, $\hat{r}^* > r^*$, given that inflation is at the target rate p^* assuming no measurement errors; terminal rate underestimation refers to estimated terminal rate \hat{i}^* below i^* , which implies an underestimated \hat{r}^* , that is, $\hat{r}^* < r^*$, given that inflation is at the target rate p^* assuming no measurement errors. DSGE = dynamic stochastic general equilibrium.

The author of this box is Tianxiao Zheng.

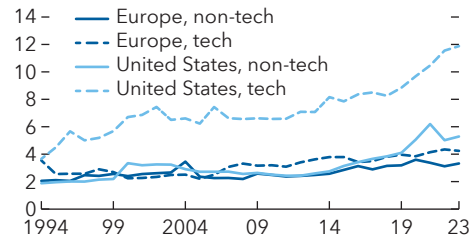
Box 3. What Is Constraining Europe's Productivity Growth? Evidence from a Firm-Level Study

Insufficient market size. An in-depth analysis of firm-level performance (October 2024 *Regional Economic Outlook: Europe* Note 1) reveals that, among the largest firms, productivity growth in Europe is far slower than in the United States. The divergence encompasses all sectors but is particularly stark in the tech sector: whereas European productivity has been virtually stagnant since 2005, it has grown by nearly 40 percent in the United States. One important reason behind this dynamic is the lack of size of European-listed firms, which spend less on innovative activities than in the United States. While research and development expenses currently represent about 10 percent of sales for listed US-tech firms, it is just 4 percent for their European counterparts (Box Figure 3.1).

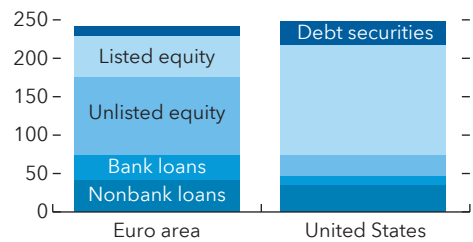
Capital market financing. US-listed firms access equity issuance at twice the rate of European firms. This difference is evident in corporate funding structures (Box Figure 3.2). Equity provides a way to fund intangible investments, given that intangibles cannot easily be pledged as collateral. Yet venture capital in the EU—equity stakes and managerial advice for small firms to grow rapidly—is only one-fourth of what it represents for the US economy (Arnold, Claveres, and Frie 2024). This also partly explains why Europe has a broader lack of business dynamism. For example, the share of young firms (those aged 5 or below) in Europe is only about half that in the United States (Box Figure 3.3). This fact is particularly relevant given that firms with at most 10 employees account for nearly twice as much of employment in Europe than in the United States.

Skilled labor shortages can hamper the formation of innovative new firms as documented for the United States (Engbom 2019; Hopenhayn, Neira, and Singhania 2022). In Europe, adverse demographics are slowing the availability of young, high-skilled workers (share of 25-34-year-olds with college degrees in labor force) and high-skilled migrant workers. These shortages have been another headwind to gazelle formation and productivity growth.

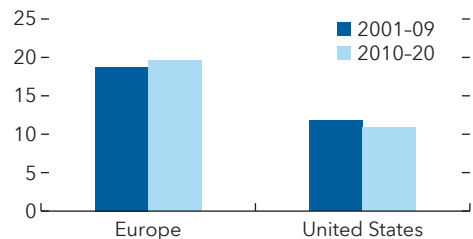
Box Figure 3.1. Listed Firms' Research and Development Intensity over Sales
(Percent)



Box Figure 3.2. Nonfinancial Corporations Funding Structure, 2023
(Research and development investment over sales, percent)



Box Figure 3.3. Employment Share of Small Firms
(Percent)



Sources: Business Dynamics Statistics; CompNet; Compustat; Haver Analytics; and IMF staff calculations.

Notes: In panel 1, Europe includes Belgium, France, Germany, Ireland, Italy, The Netherlands, Spain, Switzerland, and the United Kingdom. In panel 3, CompNet is used for European firms, covering Belgium, Croatia, Czech Republic, Denmark, Hungary, Italy, The Netherlands, Slovenia, Spain, and Sweden. Business Dynamics Statistics data are used for US firms. In panel 3, small firms are defined as those with 10 employees or less.

The authors of this box are Oyun Adilbish, Diego Cerdeiro, Romain Duval, Gee Hee Hong, Luca Mazzone, Hasan Toprak, and Maryam Vaziri.

Box 4. How Large Are Europe's Convergence Effect and What Are Their Main Drivers?

Convergence speed. The EU has seen strong convergence effects over the past 30 years (October 2024 *Regional Economic Outlook: Europe* Note 2). Countries with lower per capita incomes have grown faster (beta convergence) and converged faster than others globally (Box Figure 4.1).

EU enlargement effects. Periods following EU enlargement led to sizable increases in EU per capita GDP. A synthetic difference in difference analysis puts the gains at more than 30 percent and 10 percent in new and old member states, respectively, after 15 years. The main channels have been productivity catch-up and capital deepening often through foreign direct investment.

Economic integration and financial depth. One key contributing factor has been the degree of economic integration measured using input-output tables at the time of enlargement. Both better-integrated new and old member states experienced higher growth and productivity gains compared to less integrated regions (Box Figure 4.2). An analysis of the drivers in EU value chain integration in EU countries using machine learning models (Box Figure 4.3) finds that transport connectivity, quality of the workforce, and depth of financial markets have played a substantive role.¹ Other determinants include the strength of rule-of-law, labor cost competitiveness, and digital connectivity. The factors are equally important in the Central, Eastern, and Southeastern Europe (CESEE) and non-CESEE EU member states implying that both country-specific factors (infrastructure) and EU-wide drivers (depth of capital markets) matter for integration.

Structural reforms. A comparison of structural reform progress in countries joining the EU with the rest of the world shows that, in the 10 years' pre-accession, progress in these countries was significantly faster than the world average in the areas of domestic finance, external finance, product markets, and trade. However, in the 10 years' post-accession, only product market reforms continued at a pace significantly faster than the world average (Box Figure 4.4). More generally, and affecting all member states, financial integration slowed, reflecting a retrenchment in cross-border exposures following the global financial crisis while progress on the EU's capital market and banking union has been slow for years due to various impasses at the EU level.

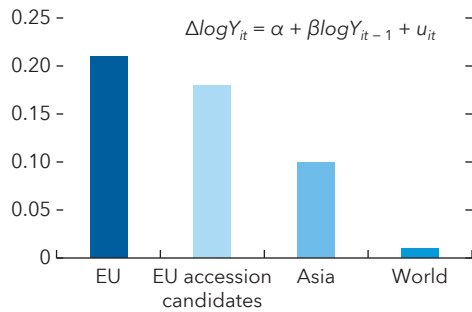
The authors of this box are Robert Beyer, Claire Li, Giacomo Magistretti, Gohar Minasyan, and Iglia Vassileva.

¹ Magistretti and Vassileva (2024): Machine learning models have been assessed in terms of their forecasting accuracy based on their coefficient of determination, the mean squared error, and the Diebold-Mariano test for forecasting performance. The values found using shapley additive explanations technique quantify the contribution of the respective feature to the deviation of the outcome forecast from its average forecast value, which is the value that would have been forecast if no information about any features was available (Lundberg and Lee 2017).

Box 4. (Continued)

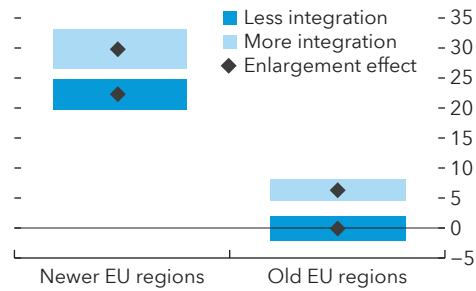
Box Figure 4.1. Per Capita Convergence across Regions (1995-2024)

(Beta: coefficient)



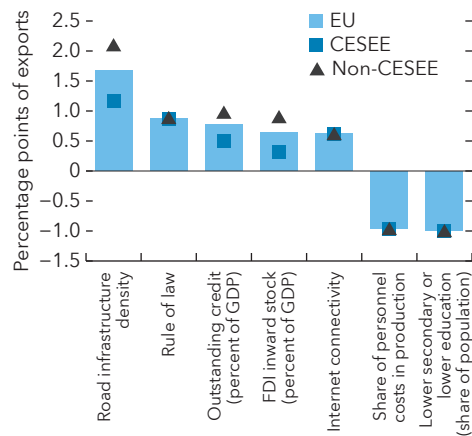
Box Figure 4.2. EU Integration and Returns from Enlargement: Cumulative per Capita Increase

(Percentage points)



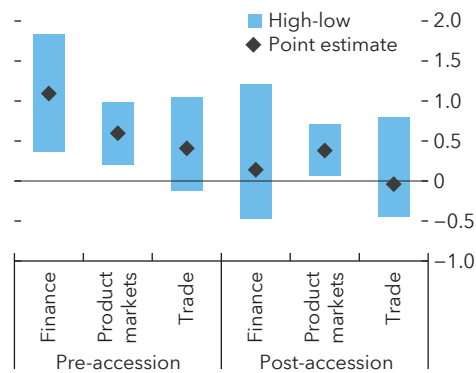
Box Figure 4.3. Determinants of Integration in EU Value Chains by EU Countries

(Percent)



Box Figure 4.4. Structural Reforms Pre- and Post-Accession

(Index)



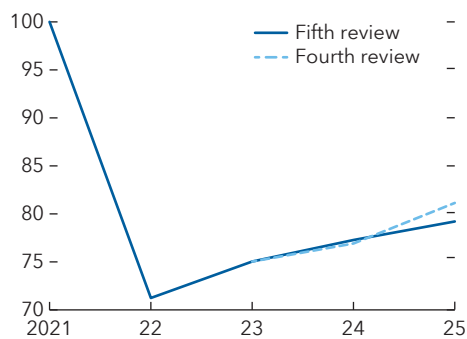
Sources: Amendolagine and others (2024); European Commission; Haver Analytics; IMF, Structural Reform Database; IMF, World Economic Outlook database; and IMF staff calculations.

Note: In Figure 4.1, the values are obtained from the coefficients of the regression of the real GDP per capita growth rate over 1995-2024 on the level of GDP per capita in the previous period. In Figure 4.2, countries severely affected by the European Debt Crisis (Greece, Ireland, Italy, Portugal, Spain) are excluded from the sample. The estimation is based on a synthetic difference-in-difference estimator and uses the median economic proximity to old/new member states in 2000 constructed by Amendolagine and others (2024) to split the sample. Figure 4.3 shows SHAP values averaged across six machine learning models (linear regression, elastic net, support vector machine, random forest, extreme gradient boosting, *k*-nearest neighbors) trained on available data for EU-27 countries for the period 2008-20. The dependent variable is the sum of the value added coming from EU countries embodied in domestic exports (EU backward linkages) and the domestic value-added content in exports to EU countries (EU forward linkages). CESEE = Central, Eastern, and Southeastern Europe; FDI = foreign direct investment.

Box 5. Ukraine: Heightened Risks, Longer War, and Continued Resilience

Following the initial shock from Russia’s invasion of Ukraine—output collapsed by nearly a third in 2022—economic activity has been resilient. Ukraine has achieved sustained growth since 2023, supporting macroeconomic stability despite extremely challenging circumstances.

Box Figure 5.1. Real GDP
(2021 = 100)



Sources: State Statistics Service of Ukraine; and IMF staff calculations.

The stability has been underpinned by the adaptability of firms and households, robust external support, and agile policymaking by the Ukrainian authorities. Ukraine’s policy implementation under its extended fund facility program with the IMF has remained strong; a staff-level agreement for the 5th Review was reached in September 2024. Reflecting recent developments and a revised outlook on the war, which is now expected to last longer than previously envisaged, staff has revised its outlook for 2024 and 2025 (Box Figure 5.1). The outlook considers the key factors that have supported Ukraine’s economic performance in wartime, such as access to trade routes, developments in the labor market, energy supply, and external support.

2024

Growth and Inflation. According to the authorities’ preliminary estimates, the economy expanded by 4.1 percent y/y in 2024:H1. High-frequency indicators point to activity remaining robust, despite large-scale attacks on energy infrastructure. However, there are major headwinds to economic growth going forward, and 2024:H2 will likely see a slowdown due to the impact of the war and the energy deficit (up to 2-4 GW at peak during the heating season). Staff projects 2024 growth at 3 percent y/y, reflecting a combination of these headwinds, strong H1 outturns, as well as some offset by increased government spending and repair and investments in the energy sector. Increased labor and energy costs together with base effects are expected to lift inflation to 9 percent by the end of the year.

Fiscal Position. The overall fiscal deficit is expected to remain sizable in 2024 at 18.8 percent of GDP, 4.6 percentage points higher than expectations at the 4th Review, driven by increased expenditures to meet defense needs. The deficit remains mainly financed by external donor support, but the increased financing needs in late 2024 are expected to be met through domestic bond issuance amid high liquidity in the banking system. The recently concluded eurobond restructuring has also unlocked substantial debt relief that can now be directed to Ukraine’s expenditure priorities.

Balance of Payments. The current account deficit is expected to widen to \$15 billion in 2024 (8.2 percent of GDP) on account of a wider trade balance (demand from energy and defense, unfavorable energy prices and harvest despite the benefits of stable Black Sea shipping routes) and a moderation in grants that offset flow relief from the commercial debt restructuring. Increased external financing should help increase gross international reserves to \$42.5 billion by the end of the year (113.4 percent of the Assessing Reserve Adequacy metric).

The author of this box is Andrea Manera.

Box 5. (Continued)

2025

The war is expected to continue into 2025 and continue shaping the economic outlook through high government spending, risks to logistics and energy infrastructure, and strains in the labor market from conscription and weak net migration. Financing needs will increase given the more prolonged war than previously expected, necessitating additional external support.

Growth and Inflation. Based on the geographical and sectoral distribution of economic activity, as well as estimated destroyed capacity, the end of 2023 value-added remained between 4 and 9 percent below its potential level, leaving room for the recovery to continue into 2025. That said, growth is expected to moderate to about 2.5 to 3.5 percent on the back of worsened labor force dynamics and weak sentiment from a longer war, which would constrain private consumption. A longer war will entail strong government consumption and some investment for repair and recovery, supporting GDP and real wages, while net exports are expected to remain a drag on growth given war-related impacts (see the following paragraphs). Continued supply-side shortages and higher input costs would contribute to keep inflation at 7.5 percent by the end of the year.

Fiscal Position. The overall fiscal deficit is expected to expand in 2025 to 19.2 percent of GDP, as defense spending remains high due to the longer war. The authorities plan to take measures to ensure that this deficit is manageable including continued streamlining of nondefense expenditures and new tax measures. The deficit will continue to be mostly financed by external sources.

Balance of Payments. The current account balance is expected to further deteriorate to \$27.1 billion (14.3 percent of GDP), driven by a worsening of the trade balance (with recovering exports more than offset by sustained import demand for priority spending needs) and a persisting services balance deficit from migrant spending abroad. Gross reserves are projected to remain adequate at \$44.8 billion (104.6 percent of Assessing Reserve Adequacy), supported by continued external financing.

Looking ahead, risks to the outlook remain exceptionally high. The authorities will need to adapt their fiscal and monetary policies for 2025 to maintain macrofinancial stability amid a longer war, while restoring medium-term external viability and debt sustainability. In this light, progress on structural reforms, particularly on the governance and fiscal structural areas, will be critical to ensure robust growth prospects in line with the EU accession path, securing needed reconstruction investment, and enabling the return of migrants.

Annex Table 1.1 Real GDP Growth*(Year-over-year percent change; aggregation based on GDP in purchasing power parity terms)*

	October 2024 WEO				April 2024 WEO			Difference		
	2023	2024	2025	2026	2024	2025	2026	2024	2025	2026
Europe	1.5	1.7	1.7	1.9	1.6	2.0	1.9	0.1	-0.3	0.0
Advanced European Economies	0.6	1.0	1.4	1.6	0.8	1.6	1.6	0.2	-0.2	0.0
Euro Area	0.4	0.8	1.2	1.5	0.8	1.5	1.4	0.0	-0.3	0.1
Austria	-0.8	-0.6	1.1	1.7	0.4	1.6	1.4	-1.0	-0.5	0.3
Belgium	1.4	1.1	1.2	1.3	1.2	1.2	1.2	-0.1	0.0	0.1
Croatia	3.1	3.4	2.9	2.7	3.0	2.7	2.7	0.4	0.2	0.0
Cyprus	2.5	3.3	3.1	3.0	2.7	2.9	3.0	0.6	0.2	0.0
Estonia	-3.0	-0.9	1.6	2.3	-0.5	2.2	2.0	-0.4	-0.6	0.3
Finland	-1.2	-0.2	2.0	1.8	0.4	1.9	1.9	-0.6	0.1	-0.1
France	1.1	1.1	1.1	1.3	0.7	1.4	1.6	0.4	-0.3	-0.3
Germany	-0.3	0.0	0.8	1.4	0.2	1.3	1.5	-0.2	-0.5	-0.1
Greece	2.0	2.3	2.0	1.7	2.0	1.9	1.7	0.3	0.1	0.0
Ireland	-5.5	-0.2	2.2	2.4	1.5	2.5	2.5	-1.7	-0.3	-0.1
Italy	0.7	0.7	0.8	0.7	0.7	0.7	0.2	0.0	0.1	0.5
Latvia	-0.3	1.2	2.3	2.5	1.7	2.4	2.5	-0.5	-0.1	0.0
Lithuania	-0.3	2.4	2.6	2.4	2.2	2.5	2.3	0.2	0.1	0.1
Luxembourg	-1.1	1.3	2.7	2.5	1.3	2.9	2.5	0.0	-0.2	0.0
Malta	7.5	5.0	4.0	3.5	5.0	4.0	3.6	0.0	0.0	-0.1
Netherlands, The	0.1	0.6	1.6	1.7	0.6	1.3	1.9	0.0	0.3	-0.2
Portugal	2.3	1.9	2.3	2.0	1.7	2.1	2.0	0.2	0.2	0.0
Slovak Republic	1.6	2.2	1.9	2.3	2.1	2.6	2.8	0.1	-0.7	-0.5
Slovenia	2.1	1.5	2.6	2.5	2.0	2.5	2.7	-0.5	0.1	-0.2
Spain	2.7	2.9	2.1	1.8	1.9	2.1	1.8	1.0	0.0	0.0
Nordic Economies	0.8	1.4	2.0	1.8	1.1	1.9	1.9	0.3	0.1	-0.1
Denmark	2.5	1.9	1.6	1.4	2.1	1.5	1.5	-0.2	0.1	-0.1
Iceland	5.0	0.6	2.4	2.2	1.7	2.0	2.2	-1.1	0.4	0.0
Norway	0.5	1.5	1.8	1.7	1.5	1.9	1.7	0.0	-0.1	0.0
Sweden	-0.2	0.9	2.4	2.2	0.2	2.2	2.2	0.7	0.2	0.0
Other European Advanced Economies	0.5	1.1	1.6	1.9	0.7	1.9	1.9	0.4	-0.3	0.0
Andorra	1.4	1.4	1.6	1.5	1.8	1.5	1.5	-0.4	0.1	0.0
Czech Republic	-0.1	1.1	2.3	2.3	0.7	2.0	2.1	0.4	0.3	0.2
Israel	2.0	0.7	2.7	4.8	1.6	5.4	3.1	-0.9	-2.7	1.7
San Marino	0.4	0.7	1.3	1.2	1.3	1.3	1.3	-0.6	0.0	-0.1
Switzerland	0.7	1.3	1.3	1.8	1.3	1.4	1.8	0.0	-0.1	0.0
United Kingdom	0.3	1.1	1.5	1.5	0.5	1.5	1.7	0.6	0.0	-0.2

	October 2024 WEO				April 2024 WEO			Difference		
	2023	2024	2025	2026	2024	2025	2026	2024	2025	2026
European Emerging Market Economies	3.3	3.2	2.2	2.5	3.1	2.8	2.6	0.1	-0.6	-0.1
Central Europe	0.0	2.7	3.4	3.3	2.9	3.5	3.2	-0.2	-0.1	0.1
Hungary	-0.9	1.5	2.9	3.0	2.2	3.3	2.8	-0.7	-0.4	0.2
Poland	0.2	3.0	3.5	3.4	3.1	3.5	3.3	-0.1	0.0	0.1
Eastern Europe	3.8	3.6	1.5	1.6	3.1	2.2	1.6	0.5	-0.7	0.0
Belarus	3.9	3.6	2.3	1.9	2.4	1.1	1.3	1.2	1.2	0.6
Moldova	0.7	2.6	3.7	4.4	2.6	4.8	5.0	0.0	-1.1	-0.6
Russia	3.6	3.6	1.3	1.2	3.2	1.8	1.2	0.4	-0.5	0.0
Ukraine	5.3	3.0	2.5	5.3	3.2	6.5	5.0	-0.2	-4.0	0.3
Southeastern European EU Member States	2.1	2.0	3.1	3.5	2.8	3.5	3.7	-0.8	-0.4	-0.2
Bulgaria	1.8	2.3	2.5	2.8	2.7	2.9	2.9	-0.4	-0.4	-0.1
Romania	2.1	1.9	3.3	3.7	2.8	3.6	3.8	-0.9	-0.3	-0.1
Southeastern European Non-EU Member States	2.5	3.4	3.7	3.7	3.2	3.9	3.7	0.2	-0.2	0.0
Albania	3.5	3.3	3.4	3.5	3.1	3.4	3.5	0.2	0.0	0.0
Bosnia and Herzegovina	1.7	2.5	3.0	3.0	2.5	3.0	3.0	0.0	0.0	0.0
Kosovo	3.3	3.8	4.0	4.0	3.8	4.0	3.9	0.0	0.0	0.1
Montenegro	6.0	3.7	3.7	3.0	3.7	3.0	3.0	0.0	0.7	0.0
North Macedonia	1.0	2.2	3.6	3.8	2.7	3.7	3.9	-0.5	-0.1	-0.1
Serbia	2.5	3.9	4.1	4.0	3.5	4.5	4.0	0.4	-0.4	0.0
Türkiye	5.1	3.0	2.7	3.2	3.1	3.2	3.3	-0.1	-0.5	-0.1
<i>Memorandum</i>										
World	3.3	3.2	3.2	3.3	3.2	3.2	3.2	0.0	0.0	0.1
Advanced Economies	1.7	1.8	1.8	1.8	1.7	1.8	1.8	0.1	0.0	0.0
Emerging Market and Developing Economies	4.4	4.2	4.2	4.2	4.2	4.2	4.1	0.0	0.0	0.1
Emerging and Developing Europe	3.3	3.2	2.2	2.5	3.1	2.8	2.6	0.1	-0.6	-0.1
European Emerging Market Economies, excluding Belarus, Russia, Türkiye, and Ukraine	0.9	2.6	3.3	3.4	2.9	3.5	3.4	-0.3	-0.2	0.0
European Union	0.6	1.1	1.6	1.7	1.1	1.8	1.7	0.0	-0.2	0.0
United States	2.9	2.8	2.2	2.0	2.7	1.9	2.0	0.1	0.3	0.0
China	5.2	4.8	4.5	4.1	4.6	4.1	3.8	0.2	0.4	0.3
Japan	1.7	0.3	1.1	0.8	0.9	1.0	0.8	-0.6	0.1	0.0

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

Annex Table 1.2. Headline Inflation*(Year-over-year percent change; aggregation based on GDP in purchasing power parity terms)*

	October 2024 WEO				April 2024 WEO			Difference		
	2023	2024	2025	2026	2024	2025	2026	2024	2025	2026
Europe	9.8	7.8	5.2	3.8	8.4	6	4.3	-0.6	-0.8	-0.5
Advanced European Economies	5.7	2.4	2.0	2.0	2.4	2.1	1.9	0.0	-0.1	0.1
Euro Area	5.4	2.4	2.0	2.0	2.4	2.1	2.0	0.0	-0.1	0.0
Austria	7.7	3.0	2.5	2.3	3.9	2.8	2.3	-0.9	-0.3	0.0
Belgium	2.3	4.3	2.1	2.0	3.6	2.0	1.9	0.7	0.1	0.1
Croatia	8.4	4.0	2.8	2.2	3.7	2.2	2.2	0.3	0.6	0.0
Cyprus	3.9	2.2	2.0	2.0	2.3	2.0	2.0	-0.1	0.0	0.0
Estonia	9.1	3.4	2.0	1.9	4.2	2.5	2.5	-0.8	-0.5	-0.6
Finland	4.3	1.2	1.9	2.0	1.2	1.9	2.0	0.0	0.0	0.0
France	5.7	2.3	1.6	1.8	2.4	1.8	1.8	-0.1	-0.2	0.0
Germany	6.0	2.4	2.0	2.0	2.4	2.0	2.0	0.0	0.0	0.0
Greece	4.2	2.9	2.1	2.0	2.7	2.1	2.0	0.2	0.0	0.0
Ireland	5.2	1.7	1.8	2.0	2.4	2.0	2.0	-0.7	-0.2	0.0
Italy	5.9	1.3	2.1	2.0	1.7	2.0	2.0	-0.4	0.1	0.0
Latvia	9.1	1.4	2.2	2.2	2.0	3.6	2.2	-0.6	-1.4	0.0
Lithuania	8.7	0.9	2.4	2.6	1.5	2.3	2.2	-0.6	0.1	0.4
Luxembourg	2.9	2.5	2.6	2.3	2.5	3.1	2.1	0.0	-0.5	0.2
Malta	5.6	2.7	2.5	2.2	2.9	2.1	2.0	-0.2	0.4	0.2
Netherlands, The	4.1	3.2	2.3	2.0	2.7	2.1	2.0	0.5	0.2	0.0
Portugal	5.3	2.5	2.1	2.0	2.2	2.0	2.0	0.3	0.1	0.0
Slovak Republic	11	2.8	5.1	2.4	3.6	3.9	2.5	-0.8	1.2	-0.1
Slovenia	7.4	2.0	2.7	2.1	2.7	2.0	2.0	-0.7	0.7	0.1
Spain	3.4	2.8	1.9	2.0	2.7	2.4	1.9	0.1	-0.5	0.1
Nordic Economies	5.2	2.4	2.2	2.0	2.5	2.2	2.0	-0.1	0.0	0.0
Denmark	3.4	1.8	2.2	2.0	1.5	2.0	2.0	0.3	0.2	0.0
Iceland	8.7	6.0	3.3	2.5	5.6	3.4	2.5	0.4	-0.1	0.0
Norway	5.5	3.3	2.4	2.0	3.3	2.6	2.0	0.0	-0.2	0.0
Sweden	5.9	2.1	2.0	2.0	2.6	2.0	2.0	-0.5	0.0	0.0
Other European Advanced Economies	6.7	2.4	2.0	1.9	2.3	2.0	1.9	0.1	0.0	0.0
Andorra	5.6	3.6	2.5	2.0	4.3	2.4	2.1	-0.7	0.1	-0.1
Czech Republic	10.7	2.3	2.0	2.0	2.1	2.0	2.0	0.2	0.0	0.0
Israel	4.2	3.1	3.0	2.4	2.4	2.5	2.1	0.7	0.5	0.3
San Marino	5.9	1.3	2.0	2.0	2.3	2.0	2.0	-1.0	0.0	0.0
Switzerland	2.1	1.3	1.0	1.0	1.5	1.2	1.2	-0.2	-0.2	-0.2
United Kingdom	7.3	2.6	2.1	2.0	2.5	2.0	2.0	0.1	0.1	0.0

	October 2024 WEO				April 2024 WEO			Difference		
	2023	2024	2025	2026	2024	2025	2026	2024	2025	2026
European Emerging Market Economies	18.5	18.8	11.7	7.5	20.9	14.1	9.1	-2.1	-2.4	-1.6
Central Europe	12.5	3.9	4.3	3.3	4.8	4.7	3.5	-0.9	-0.4	-0.2
Hungary	17.1	3.8	3.5	3.1	3.7	3.5	2.9	0.1	0.0	0.2
Poland	11.4	3.9	4.5	3.4	5.0	5.0	3.6	-1.1	-0.5	-0.2
Eastern Europe	6.5	7.6	6.2	4.4	6.8	4.9	4.3	0.8	1.3	0.1
Belarus	5.0	6.0	6.4	6.1	6.3	6.5	5.9	-0.3	-0.1	0.2
Moldova	13.4	5.0	5.0	5.0	5.0	5.0	5.0	0.0	0.0	0.0
Russia	5.9	7.9	5.9	4.0	6.9	4.5	4.0	1.0	1.4	0.0
Ukraine	12.9	5.8	9.0	7.7	6.4	7.6	6.2	-0.6	1.4	1.5
Southeastern European EU Member States	10.0	4.8	3.4	3.0	5.5	3.8	3.1	-0.7	-0.4	-0.1
Bulgaria	8.6	2.8	2.6	1.9	3.4	2.7	2.2	-0.6	-0.1	-0.3
Romania	10.4	5.3	3.6	3.3	6.0	4.0	3.3	-0.7	-0.4	0.0
Southeastern European Non-EU Member States	9.2	3.5	2.9	2.6	4.1	2.9	2.7	-0.6	0.0	-0.1
Albania	4.8	2.2	2.4	2.6	3.5	3.0	3.0	-1.3	-0.6	-0.4
Bosnia and Herzegovina	6.1	2.2	2.0	2.0	3.0	2.7	2.5	-0.8	-0.7	-0.5
Kosovo	4.9	2.1	2.0	2.0	3.5	2.3	1.9	-1.4	-0.3	0.1
Montenegro	8.6	4.2	3.7	2.9	4.2	2.7	2.1	0.0	1.0	0.8
North Macedonia	9.4	3.3	2.3	2.0	4.0	2.5	2.0	-0.7	-0.2	0.0
Serbia	12.4	4.5	3.6	3.1	4.8	3.1	3.0	-0.3	0.5	0.1
Türkiye	53.9	60.9	33.0	19.2	59.5	38.4	22.4	1.4	-5.4	-3.2
<i>Memorandum</i>										
World	6.7	5.8	4.3	3.6	5.9	4.5	3.7	-0.1	-0.2	-0.1
Advanced Economies	4.6	2.6	2.0	2.0	2.6	2.0	2.0	0.0	0.0	0.0
Emerging Market and Developing Economies	8.1	7.9	5.9	4.7	8.3	6.2	4.9	-0.4	-0.3	-0.2
Emerging and Developing Europe	17.1	16.9	11.1	7.3	18.8	13.1	8.8	-1.9	-2.0	-1.5
European Emerging Market Economies, excluding Belarus, Russia, Türkiye, and Ukraine	11.5	4.1	3.9	3.2	4.9	4.2	3.3	-0.8	-0.3	-0.1
European Union	6.3	2.6	2.3	2.1	2.7	2.4	2.1	-0.1	-0.1	0.0
United States	4.1	3.0	1.9	2.1	2.9	2.0	2.1	0.1	-0.1	0.0
China	0.2	0.4	1.7	2.0	1.0	2.0	2.0	-0.6	-0.3	0.0
Japan	3.3	2.2	2.0	2.0	2.2	2.1	2.0	0.0	-0.1	0.0

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

