

Press Points for Chapter 2: *The Crisis and Potential Output*

Fall 2009 Regional Economic Outlook: Europe

Prepared by Thomas Harjes and Srobrona Mitra

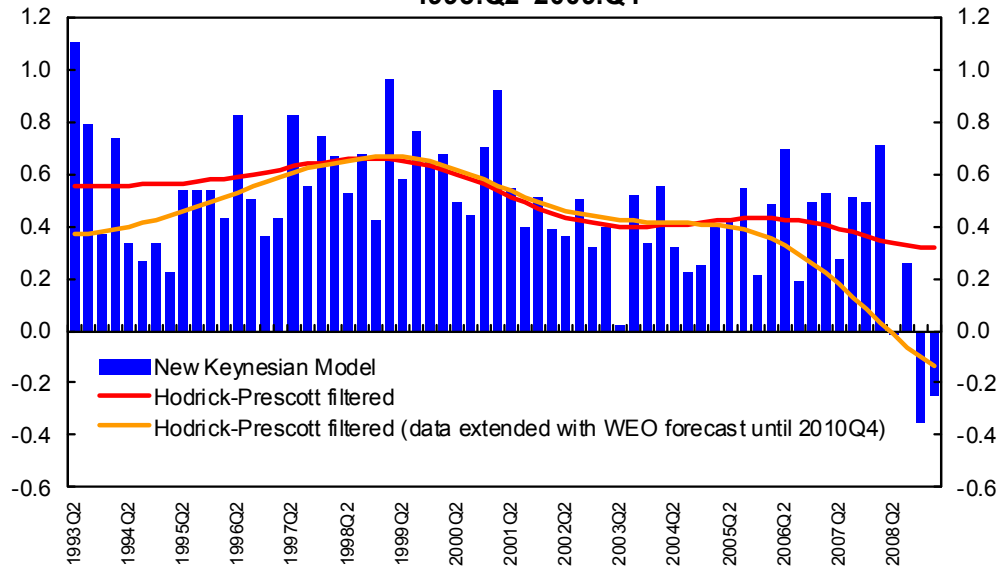
Key Points

- **Financial sector difficulties, weak investment, and long spells of unemployment are likely to hold back potential growth in Europe over the next few years, but the magnitude of their impact is uncertain.**
- **Potential growth should return to historic trends in most advanced economies over the long term, except where past financial sector activity was exuberant.**
- **Renewed progress in European financial market integration and structural reforms would bolster growth prospects.**
- **In emerging Europe, resuming convergence will depend on restoring sustainable capital inflows by ensuring a business-friendly environment, strengthening policy frameworks to reduce uncertainty, and implementing sound macroeconomic policies.**

The crisis will have a negative effect on economic growth in Europe beyond the short term and weigh on potential growth over the next few years. Recessions associated with a financial crisis, such as the recent one, often involve large and lasting output losses, especially if accompanied by credit crunches and busts in real estate bubbles. In such cases, weak investment, and long spells of unemployment often continue to weigh on potential output for several years resulting in a weak recovery that features growth rates close to or even below their long-run trend.

Considerable uncertainty prevails over the magnitude of the drop in potential growth. Potential output cannot be observed directly and its estimation is fraught with difficulties, in particular in times of severe crisis when actual output fluctuates sharply. Estimation methods that incorporate the anticipated weak recovery in most European economies, as well as others that rely on the link between inflation and the output gap suggest a relatively sharp drop in potential output growth. Other methods, however, point to a more modest decline in potential growth (see figure).

**Potential Euro-Area Growth Estimated with Different Methodologies,
1993:Q2–2009:Q1**



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

Over the long term, potential growth should return to its historic trend in most of Europe’s advanced economies, except where unsustainable financial sector profits might have exaggerated growth. For the euro area, potential growth of about 2 percent should be achievable in the long run. But if European financial market integration proceeds and the structural reforms including those envisaged under the Lisbon agenda are implemented, long-run growth potential could be bolstered further. Where extraordinary financial sector profits might have exaggerated growth over the past years, as for example in the United Kingdom, long-term growth may only recover to levels somewhat below the average growth rates experienced in recent years.

Medium-term growth and convergence in the European emerging economies could suffer from lower capital inflows. Growth in European emerging economies far outpaced growth in the euro area on average over the past two decades as the result of a catching-up process. FDI and bank-related capital inflows were essential for this income-convergence process. Poorer countries benefited more from these capital inflows. With more wary investors, higher financing costs, and the rise in government debt in the aftermath of the crisis, the convergence process could slow with lower capital inflows to the private sector.

Policies that support the resumption of healthy capital inflows are key for restarting the convergence momentum in emerging Europe. On that score, governments will need to ensure a business-friendly environment, strengthen financial sector and fiscal policy frameworks to reduce uncertainty, further support integration of financial markets and provide macroeconomic stability.

Press Points for Chapter 3: *Implications of the Fall in Potential Output for Macroeconomic Policies*

Fall 2009 Regional Economic Outlook: Europe

Prepared by Helge Berger and Emil Stavrev

Key Points

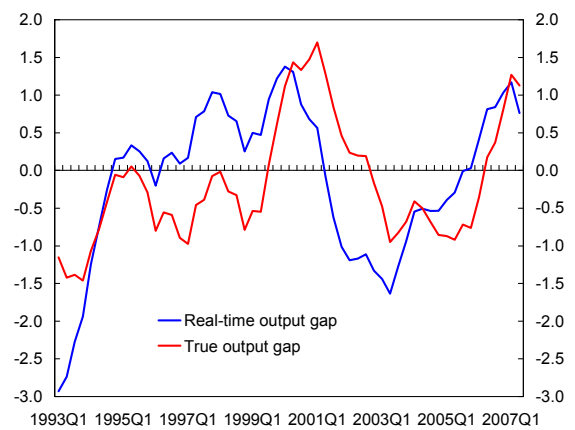
- **The uncertainty around the extent of the fall in potential output can lead to policy mistakes.**
- **To keep inflation expectations anchored, monetary policymakers will need to clearly communicate their views on potential output on which policy rate decisions are based, while emphasizing their commitment to adjust as new information arrives.**
- **Given the large fiscal costs of the crisis, fiscal policy should err on the side of caution and consolidate as soon as the recovery takes momentum.**

The decline in potential output and the surrounding uncertainty complicates both fiscal and monetary policy decisions in an already difficult environment. For instance, if fiscal policy neglected or underestimated the decline in potential output, it could put the sustainability of public finances at risk. However, overestimating the drop in potential output might mean withholding needed fiscal support from the economy. Similarly, if monetary policy overestimated the decline in potential output, it would risk being overly restrictive, while underestimating it might lead to too loose a policy stance and open the door to inflationary pressures. In addition, these uncertainties may result in different perceptions about the path of potential output between the policymakers and the public, further complicating policy choices.

Monetary Policy

Measuring the output gap in real time is not easy. A comparison of real-time estimates of the output gap in the euro area with the actual gap computed with the advantage of hindsight over a longer period provides a clear illustration (see first figure). The measurement errors are large and tend to linger. Moreover, because at times the real-time output gap takes

Euro Area: "Real-time" and "True" Output Gaps, 1993:Q1–2007:Q2 (Percent)



Source: IMF staff estimations.

the opposite sign of the true gap (suggesting that actual output is lower than potential when it is not) it could mislead policymakers about the direction of price pressures.

This opens the door to policy mistakes. Model simulations for the euro area suggest that the economy will be worse off (that is, the volatility of output and inflation increases) if the output gap is not taken into account, even in the presence of measurement error. However, reacting to the output gap based on wrong assumptions about potential output can also be costly. For instance, if monetary policymakers were overly pessimistic about potential output and underestimated the output gap by $\frac{1}{2}$ a percentage point, they would set interest rates too high compared to what they would do if they knew the path of potential output with certainty, causing an unintended fall in inflation of about 0.7 percentage point.

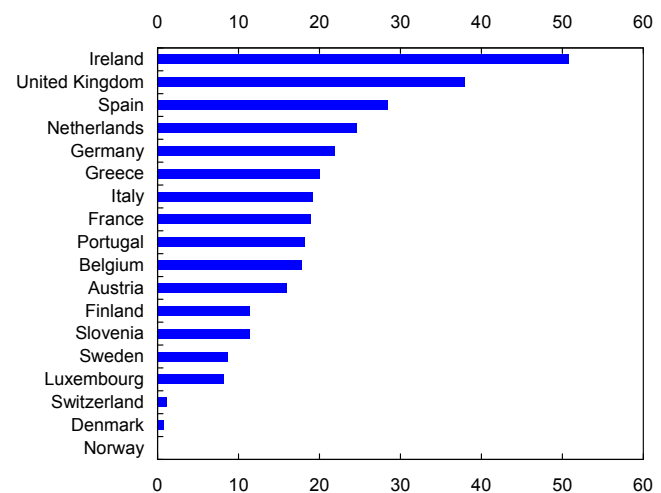
Given that policy mistakes are hard to avoid completely, the question is how to minimize their costs. Central banks need to communicate forcefully their commitment to maintaining price stability. Under the present circumstances, reinforcing the central bank's commitment to price stability with a particular focus on the repercussions of uncertainty about the output gap on inflation would help anchor inflation expectations more firmly as well as more closely align the beliefs of the central bank and those of the public about the output gap. In practice, this approach would require a specific communication effort, implying, in particular, that the central bank make transparent its views on the development of potential output upon which it is basing current monetary policy decisions and announce clearly its willingness to adjust these views in light of new information and to act upon it to ensure price stability. An effort along these lines would seem especially helpful in transitioning from the current policy stance of very low interest rates to avoid unwittingly creating deflationary expectations.

Fiscal Policy

Fiscal authorities across Europe also have reasons to worry about the impact of a decline in potential growth. A negative shock to potential growth, even if only temporary, will lead to budget shortfalls because structural revenues will fall, increasing public debt. In addition, the crisis has also forced policymakers to use fiscal resources to intervene in the financial system, both directly and indirectly through guarantees, adding to the debt level. Overall, public debt is expected to

Projected Changes in Public Debt

(Percent of GDP; change end-2007–end-2010)



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

increase by about a cumulated 16 percent of GDP for advanced and 11 percent of GDP for European emerging countries for the years 2008–10 (see second figure).

Against this background, there is a need for a significant fiscal adjustment. Even under the most benign set of assumptions about the crisis growth and debt effects, the average annual primary fiscal surplus required for an euro area member country to bring debt back to the Stability and Growth Pact target by 2020 would increase by about 0.6 percentage point of GDP. Under less benign assumptions, the required adjustment could be two or three times as large.

The necessary improvement in the primary balance should come as soon as the recovery has firmed up, supported by improvements in fiscal frameworks and reforms to raise potential output. The looming age-related fiscal pressures in Europe add to the damage to the public finances inflicted by the crisis, making fiscal adjustment even more urgent. Thus, policymakers should err on the side of caution and start the required consolidation as soon as the state of the cycle allows. Improving fiscal frameworks by introducing new national fiscal rules or strengthening existing ones and enhancing the preventive arm of the Stability and Growth Pact will also help mitigate the fallout from the crisis and safeguard fiscal sustainability. Finally, there is a pressing need to boost potential growth through structural reforms, which will support the budget, including through higher revenue growth.

Press Points for Chapter 4: *Policies in Emerging Economies to Cope with Heightened Risk during Recovery*

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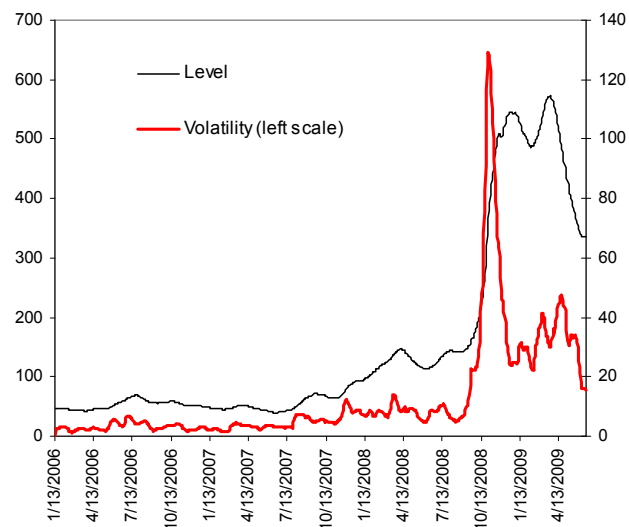
Prepared by Srobona Mitra

Key Points

- **Emerging Europe is likely to face higher risk premiums and a more volatile environment in the aftermath of the financial crisis, as investors pay increased attention to domestic policies in individual countries.**
- **Higher and more volatile spreads adversely affect long-term growth and lead to higher variability in both inflation and output over the cycle.**
- **Adopting policies that lower uncertainty about the state of the financial system and reduce fiscal discretion would go a long way in addressing these concerns and will yield a “double dividend” in improving prospects for long-term growth.**

Even though investor’s appetite for risk has moved away from its crisis-induced lows, **emerging markets continue to face a significantly more volatile external environment.** Interest rate spreads on sovereign bonds have increased, and interest rates and exchange rates have become more volatile (see first figure). Behind this shift lies a change in investor attitude. Taking their cue from the crisis, investors have become more conscious of extreme risks and charge higher risk premiums. Thus, even with the dissipation of the global financial shocks, interest rate spreads and volatilities related to country-specific vulnerabilities are likely to remain elevated in the medium term.

Level and volatility of interest rate spreads in emerging Europe (30-day rolling average and standard deviation of levels, basis points)



While common global shocks have affected the volatility of interest rate spreads and other financial indicators, banking and fiscal developments have become an important driver of the turbulence. Foreign investors are wary about the uncertainty regarding the financing needs of banks and the government, the rollover of maturing corporate and government debt, the capacity for dealing with household indebtedness and associated

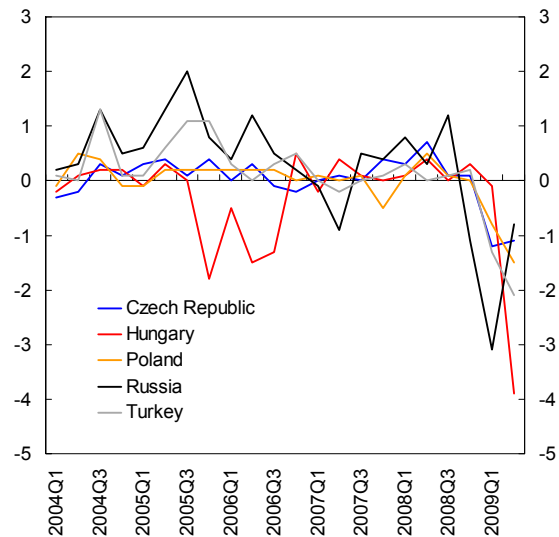
foreign-currency mismatches, and the eventual contingent liabilities of the government. Moreover, the cyclical effects of the recession continue to contribute to the unsteadiness of the fiscal situation. These developments have led to unusually large and frequent revisions in the forecasts of budget balances in emerging European economies (see second figure).

Most policymakers are thus confronted with lower medium-term growth, more fickle investors, and, consequently higher variability in inflation and output. Under fixed exchange rates, stabilizing output and inflation in the face of external shocks is intrinsically difficult under the best of circumstances because monetary policy is hamstrung. The traditional policy advice is for fiscal policy to step up. However, under the heightened post-crisis scrutiny of international investors, a more activist use of fiscal policy tools may cast doubt on fiscal sustainability and backfire in the form of higher and more volatile interest rate spreads in the medium-term. This could add to the volatility of the economy rather than countering it. It could also lower growth, especially in emerging economies depending on capital inflows for growth. And even under flexible exchange rates, the possibilities for financial sector intervention or macroeconomic stabilization can be limited, especially when exchange rate changes pass through quickly to inflation or large foreign currency debt overhangs make exchange rate depreciations costly.

The solution lies in forcefully addressing financial sector problems and steadying fiscal policy around a sustainable path. This will not only promote a smooth recovery and reduce the variability in output and inflation, but it will also help longer-term growth and reestablish sustainable income-convergence through higher capital inflows, promising a double dividend. A number of specific policy options are available:

- Lingering problems in the financial sector need to be addressed. The ongoing stress tests in the Central, Eastern, and Southern European countries, coordinated by the IMF, will identify recapitalization needs in banks. The stress test results would help lower uncertainty about the banking sectors, especially if this information is used to take action to recapitalize or restructure viable institutions and resolve others.

Selected European Countries: Quarterly Revisions in Fiscal Balance Forecast, 2006:Q1–2009:Q2 1/



Sources: Consensus Economics; and IMF staff calculations.
1/ Change (in percentage points) in the fiscal balance forecast for the year, average of the Consensus Forecasts.

- Increasing the transparency of contingent fiscal liabilities that emanate from the stresses in the financial system or other sources and properly disclosing the attendant risks will reduce the uncertainty about the fiscal outlook.
- A rules-based fiscal policy that limits changes in deficits mostly to automatic stabilizers would help to anchor long-term fiscal sustainability and predictability. Avoiding the surprises inherent in discretionary fiscal policy would help reduce volatility in the business cycle.
- Strengthening the supervisory, regulatory, and macroprudential framework to reduce vulnerabilities and avoid boom-and-bust cycles in the future would directly lower the risk premium and its uncertainty. Some examples include stricter capital requirements for weaker banks while strengthening home-host cross-border cooperation and implementing forward-looking (countercyclical) provisioning policies to reduce volatility of bank profits.