

INTERNATIONAL MONETARY FUND

# REGIONAL ECONOMIC OUTLOOK

EUROPE

Restoring Price Stability and  
Securing Strong and Green Growth

**2023**  
**NOV**



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# Executive Summary

After having dealt successfully with the challenges of the pandemic and the energy price shock triggered by Russia's war in Ukraine, Europe faces the difficult task of restoring price stability while securing strong and green growth over the longer term. Global shifts from geoeconomic fragmentation and the current impact of climate change have introduced new economic challenges that add to long-standing growth problems and could stall convergence.

Cooling headline inflation is providing some relief to households and firms. Easing commodity prices and supply constraints have been mainly responsible, but persistent core inflation has proved more difficult to tackle. Central banks across Europe have tightened their monetary policies substantially, and governments are scaling back fiscal support.

The lingering effects of last year's energy price shocks and tighter policies are also contributing to a growth slowdown this year. Countries with larger manufacturing or energy-intensive sectors are slowing more than those that depend on services and tourism. Overall, the growth forecast is shaped by the opposing forces of tighter macroeconomic policies and the recovery in real incomes, as inflation falls and wages rise.

The outlook for Europe is for a soft landing, with inflation declining gradually. Growth in the region overall is expected to slow to 1.3 percent in 2023 from 2.7 percent last year, and improve to 1.5 percent in 2024. Within advanced European economies, service-oriented economies will recover faster than those with relatively larger manufacturing sectors, which face low external demand and are more exposed to high energy prices. Similarly, European emerging market economies will experience a mild recovery in 2024, but the extent will vary across countries depending on the energy intensity of production, service sector orientation, and, especially for the easternmost countries, disruption of trade relationships with Russia.

Monetary policy is approaching the end of the tightening cycle. A moderate fiscal consolidation is projected for 2023, picking up in 2024. Although a robust US economy is an important backstop to global demand, weaker activity in China, additional commodity price shocks, and the materialization of financial stability risks are important downside risks to growth. Tighter monetary policy has elevated credit costs and weakened household and corporate real estate balance sheets. Even though banks' capital buffers are healthy, they could become strained under an adverse scenario.

Inflation is expected to recede only gradually over the forecast period. While subdued domestic demand in 2023 and lower commodity prices will be passed through to core inflation, the projected recovery in real incomes and still-strong labor markets will slow the pace of disinflation. Most countries are not expected to reach inflation targets before 2025. Sustained nominal wage growth above inflation and productivity growth rates is a key risk to disinflation, especially in European emerging market economies. Inflation could become entrenched, requiring additional policy tightening and potentially leading to stagflation.

Europe is facing these risks at a time when structural shifts from geopolitical fragmentation and climate change are compounding already-existing long-term growth problems. Europe's medium-term growth prospects have declined for some time, with weakening productivity growth a key factor. The new challenges of higher and more volatile energy costs and changes in supply and trade relationships are disrupting production structures. They add to well-known factors (such as population aging and labor supply constraints) that have stymied potential growth.

For most European emerging market economies, the combination of weak productivity and a loss of wage-cost competitiveness could stall economic convergence. In these circumstances, stabilization of public debt trajectories could also prove challenging, especially in high-debt countries where debt needs to be outright reduced.

In this context, economic policies should aim to restore price stability and strengthen economic fundamentals. History suggests that it takes several years for inflation to return to normal levels after an inflationary episode.

Maintaining a restrictive monetary policy stance is thus paramount to securing the return of inflation to target within a reasonable timeframe. Uncertainty about inflation persistence is large, and the cost of easing too early is substantial. The required tightness of monetary policy varies with country circumstances, but many central banks will have to maintain high policy rates for some time.

Meanwhile, countries should step up their efforts to rebuild or preserve fiscal buffers while protecting critical spending needs. By reducing deficits, fiscal policy complements monetary policy in the fight against inflation. Remaining untargeted energy support should be phased out and expenditure and revenue inefficiencies tackled. But these savings may not be enough to address spending needs on education, demographic headwinds, infrastructure, and climate change while also reining in large deficits. Moreover, public debt-to-GDP ratios are projected to increase over the medium term in most European emerging market economies, as a result of sluggish growth and rising debt service cost. These countries will also need to better rationalize expenditure and mobilize revenues to bring public debt ratios on a downward path. For EU economies, strengthening the capacity to absorb EU grants for climate-resilient infrastructure, social protection, and accelerating the green transition continues to be a priority.

Macrofinancial policies should ensure that emerging risks to stability are monitored and contained. Banks have increased their profits from rising net interest margins. These resources should be used to raise capital buffers, including through regulatory requirements. Given banks' credit exposure to the real estate sector, robust buffers are even more important at a time, like the current one, when the property market faces structural and cyclical headwinds.

Structural policies remain crucial for achieving strong, green, and evenly distributed growth. Reforms should focus on removing barriers that prevent economic innovation and dynamism. A strengthened business environment with policies that encourage investment and spending on research and development will enhance competition that increases productivity. In European emerging market economies, attracting investment also requires strengthening public sector management and governance; better job matching; and reliable digital, transportation, and energy infrastructure. Europe needs to preserve its most important growth asset—the single market. Sectoral policies can play a role (when network externalities are present) by raising research and development spending and opening access to new technologies, leading to increased efficiencies and facilitating the green transition. But such policies need to be deployed surgically and with care, avoiding costly subsidy races or use of distortionary tariffs. International collaboration on climate change, including a global carbon price floor, is essential to reducing emissions while maintaining competitiveness. Recent agreements on strengthening Europe's emissions trading system are an important step toward achieving the European Union's climate goals.

# Restoring Price Stability and Securing Strong and Green Growth<sup>1</sup>

*After navigating the double crisis of the pandemic and the energy price shock triggered by Russia's war in Ukraine, Europe faces the difficult task of restoring price stability and building fiscal buffers while securing strong and green growth over the longer term. Failing to tackle inflation decisively now will diminish resilience and risk permanent damage to growth in a world increasingly exposed to shocks from fragmentation, new technologies, and climate change. These global structural shifts compound Europe's persistent growth and convergence problems which predate the pandemic. To lift Europe's growth potential while easing inflation pressures, structural policies need to ease supply constraints, raise labor supply, and improve productivity. These policy challenges vary widely among advanced and European emerging market economies and depend on how hard recent shocks affected the economy, the effectiveness of macroeconomic policies, and the ability to reallocate labor and capital into areas of new growth.*

## Finally, signs of inflation cooling . . .

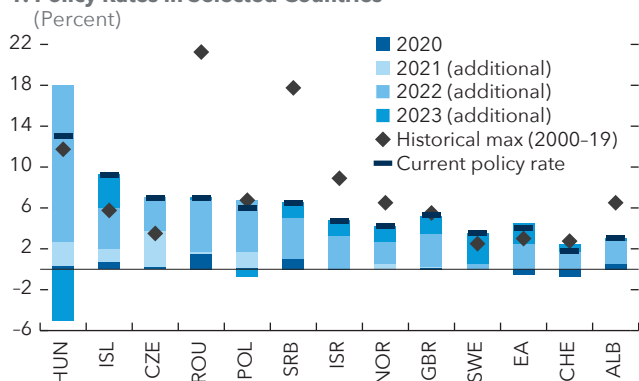
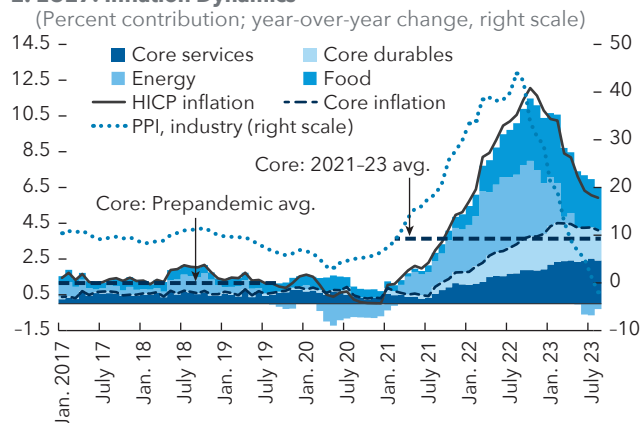
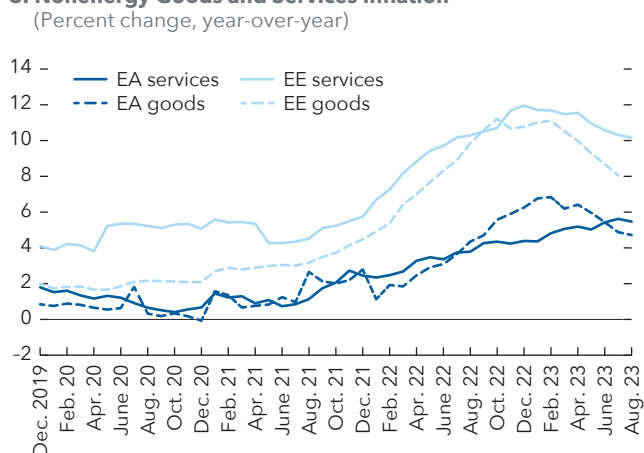
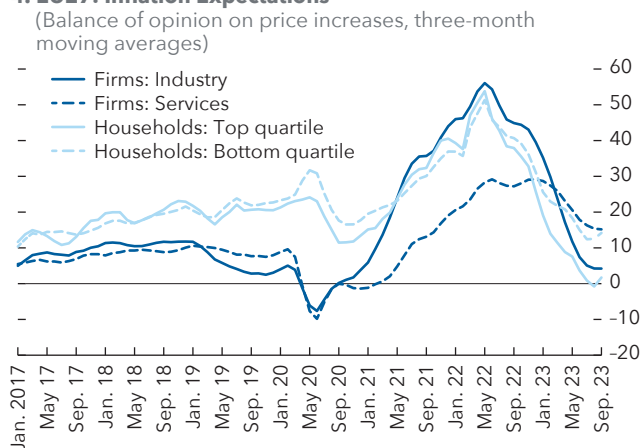
Europe is at a turning point. The continent simultaneously grapples with firmly bending the inflation curve in the near term and attempting to revive its growth engine to meet future structural challenges. As the immediate economic effects of the pandemic and energy crisis are fading, policymakers now need to focus on creating the conditions for countries to operate successfully in a more uncertain and shock-prone global environment. Establishing macroeconomic stability and creating more flexible and adaptable economies will be crucial.

Major central banks in Europe and other regions have continued tightening their monetary policy. Some reached their highest rates over two decades (Figure 1.1, panel 1). In contrast to advanced European economies, central banks in European emerging market economies raised rates earlier and have slowed or paused hikes in 2023 (*Czech Republic, Romania*), with some starting to ease (*Hungary, Poland*). Most countries are also rolling back broad-based fiscal support to cope with high energy costs and are starting to consolidate fiscal positions. Although domestic demand has been slowing over the summer months, substantial recessions have been avoided, partly because of still-strong labor markets.

Inflation is finally showing signs of declining. Headline inflation is falling rapidly while core inflation—a gauge of underlying inflation pressures—remains substantially above central bank targets (Figure 1.1, panel 2). The interplay of three salient factors is driving disinflation. The first is *the easing of commodity and other supply constraints*. Falling energy and, to some extent, food prices directly reduce goods prices in the consumer price index basket and have been driving headline inflation down from its peak, doing so especially fast in the economies of Central, Eastern, and Southeastern Europe (CESEE). The impact on core items has been limited, given a slow pass-through of energy price declines into retail prices, particularly services (Figure 1.1, panel 3). A second factor is a decline in *domestic demand and activity*. Less fiscal support than last year and the transmission of tighter monetary policy are cooling the economy and reducing inflationary pressures. However, the effects are building only gradually, given transmission lags (see Box 1.1). A third factor is the decline in *short-term inflation expectations* from their peak in 2022 (Figure 1.1, panel 4), which had in the past driven inflation up (October 2023 *World Economic Outlook*, Chapter 2).

<sup>1</sup> This chapter was prepared by Manasa Patnam with contributions from Oyon Adilbish, Gianluigi Ferrucci, Claire Li, Giacomo Magistretti, Ben Park, Keyra Primus, Frederik Toscani, and Tianxiao Zheng under the supervision of Helge Berger and Stephan Danninger. Gabriel Di Bella provided useful advice and comments. Agnesa Zalezakova was expertly in charge of administrative support.



**Figure 1.1. Inflation Developments and Policy Rates****1. Policy Rates in Selected Countries****2. EU27: Inflation Dynamics****3. Nonenergy Goods and Services Inflation****4. EU27: Inflation Expectations**

Sources: Central bank statistics; European Commission; Eurostat; Haver Analytics; and IMF staff calculations.

Note: In panel 1, data are as of the end of September 2023. For Hungary, the one-day deposit tender is used as the de facto policy rate between October 2022 and September 2023. In panel 2, constant weights are used to compute the contribution to headline inflation. In panel 3, EE excludes Russia, Türkiye, and Ukraine. In panel 4, price expectations are over the next year (households) and the next three months (services). EA = euro area; EE = European emerging market economies; HICP = Harmonised Index of Consumer Prices; PPI = producer price

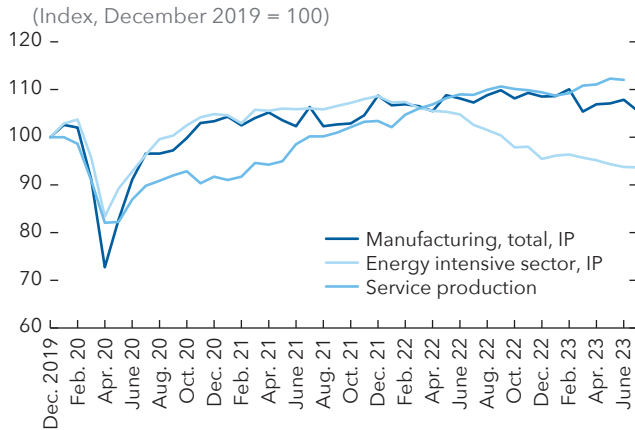
## ... while growth is slowing at varying degrees.

The same forces that are driving disinflation are shaping activity in Europe: tighter macroeconomic policy on the one hand and the disinflationary effects of recent supply shocks easing on the other. However, the impact of these forces varies and depends (among other factors) on the impact of recent shocks (reflecting energy intensity and trade orientation), the strength of policies and the speed of energy price pass-through, and changes in the relative demand for services over goods.

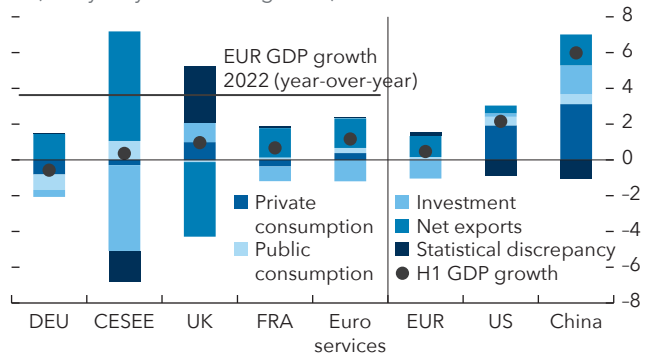
In the first half of this year, the growth downturn was broadly in line with forecasts for most European countries, with energy-intensive manufacturing especially hit hard (Figure 1.2, panel 1). The overall weakening of growth for Europe stands in contrast to developments in the United States, where surprisingly robust private consumption is supporting fairly strong growth. In China, however, the economy has slowed because of headwinds from its domestic real estate sector (Figure 1.2, panel 2). These offsetting forces from the United States and China are dampening global spillovers to Europe, although the magnitude of the impact could vary across countries. Manufacturing-dependent advanced European economies (for example, *Germany*) recorded downsides, while

**Figure 1.2. Recent Economic Developments**

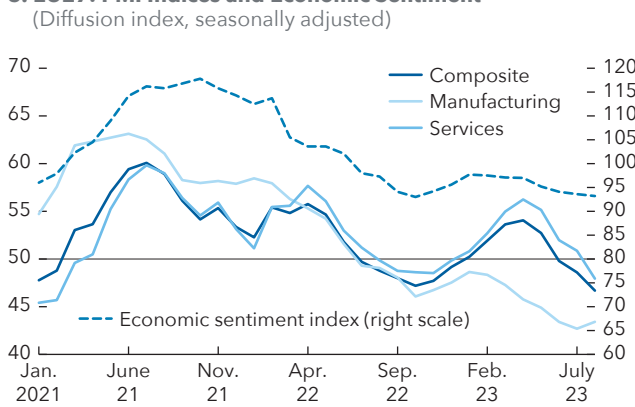
**1. EU27: Production Indices**



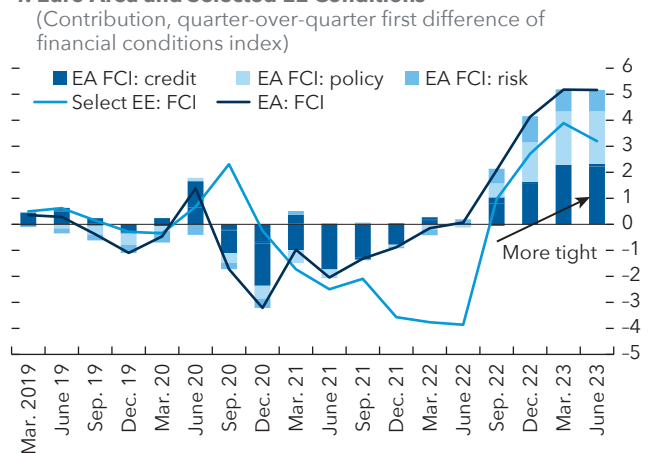
**2. Europe: First Half of 2023 GDP Growth and Contributors**  
(Half-yearly annualized growth)



**3. EU27: PMI Indices and Economic Sentiment**



**4. Euro Area and Selected EE Conditions**



Sources: Borraccia and others 2023; central banks; European Commission; Eurostat; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.

Note: In panel 2, Euro services refers to service sector intensive countries and includes Greece, Italy, Portugal, and Spain; CESEE countries include Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Romania. In panel 4, credit availability and costs, external conditions, and funding constraints are grouped as "FCI: credit." EE FCI is PPP-weighted average of Czech Republic, Hungary, and Poland. Country abbreviations are International Organization for Standardization (ISO) country codes. CESEE = Central, Eastern, and Southeastern Europe; EA = euro area; EE = European emerging market economies; EUR = Europe; FCI = financial conditions index; IP = industrial production; PMI = purchasing managers' index; PPP = purchasing power parity.

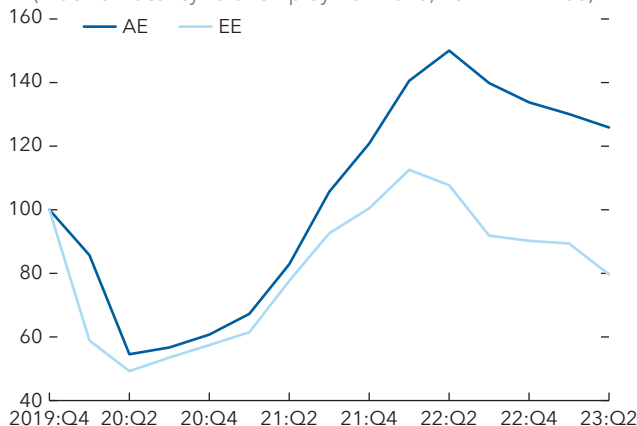
countries that depend on services and tourism have performed better (for example, *Portugal* and *Spain*), largely because of the ongoing normalization of travel activity in the summer. Growth in CESEE countries benefited from a reorientation of external demand and weaker imports (from a compression of energy demand) which strengthened trade balances (Figure 1.2, panel 2).

Regarding underlying expenditure components, improvements in net exports balances driven by sharply falling energy imports have helped growth in many countries (the United Kingdom is one exception). Private consumption has been weak throughout Europe, and investment declined, given real income losses and rising financing costs, although infrastructure spending moderated the slowdown.

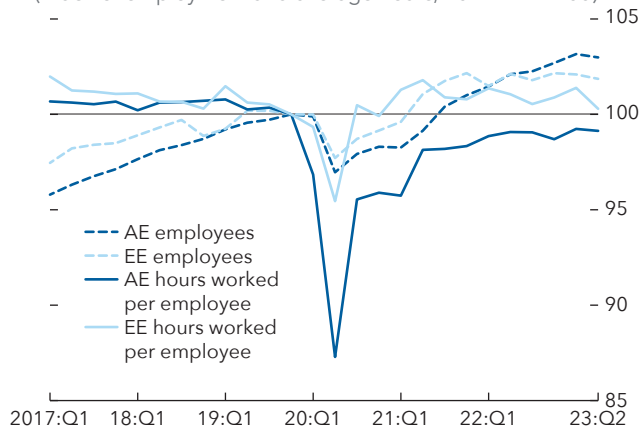
Indications point to a slowdown in growth in the third quarter. High-frequency surveys suggest that service sector activity is also cooling, with services purchasing managers' indexes entering contractionary territory in the euro area. Private consumption has continued to soften, with consumer confidence tapering off, while business expectations are declining across all major sectors (Figure 1.2, panel 3).

**Figure 1.3. Labor Market Developments****1. Demand for Workers: Labor Market Tightness**

(Index of vacancy-to-unemployment ratio, 2019:Q4 = 100)

**2. Labor Supply: Employment and Hours Worked**

(Index of employment and average hours, 2019:Q4 = 100)



Sources: Eurostat; Haver Analytics; Indeed, Wage Tracker; and IMF staff calculations.

Note: In panel 1, AE excludes Israel, San Marino, and Switzerland. EE includes Bulgaria, Hungary, Poland, and Romania. In panel 2, AE excludes Iceland, Israel, Italy, and San Marino. EE includes Bulgaria, Hungary, the former Yugoslav Republic of Macedonia, Poland, and Romania because of data constraints. AE = advanced Europe; EE = European emerging market economies.

Financial conditions remain tight, driven by central bank action and stricter lending standards (Figure 1.2, panel 4). Credit growth had started to slow last year in European emerging market economies and has begun to soften in advanced economies this year. Sovereign spreads have widened in European emerging market economies as public debt has risen further amid uncertain growth prospects. Comfortable capital buffers have helped European banks weather the systemwide effects from earlier US banking sector turmoil and the sale of Credit Suisse. But an extended period of high rates could present material risks to bank balance sheets. While banks' profits have cyclically increased as a result of higher net interest margins, banks are also exposed to growing credit risk from, among other things, the buildup of risks in the residential real estate and commercial real estate (CRE) sector, given falling valuations amid changes in demand (for example, from the shift toward hybrid work and e-commerce).

## Continued labor market tightness may pare disinflation gains . . .

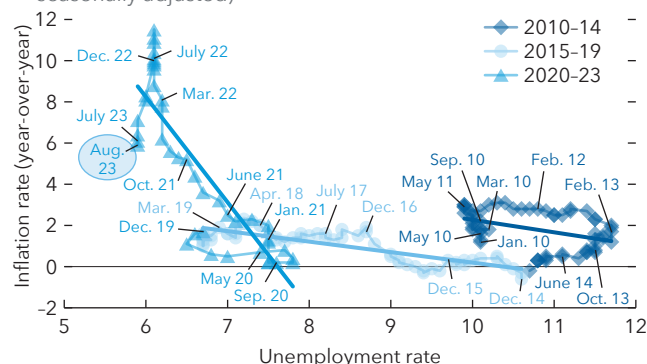
The policy-led financial tightening has slowed labor markets, but it remains tight overall. Vacancy-to-unemployment ratios are still at high levels but have declined from recent peaks (Figure 1.3, panel 1). Labor supply has recovered, and employment is 1-2 percentage points above its precrisis level, despite some shortfall in average hours (Figure 1.3, panel 2). The still-persistent tightness could reflect lagged cyclical adjustment of labor demand and binding constraints in labor supply from a secular—potentially preference-driven—decline in working hours (see Chapter 2). Nominal wage growth has picked up and exceeded inflation in European emerging market economies, starting to drive up unit labor costs.

Along with the trajectory of energy and food prices, the behavior of labor markets will be among the key drivers of inflation. Although unemployment has remained virtually stable despite heightened inflation dynamics, the observed Phillips curve has steepened in the postpandemic period (Figure 1.4, panel 1), likely reflecting the fluctuations of energy and food prices and inflation expectations. However, the stability of the slope is uncertain and with it the economic costs of disinflation.<sup>2</sup> Since last year, rising nominal wage growth in CESEE countries is

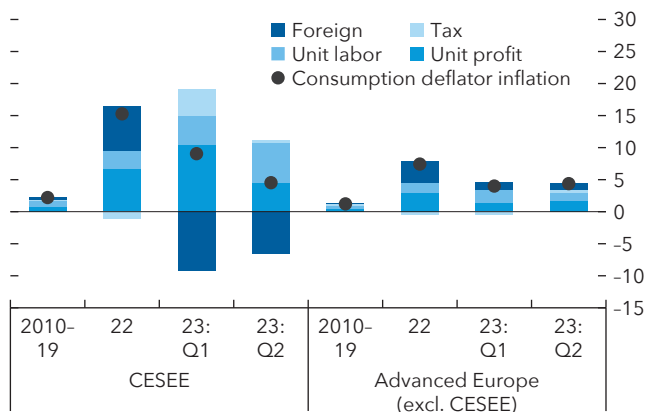
<sup>2</sup> The shifting Phillips curve could be the result of (1) nonlinearity in the Phillips curve from wage rigidity (Benigno and Eggertsson 2023) and volatile price changes (Hall 2023; Lorenzoni and Werning 2023) and/or (2) a short-term slope "dislocation" as a result of cost-push inflation (Blanchard and Bernanke 2023) and disanchoring of short-term inflation expectations (October 2023 *World Economic Outlook*, Chapter 2).

**Figure 1.4. Interplay among Wages, Profits, and Prices****1. EU27: Observed Phillips Curve**

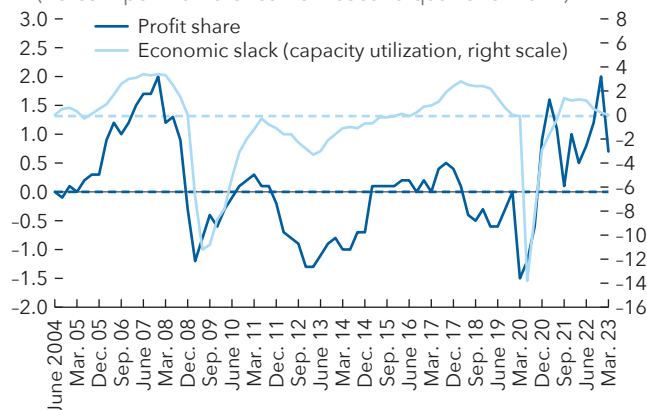
(Annual inflation rate versus unemployment rate, seasonally adjusted)

**2. Inflation Decomposition by Wage and Profits**

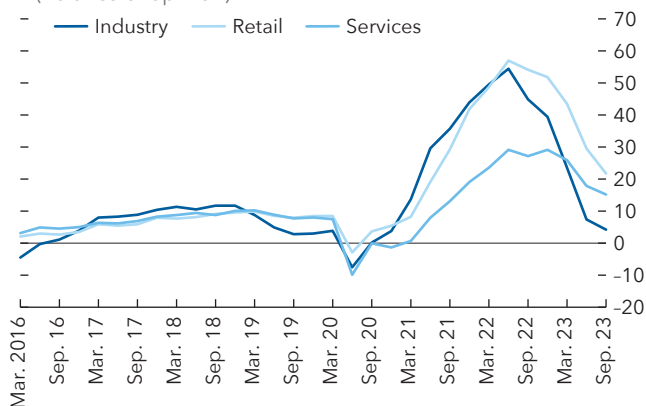
(Percent contributions to change in deflator)

**3. EU27: Profits and Slack**

(Percent point difference from second quarter of 2019)

**4. EU27: Selling Price Expectations**

(Balance of opinion)



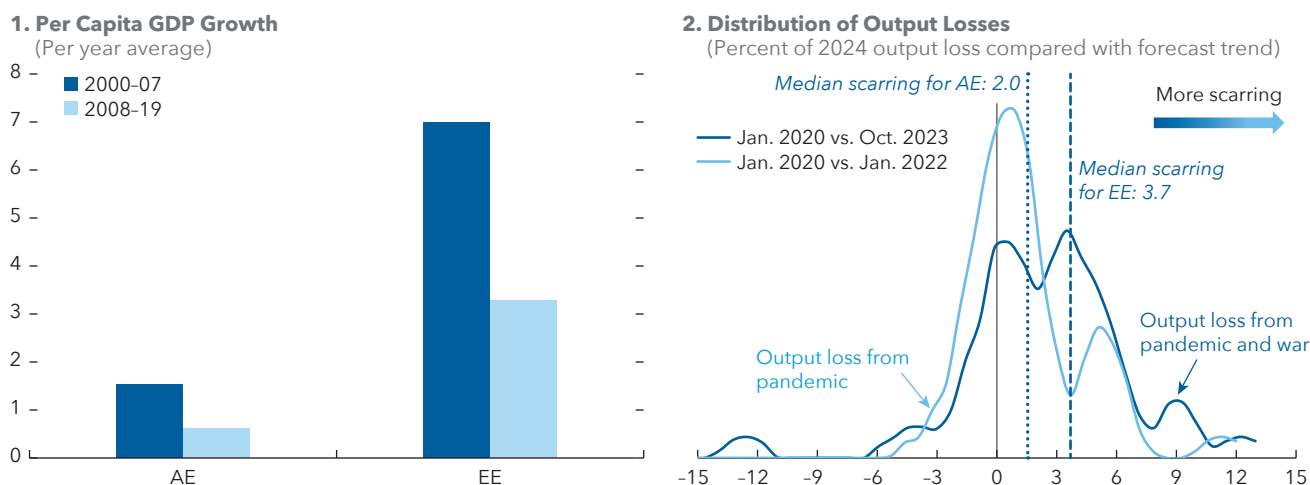
Sources: European Commission; Eurostat; Haver Analytics; Hansen, Toscani, and Zhou 2023; and IMF staff calculations.

Note: In panel 1, inflation rate is the year-over-year change in Harmonised Index of Consumer Prices. Unemployment rate is seasonally adjusted. In panel 2, "Foreign" refers to import prices. Advanced Europe includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, The Netherlands, Norway, Portugal, Spain, Sweden, and the United Kingdom. CESEE includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia. In panel 3, profit share is calculated as nominal profits per unit of gross operating surplus. Capacity utilization is measured in percentage of total capacity. In panel 4, selling price expectation are over the next 12 months. CESEE = Central, Eastern, and Southeastern Europe.

playing an increasingly important role in raising inflation (Figure 1.4, panel 2). Declining profit shares—after initially rising and feeding into higher prices<sup>3</sup>—are some offset to rising labor costs. As Chapter 2 discusses, wage growth is projected to remain elevated at about 7½ percent and 4 percent in CESEE and advanced European (excluding CESEE) countries, respectively, at the end of 2024, accounting for ½ to 1 percentage point of projected inflation.

Overall, uncertainty about the inflation momentum remains large. Wages pressures could rise. The labor markets may be tighter than envisioned, workers' demand for higher compensation to recover lost purchasing power may trigger wage-price feedback loops, and recent positive shocks to wage formation may persist. However, profits offer some additional room to buffer this risk (Figure 1.4, panel 3). The degree of price adjustments to higher

<sup>3</sup> See Hansen, Toscani, and Zhou (2023), who find that aggregate markups returned to pre-COVID-19 levels in late 2022 in a selection of euro area countries, despite a substantial increase in a few sectors such as construction and transport in Germany and Italy (Colonna, Torrini, and Viviano 2023). In the past, profit margins have co-moved with economic slack. Some decoupling has occurred in recent quarters, likely from factors unique to the energy crises such as the sectoral concentration of pricing power and temporary support provided to crisis-affected firms (Figure 1.4, panel 1; see also INSEE 2022).

**Figure 1.5. Europe: Growth, Productivity, and Convergence**

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

Note: In panel 1, GDP purchasing parity power-weighted average for AE and EE. The European emerging market economies sample excludes Belarus, Bosnia and Herzegovina, Kosovo, Moldova, Russia, Türkiye, and Ukraine. For years where data are not available on some countries, GDP per capita is estimated from their World Economic Outlook database submission. In panel 2, output losses are computed as the difference between current (projected) output level in 2024 and that projected in the January 2022 and January 2020 vintages of the World Economic Outlook database. AE = advanced Europe; EE = European emerging market economies.

wages will also hinge on the pace of productivity growth (which offsets the cost effects of higher nominal wages) and the easing of excess demand amid constrained supply (which would prevent firms from increasing prices to remain competitive). Survey evidence across Europe, particularly among major advanced economies, indicates that fewer sellers are expecting to increase their sales price, particularly in the goods market (Figure 1.4, panel 4).

### ... as global structural shifts weigh on economic potential.

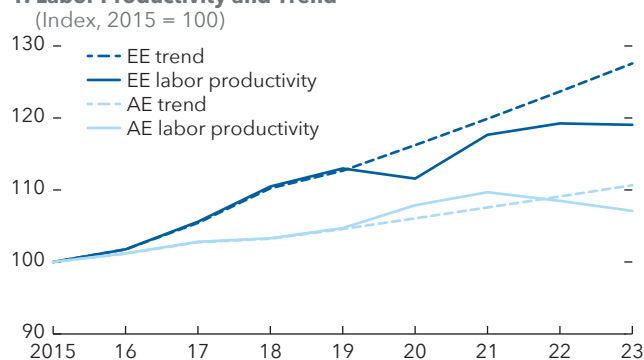
Europe's medium-term growth prospects have declined for some time. Since the 2008 global financial crisis, economic growth has been less buoyant in advanced economies and European emerging market economies (Figure 1.5, panel 1). The energy crisis and the war have increased scarring to the level of output caused by the pandemic (Figure 1.5, panel 2) at a time when countries need to also grapple with the structural shifts from geopolitical fragmentation, climate change, and technological change.

A confluence of factors could dent medium-term growth in critical ways:

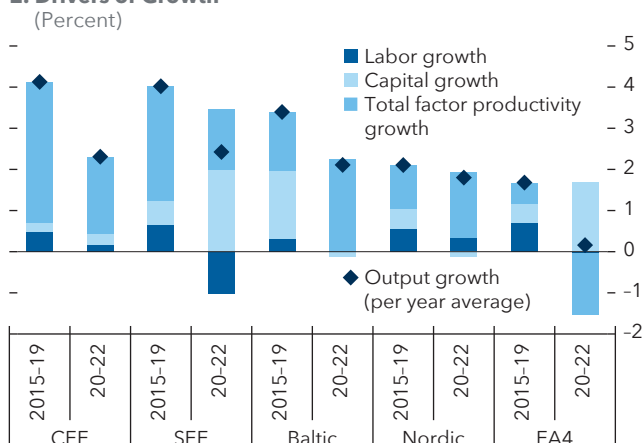
- A *preference to work* less—aided by technical advances—could limit labor supply, exacerbate inflation by keeping supply pressures elevated, and reduce potential growth (Chapter 2). Demographic pressures caused by increases in longevity amid declining fertility would reduce potential labor supply further while adding to fiscal costs. This situation is worse in many European emerging market economies, which also need to cope with steady migration.
- *Productivity* has been slowing in Europe since before the war (Figure 1.6, panel 1). The energy sector's ongoing rapid restructuring could reduce sector-specific and even aggregate total factor productivity because of a lack of input substitution possibilities (Figure 1.6, panel 2). This could slow the pace of convergence in the CESEE region as competitiveness erodes because of rising unit labor costs. The reorientation of trade and supply chains could also raise input costs in these countries and refocus efforts away from productivity improvements in sectors where countries have a relative comparative advantage.

**Figure 1.6. Past and Future Structural Issues**

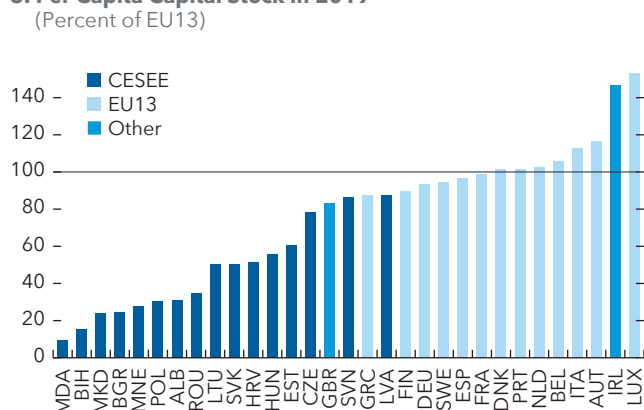
**1. Labor Productivity and Trend**



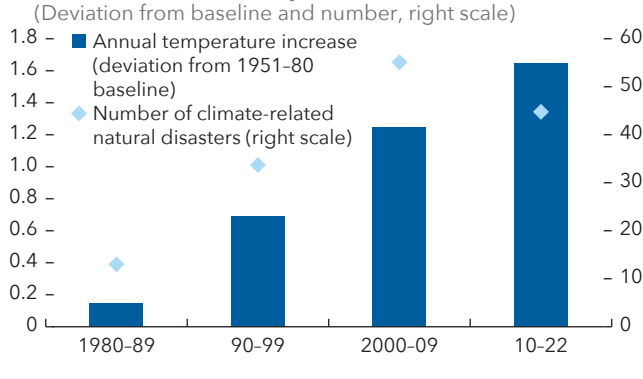
**2. Drivers of Growth**



**3. Per Capita Capital Stock in 2019**



**4. Climate Urgency: Temperature Rise and the Frequency of Natural Disasters in Europe**



Sources: Emergency Events Database; Eurostat; Haver Analytics; IMF, World Economic Outlook database; Penn World Table 10.01; and IMF staff calculations.

Note: In panel 1, labor productivity is measured by output per hours worked. Trend productivity is calculated based on the productivity growth average between 2017-19. Simple average for AE and EE. EE sample includes Bulgaria, Croatia, Hungary, Poland, and Romania. In panel 2, the total factor productivity is calculated as a residual based on the labor and capital production function for output. EA4 includes France, Germany, Italy, and Spain. In panel 3, the EU13 is defined as the former EU15 excluding Great Britain and Ireland. In panel 4, the number of disasters reported is the average number per year. The annual temperature increase deviation is averaged over the time period depicted. Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced Europe; CEE = Central and Eastern Europe; CESEE = Central, Eastern, and Southeastern Europe; EE = European emerging market economies; SEE = Southeastern Europe.

- *Capital stocks* in European emerging market economies are still substantially below the levels in advanced economies (Figure 1.6, panel 3). More capital-intensive production would raise productivity and income levels, but global uncertainty and higher financing conditions may hamper a recovery in investment in CESEE countries.
- The adverse impacts of *climate change* have already begun to unfold. All countries experience growing temperature and more intense extreme heat episodes (Figure 1.6, panel 4). Droughts are intensifying in frequency and intensity in the Mediterranean region, which, together with higher temperatures, increases fire risks. The upward trend in river floods is projected to continue and will affect Western and Central Europe.<sup>4</sup>

<sup>4</sup> See IPCC WGI Interactive Atlas.

## Europe's Outlook: Still a Soft Landing for Most

The region's economic outlook assumes a restrictive macroeconomic policy mix until late 2024. Monetary policy will remain tight in most countries, given inflation risks. Mild fiscal consolidation is expected to continue next year as support measures expire with variation across countries. Bouts of financial sector strains will remain contained. Russia's war in Ukraine continues, but no escalation is assumed. Commodity prices will lower from their peak last year but remain above prepandemic levels while remaining supply bottlenecks ease gradually (Figure 1.7, panel 1). Global growth is also broadly unchanged with the stronger-than-expected growth from the United States, offset by slower growth in China as the real estate crisis broadens.

A soft landing is expected for most of Europe. Sequential growth in the second half of the year will be slower than projected in the July 2023 *World Economic Outlook Update*, as the effects of monetary transmission set in. The lower carryover will reduce the annual forecast for next year from 1.5 to 1.7 percent projected in July. The main source for the 2024 recovery, relative to 2023, is strengthening household demand linked to improving real incomes from higher nominal wage growth and disinflation. Household spending is buffered by savings accumulated during the pandemic (although only about one-third of these savings are in liquid instruments and readily available for use<sup>5</sup>), and falling property prices are impairing net asset positions (Figure 1.7, panel 2). At the same time, the domestic demand recovery is still dampened by the effects of monetary tightening on investment, the withdrawal of fiscal support, and less demand by trading partners.

Advanced and European emerging market economies are expected to grow by 0.7 and 2.4 percent, respectively, in 2023 (Figure 1.7, panel 3), with growth dynamics differing substantially because of different economic structures and macro policies, especially related to available policy space. Service-oriented advanced economies (*France, Italy, Spain*) will benefit from higher services demand in the first half of the year and expectations of contained wage increases from collective bargaining agreements. However, weakness in investment and external demand have resulted in a downward revision of growth in both 2023 and 2024 in economies with relatively larger manufacturing sectors (*Germany*). The near-term outlook in CESEE countries is mixed, with some exiting technical recessions (for example, *Estonia* and *Lithuania*) and some with upward revisions in 2023 as a result of trade improvements (*Albania, Croatia, Slovenia*). In Türkiye, a small upward revision to the growth rate of 2023 is from higher-than-expected consumption in the second quarter and slightly larger fiscal expansion. Growth in Russia has also been revised upward for 2023, reflecting a strong shift from external to domestic demand (see Box 1.2). A gradual economic recovery is underway in Ukraine, with overall growth of 1–3 percent projected for 2023, with some upside risk (see Box 1.1).

Growth spillovers from outside of Europe are expected to remain limited, as stronger US growth is offsetting sluggish growth in China. Within Europe, the synchronicity of fiscal and monetary tightening limits the degree of demand spillovers. However, they could become more important if differences in monetary policy stance and fiscal adjustment pace become large, including because of possible exchange rate adjustments.

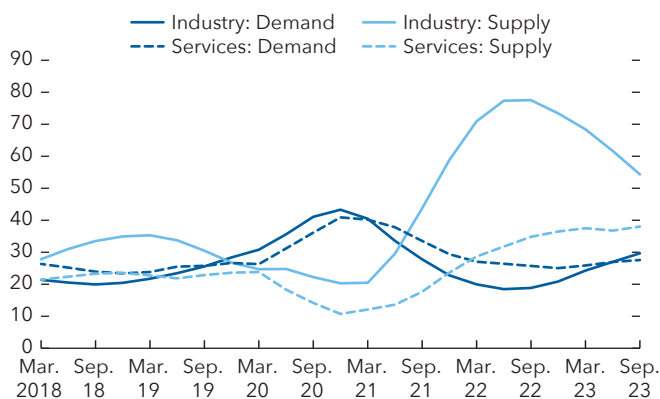
Falling commodity and energy prices are expected to be the main drivers of headline inflation this year (Figure 1.7, panel 4). Average annual headline inflation is projected to fall to 3.3 percent in 2024 from 5.8 percent in 2023 for advanced European economies and to 5.8 percent from 11.9 percent for European emerging market economies (excluding Belarus, Russia, Türkiye and Ukraine). Core inflation is projected to slow at a more gradual pace, particularly in European emerging market economies because of sustained wage growth contributing to highly persistent services inflation. Most countries will not reach inflation targets before 2025, when wage growth normalizes and the pass-through of commodity and food disinflation is complete.

<sup>5</sup> This illiquidity together with the concentration of excess savings among households in the top income quantiles could explain the lower depletion of accumulated savings in Europe relative to the United States where a large part of it has already been spent.

**Figure 1.7. Growth Tailwinds**

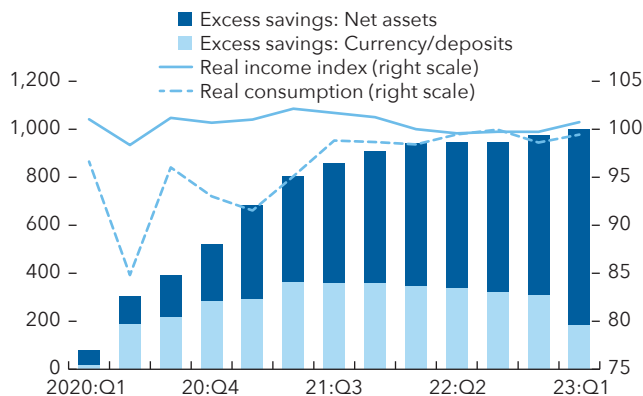
**1. EU27: Factors Limiting Production**

(Percent of respondents, seasonally adjusted)



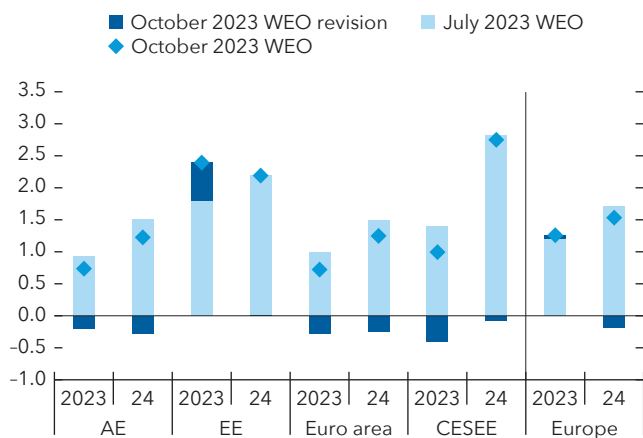
**2. Euro Area: Excess Savings and Real Incomes**

(Billions of euro; index, 2019:Q4 = 100)



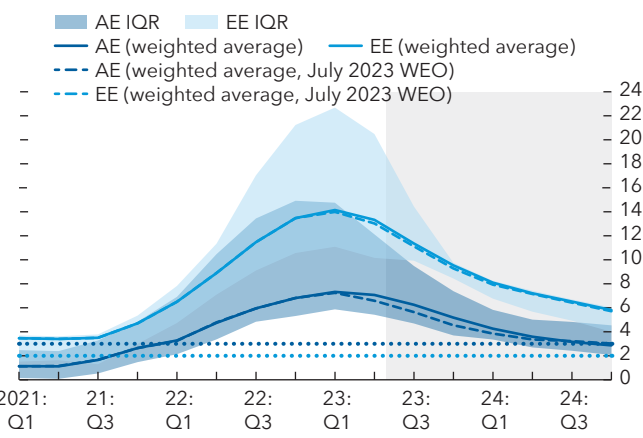
**3. Growth Outlook**

(Percent)



**4. Inflation Outlook**

(Percent)



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

Note: In panel 2, real income and consumption refer to gross adjusted disposable income and final consumption expenditures deflated by consumer price index. In panel 4, EE sample excludes Belarus, Russia, Türkiye, and Ukraine. Dotted light and dark blue lines in panel 4 indicate the median central bank target for EE (light blue) and AE (dark blue). AE = advanced Europe; CESEE = Central, Eastern, and Southeastern Europe; EE = European emerging market economies; IQR = interquartile range; WEO = *World Economic Outlook*.

Medium-term growth forecasts are more subdued than forecast in the April 2023 *World Economic Outlook*. For many countries in the region, both COVID-19 and energy crises are weighing heavily on productivity and potential output, with the median output loss from the double crisis estimated at 2 percent and 3.7 percent for advanced and European emerging market economies, respectively (Figure 1.5, panel 2). Moreover, an incomplete structural policy agenda implies that economic challenges from fragmentation, climate change, and technological transformation will lead to additional reductions in potential growth over the medium term.

## Growth Prospects Are Stymied by Upside Inflation Risks

The economic recovery path remains uncertain. On the upside, inflation could move back to target faster than anticipated—for example, if short-term inflation expectations adjusted more quickly back to targets across the region, driven by falling energy prices. In such a scenario, central banks could lower policy rates faster than anticipated, which would lift growth compared with the baseline.



However, overall, downside risks to growth dominate. A stagflation scenario with higher inflation and stagnant growth is a key risk that could lead to adverse macro-financial spillovers to financial stability and debt sustainability. Additional commodity price shocks or more persistent core inflation than currently predicted could force central banks to tighten monetary policy more than expected, thus lowering growth. For example, Chapter 2 explores a plausible risk scenario in which more backward-looking wage setting and tighter labor markets lead to 1 and ½ percentage points higher core inflation in CESEE and advanced European economies (excluding CESEE), respectively, over the 2024–25 forecast horizon. Other risks include possible monetary policy missteps—(for example, if central banks loosen the monetary policy stance prematurely)—or unanticipated fiscal loosening, which could increase inflation expectations and inflation persistence. On the flip side, a much quicker than anticipated transmission of monetary policy or excessive tightening could lead to adverse growth effects, including through risk repricing. For countries in advanced Europe, a re-materialization of deflationary risk could occur if inflation were to significantly fall below target.

Risks to financial stability are high. An asset price correction from larger-than-expected interest rate hikes or stronger-than-expected transmission to activity and credit quality, together with a weakness in Europe’s property market, could create systemic financial instability. Associated losses in open-ended investment funds with CRE holdings can prompt redemptions—triggering the need for further asset disposals—and spill over to other asset classes, amplifying systemic risk.

Risks remain substantial on the geopolitical front. An escalation of Russia’s war in Ukraine and associated sanctions would disrupt trade, remittances, foreign direct investment, and financial flows, threatening recovery prospects. Over the medium term, weakened international cooperation, protectionism, or shortages in critical metals could result in persistent supply disruptions, rising input costs, and financial instability from stranded assets, leading to subdued investment and output growth. A greater-than-expected weakening to growth in China could spill over to global capital and funding markets.

## Policies: Securing Price Stability and Strengthening Fundamentals

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Policy efforts to counter inflation and its adverse effects are starting to pay off, but the fight is not yet over. Given upside risks to inflation, monetary policy needs to maintain a sufficiently restrictive stance to ensure that inflation moves back to target in a timely manner. Price stability is critical for countries to operate in a shock-prone world. Similarly, fiscal policy should rebuild buffers, thus aiding disinflation in the near term. Financial sector policies will need to be deployed nimbly to preserve financial stability and preemptively address any pockets of strain. Recent bank profits should be used to build buffers. Structural policies must address the scars left by the global pandemic and energy crises, lift productivity growth, and enhance economic adaptability—all of which can also contribute to easing inflationary pressures.

## Monetary Policy: Going the Extra Mile to Beat Inflation

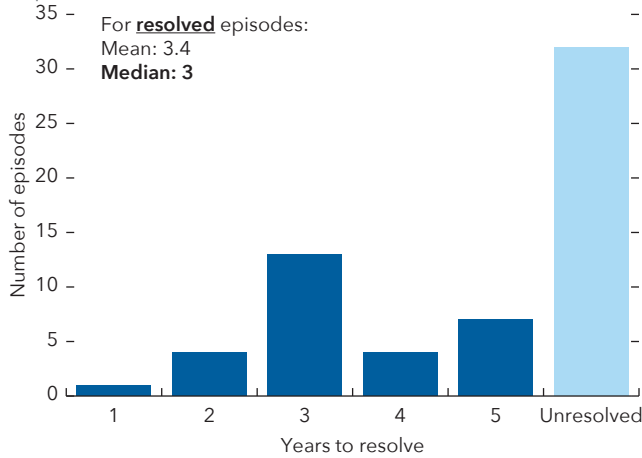
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The European Central Bank and other central banks are reaching the peak of their interest rate cycles, while some have started to reduce policy rates. Nonetheless, a prolonged restrictive stance is still necessary to ensure that inflation moves back to target. Central banks should maintain insurance against negative surprises. Simulation excises for the euro area show that the growth costs of underestimating inflation persistence could be as large as 1 percentage point of GDP over the medium term, because central banks would have to mount a second effort to ensure price stability (IMF 2023a).

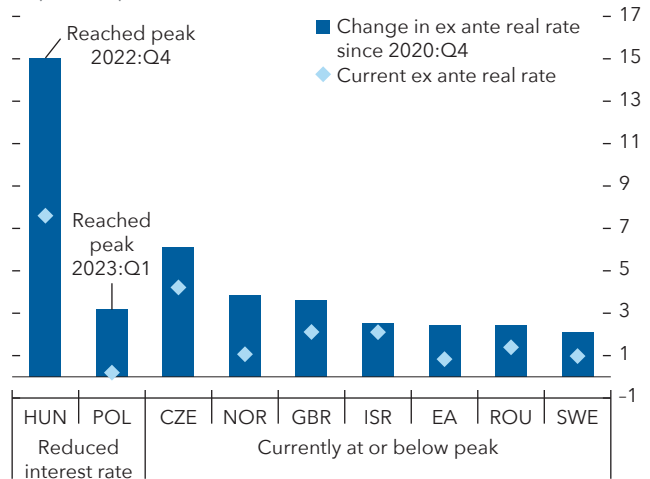
Experience from past inflation episodes cautions against easing too early—for example, because of overly optimistic predictions of speedy disinflation. Historically, disinflation episodes take an average of three years, but a sizable share of disinflation episodes took longer, and not all efforts ultimately succeeded (Figure 1.8, panel 1).

**Figure 1.8. Europe: Inflation Persistence and Policy****1. Historical Inflation Persistence**

(Years until inflation falls within 1 percentage point of preshock rate)

**2. Real Rate Change and Monetary Stance in Selected Countries**

(Percent)



Sources: Ari and others 2023; Consensus Forecast; Haver Analytics; and IMF staff estimates.

Note: Panel 1 refers to episodes associated with the 1973–79 oil crises. Unresolved episodes are those in which inflation remains at least 1 percent above the preshock rate after five years. See Ari and others (2023) for further details on the methodology. In panel 2, data are as of the end of September 2023. For countries that have eased, the blue bars represent the ex ante real rate change between the month before nominal rate easing and the fourth quarter of 2020. Ex ante real rates are calculated using consensus one-year-ahead inflation expectations or desk projections. For Hungary, the one-day deposit tender is used as the de facto policy rate between October 2022 and September 2023. Country abbreviations are International Organization for Standardization (ISO) country codes. EA = euro area.

The level and duration of tightness in the monetary policy stance need to be calibrated to country-specific conditions. Depending on the data, this can mean that central banks keep rates at current levels for some time or raise them further. Although many *European emerging market economies* started raising policy rates in 2021 (and by substantial amounts), real policy rates (which correct nominal rates for expected inflation) have remained low in some countries (see, for example, Figure 1.8, panel 2). Where the current monetary policy stance is loose, policy rates might have to raise further or kept at sufficiently high levels for some time to allow falling inflation expectations to lift real rates. Given the high cost of erring on the side of a too-loose monetary policy, the empirical case for a less-restrictive stance would have to be strong. Considerations for a significant easing of the monetary stance below what is required under the baseline should include (1) a substantial improvement in the core inflation forecast from the current baseline; (2) a clear reduction of upward inflation risks, hinging on developments in the labor market (for example, the evolution of market tightness and wage dynamics); and (3) absence of any upward movements in short-term and long-term inflation expectations amid clarity about the monetary policy path.

In the *euro area*, the European Central Bank should maintain its restrictive monetary stance as inflation is forecast to return to target by 2025, at the latest. The policy rate should remain the European Central Bank's primary policy tool. Separately, the Eurosystem should continue to reduce its bond holdings gradually and predictably to shrink its footprint in the financial markets. A learning-by-doing approach to the reduction of their balance sheets should be pursued, with well-communicated escape clauses which would allow the European Central Bank to adjust course if financial conditions change sharply. For the *United Kingdom*, with significant tightening already happening, a meeting-by-meeting approach for additional rate hikes is appropriate, focusing on services inflation and wage growth. However, policy rates will need to stay high for an extended period to durably bring inflation down to target and keep inflation expectations anchored.

Along with ensuring that monetary conditions remain sufficiently tight to support disinflation, good central bank communication will be important throughout the process. For example, central banks can help anchor inflation expectations of firms and households by communicating their policy intentions and expected policy responses to changing economic data. This would also help contain the significant repricing risk from investor abruptly adjusting their expectation about the outlook.<sup>6</sup>

## Fiscal Policies: Fostering Resilience and Aiding Disinflation

Public finances are set to improve over 2023–24. Revenue is recovering, helped by inflation and the phase-out of public support measures. Public debt-to-GDP ratios will remain elevated and keep rising in European emerging market economies. In *advanced European economies*, a fiscal consolidation of 0.3 percent of GDP, based on the change in cyclically adjusted primary balance, is expected in 2023, but a meaningful reduction by 0.85 percent of GDP will take place only next year (Figure 1.9, panel 1). In *European emerging market economies*, the projected fiscal consolidation of 0.25 and 0.72 percent of GDP in 2023 and 2024, respectively, is less than projected in the April 2023 *Regional Economic Outlook: Europe* (Figure 1.9, panel 1). This reflects, among other factors, higher costs from public sector wage increases (*Romania*) and defense spending (*Poland*).

At this juncture, all countries should step up their efforts to rebuild or preserve fiscal buffers while protecting the vulnerable and supporting public investment for strong and green growth in the medium term. By reducing deficits, fiscal policy complements monetary policy in the fight against inflation. Synchronized fiscal and monetary policies offer gains, particularly for the euro area, where it is beneficial for unionwide inflation reduction. For instance, a fiscal consolidation of 2.5 percent of GDP over three years across the euro area is assessed to ease the policy interest rate by 30–50 basis points relative to the baseline scenario, while lowering inflation.<sup>7</sup> Within the euro area, countries with inflation running significantly higher than the unionwide average should also make a greater consolidation effort.

Consolidation and resource mobilization starting in the near term is needed for securing debt sustainability. In European emerging market economies as a whole, under current projections, the envisioned gradual fiscal tightening will not be sufficient to prevent public debt ratios from rising (see Box 1.3 on debt stabilization). For countries with high debt, increasing effective rates (that is, interest paid by the general government) will affect the debt trajectory adversely, and the decline in debt ratio relies primarily on projected growth, which could disappoint on the downside (Figure 1.9, panel 2). For low-debt countries, large primary deficits imply worsening debt dynamics over the medium term. Further, in an adverse scenario in which growth is weaker by 1 percentage point in 2024 and 2025, leading to lower primary balances and higher interest rates over 2024–28, the probability of debt not stabilizing rises significantly (Figure 1.9, panel 3).<sup>8</sup> The unfavorable public debt outlook and increased financing pressures reinforce the importance of carefully designed medium-term fiscal consolidations in many European economies. Any additional net spending should be weighed carefully against medium-term pressures from higher interest rates and expenditure needs from aging populations, climate change, and growth investments.

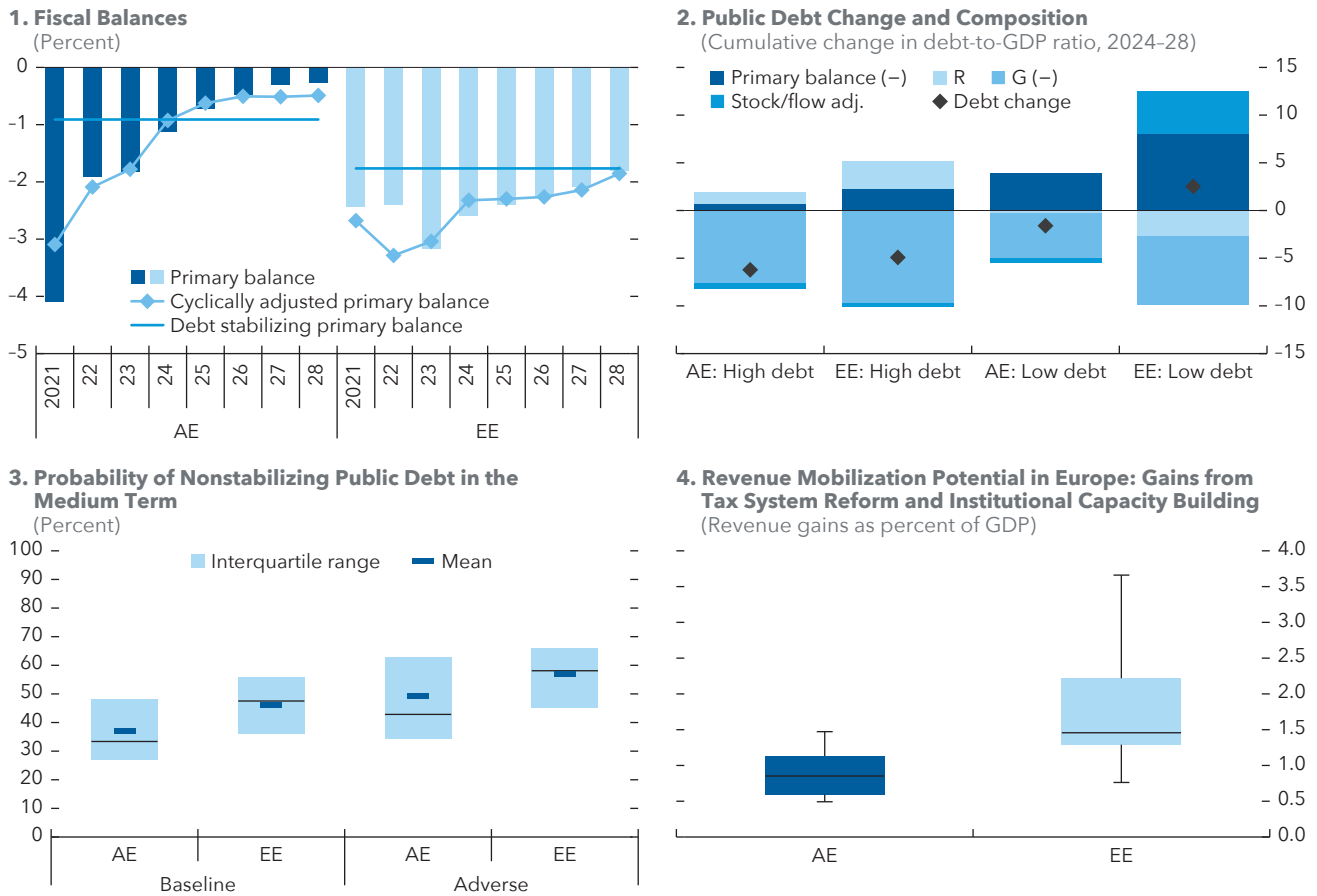
For most countries, fiscal consolidation requires action on several fronts. The pace and composition of consolidation should seek to protect growth. Untargeted pandemic and cost-of-living support during the energy crisis should be unwound to free up resources to safeguard welfare and other priority spending. The appropriate magnitude of consolidation depends on available fiscal space. In high-debt countries, decisive and sustained fiscal adjustments will be needed to secure sustainability, especially given the prospects of higher borrowing costs in the future. Countries with more fiscal space can plan for more gradual consolidations (*Austria, Latvia*).

<sup>6</sup> See the October 2023 *World Economic Outlook*, Chapter 2, and *Global Financial Stability Report*, Chapter 1.

<sup>7</sup> See Beyer and others (2023).

<sup>8</sup> In the adverse scenario, primary balances are lower by 1 percentage point of GDP, and real interest rates are 50 basis points higher for advanced European economies and 100 basis points higher for European emerging market economies.

**Figure 1.9. Fiscal Developments**



Sources: Benitez and others 2023; IMF, World Economic Outlook database; and IMF staff calculations.

Note: In panel 1, GDP purchasing power parity-weighted average for AE and EE. European emerging market economies excludes Belarus, Russia, Türkiye, and Ukraine. In panel 2, simple average for AE and EE. This panel excludes Andorra, Belarus, Kosovo, Norway, Russia, and Ukraine. For panel 3, in the adverse scenario, growth is weaker by 1 percentage point in 2024 and 2025, primary balances are lower by 1 percentage point of GDP, and real interest rates are 50 basis points higher for advanced economies and 100 basis points higher for European emerging market economies. Panel 4 reports the distribution of tax gains (in percent of GDP) across advanced and European emerging market economies. Tax gains are estimated by closing the gap between the country's observed level of tax collection and its tax potential, which is the highest observed level controlling for country characteristics. EE excludes Belarus, Ukraine, and Russia. AE = advanced Europe; EE = European emerging market economies; G = growth; R = interest rate service.

In many CESEE countries, balancing near- and medium-term needs will require realizing expenditure efficiency gains and revenue measures—including by broadening the tax base and eliminating exemptions<sup>9</sup>—to accommodate the substantial infrastructure and labor skilling investments (for example, *Bulgaria* and *Serbia*) as well as energy transition needs (for example, *Poland*). Closing the gap between the observed level of tax collection and an estimated tax potential by improving tax policy design, and moving toward a more efficient system by eliminating unwarranted exemptions, and enhancing institutional capacity is estimated to reap substantial tax gains. This can range from about 0.4 percent to 1.5 percent in advanced European economies and 0.7 percent to 3.6 percent of GDP in European emerging market economies (Figure 1.9, panel 4).<sup>10</sup>

<sup>9</sup> For instance, Hebous and others (2022) estimate gains from such revenue mobilization to be about 2 percent of GDP for Romania.

<sup>10</sup> See Benitez and others (2023). Each country's tax potential is estimated based on the highest observed level controlling for country characteristics, including GDP per capita, the size of the agriculture sector, and, importantly, government effectiveness and the perception of corruption in the public sector.

Risk-based fiscal frameworks can reduce debt vulnerabilities and build buffers. In the European Union, the ongoing reform of the EU economic governance framework is a welcome opportunity to promote sustainable public finances. The European Commission’s legislative proposal would facilitate a risk-based fiscal adjustment path which would link the speed and ambition of fiscal consolidation to the level and horizon of fiscal risks, while avoiding procyclicality. It could be strengthened by an EU-wide fiscal capacity and by introducing an independent European fiscal council. Ex ante announcing clear and ambitious medium-term adjustment paths, backed up with enacting credible medium-term fiscal frameworks consistent with the EU-level rules, would ease risks and financing pressures. In high-debt countries, a credible commitment to consolidation could also raise growth by stimulating consumption and crowding in investment through increased household confidence and credit reallocation channels.<sup>11</sup>

## Financial Policies: Maintaining Financial Stability

### Risks and Supervision

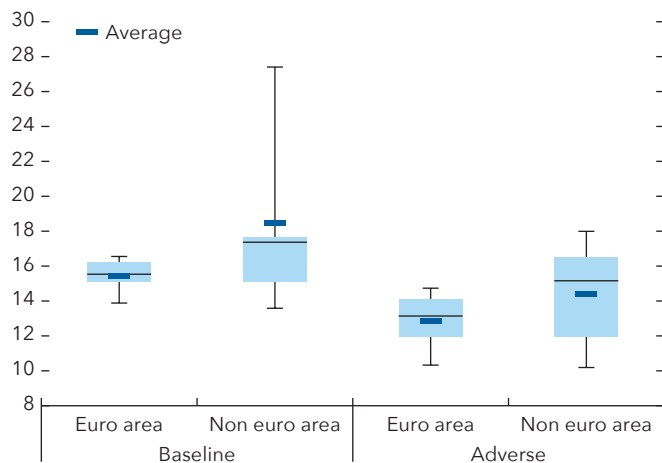
Tighter financial conditions and growth risks elevate stability concerns. Although the European banking system exhibits high levels of solvency and liquidity, banks in some jurisdictions have substantial security holdings that may lead to a significant depletion of their common equity Tier 1 ratio under an adverse stagflation scenario. For instance, banks in the euro area would suffer, on average, a 2.5 percentage point loss of capital relative to the baseline when hit by a shock to global growth of about 2 percent and more persistent inflation (Figure 1.10). The loss of capital is driven mainly by higher loan loss provisions and valuation losses. Central bank facilities

to provide emergency liquidity, and improved communication on acceptable collateral and haircuts, would be crucial to stemming such systemic risks.

Monitoring emerging financial risks is critical, including those from the nonbank sector and in the relatively illiquid leveraged loan market. Low covenant quality coupled with a weak macroeconomic outlook have increased mispricing risk that could trigger disorderly price corrections, including through indirect exposures to banks. Regulators should also remain vigilant to risks from a sovereign-bank nexus; sovereign yields could come under elevated stress as banks experience mark-to-market losses.

In the European Union, reforms (including introducing a systemic risk exemption from minimum bail-in requirements) would add needed flexibility to deal with adverse events. Public backstops need strengthening, which includes ratifying the European Stability Mechanism treaty (which would operationalize the European Stability Mechanism’s financial backstop to the Single Resolution Fund and

**Figure 1.10. European Bank Common Equity Tier 1**  
(Percent)



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

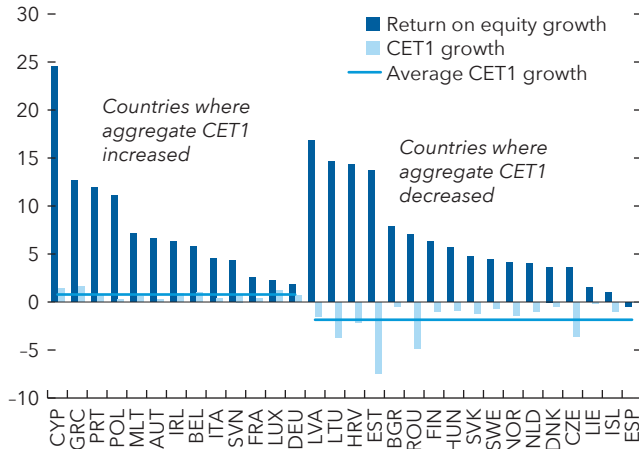
Note: The adverse scenario assumes more persistent inflation and a global economy contraction of about 2 percent in 2023, leading to recessions across regions, including in China. The peak global policy rate shock over the baseline is about 170 basis points. In the figure, capital ratios are reported for the year 2023. See the October 2023 *Global Financial Stability Report*, Chapter 2, for further details. The whiskers span 90 percent of the data, from the bottom 5 percent to the upper 95 percent.

<sup>11</sup> See Morais and others (2021) and Alesina, Favaro, and Giavazzi (2019).

**Figure 1.11. Bank Earnings, Buffers, and Credit Exposure**

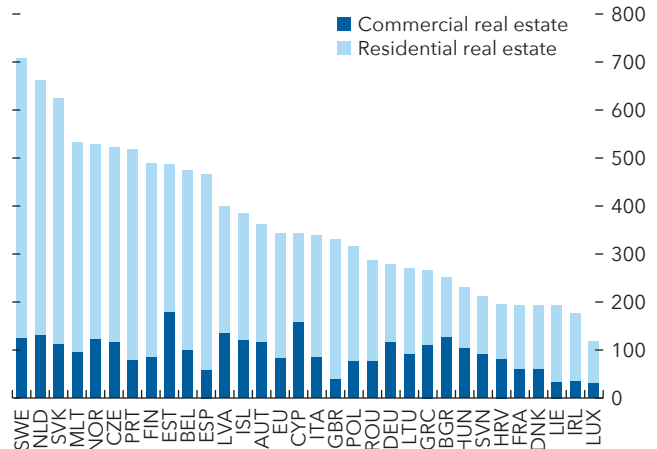
**1. Bank Profits and Capital Buffer**

(Percentage points, growth rate between 2021:Q1 and 2023:Q1)



**2. Bank Credit Exposure to Domestic and Foreign Real Estate**

(Percent of Tier 1 capital in 2023:Q1)



Sources: European banking authorities; and IMF staff calculations.

Note: For Spain, growth rates are between 2021:Q2 and 2023:Q1 as 2021:Q1 saw a sharp increase in return on equity from the realization of extraordinary gains due to the merger of two banks, among other things. Country abbreviations are International Organization for Standardization (ISO) country codes. CET1 = common equity Tier 1.

make credit management arrangements more credible) and creating a pooled European Deposit Insurance Fund (which would delink the ability to provide deposit insurance from the creditworthiness of the sovereign, thus limiting divergence in financial conditions).

**Macprudential Policies**

Given the continued high level of financial stability risks in Europe, macroprudential policies should aim to proactively ensure that banks have sufficient buffers to absorb any adverse impact of the financial tightening cycle. By mitigating financial stress and containing undesirable side effects of monetary policy, these policies also make the commitment of monetary policy to price stability less costly.

Banks have increased their profits as a result of cyclically rising net interest margins. These higher margins should support an increase in capital buffers (Figure 1.11, panel 1). Windfall taxes on bank profits should be avoided as they distort credit availability and costs. Broad-based tools such as the countercyclical capital buffer could instead be tightened to reach positive neutral rates to encourage banks to increase buffers and strengthen their ability to absorb shocks.<sup>12</sup> Raising the buffer now will also create room to promptly lower it later in response to future downturns. Targeted macroprudential tools such as borrower-based measures should be maintained or implemented in countries where they are not in force. This would prevent a lowering of credit standards in the wake of rising interest rates.

National authorities should be particularly vigilant to the buildup of risks in the CRE sector, which is vulnerable to tightening of the financial cycle and a slowdown in the growth outlook amid other structural shifts (see Box 1.4). Banks have significant exposure to CRE lending, which occurs at high loan-to-value ratios in several countries, and these exposures also spill over to the nonbank segment (Figure 1.11, panel 2). If asset repricing occurs, it would increase credit institutions' loss-given-default ratios and weigh on provisioning, creating a negative

<sup>12</sup> See also BCBS (2022), a recent communication from the Basel Committee on Banking Supervision on positive cycle-neutral countercyclical capital buffer.

spillover to aggregate credit supply. Supervisors should monitor the credit quality of banks' CRE portfolios carefully and where appropriate deploy sectoral systemic risk buffers or adjust risk weights to mitigate any stress from this segment.

## Structural Policies: Aiding Disinflation and Adapting to Global Headwinds

Getting structural fundamentals right will prepare countries to lift growth and support climate goals while helping disinflation by raising productivity. Fragmentation and higher energy costs pose new challenges that add to long-standing growth problems from slowing productivity growth and demographic constraints to labor supply.

Lifting productivity requires action on several fronts. Reforms should focus on removing barriers that prevent economic innovation and dynamism. For most of Europe, this implies improving the business environment by removing excessive regulation and high entry costs, especially for small and medium enterprises and start-ups. Enhancing the efficiency of credit allocation by reducing the tax bias toward debt and improving insolvency regimes to allow for a faster exit of unviable firms will lower the corporate debt overhang and support aggregate productivity dynamics. Support to firms to weather temporary shocks should also be minimized because it undermines efforts to build corporate resilience and comes with high fiscal costs. Important avenues to address labor shortages include eliminating disincentives for full-time employment (see Chapter 2) and easing labor market bottlenecks by improving the efficiency of job searches.<sup>13</sup> Measures to improve worker training and skills matching will be particularly important to facilitate the green transition without generating employment losses and to meet the increasing demands of the new green economy.<sup>14</sup>

The need to get structural policies right is particularly important in CESEE countries. Capital stocks remain well below levels in advanced economies (Figure 1.12, panel 1). To attract inward investment, countries should ensure business-friendly environments by strengthening public governance, developing a skilled labor force, and enhancing infrastructure (Atoyán and others 2016; Ari and others 2020). Emigration from CESEE countries has been substantial and persistent and may have also slowed growth and income convergence. Investing in human capital to align education, health, and social protection outcomes with those of EU member states can help stem the excess flow of emigration. Enhancing the labor market integration of immigrants including refugees through combined language and work-oriented activity assistance and targeted wage subsidies to incentivize hiring will also help boost their employment and productivity in the medium term.

Geoeconomic fragmentation is likely to raise the costs of critical inputs (Figure 1.12, panel 2). Considering these risks, several countries in Europe have introduced targeted sectoral policies (often called industrial policies) to jumpstart productivity growth, encourage the establishment of critical industries (for example, chips manufacturing), and accelerate the green transition.<sup>15</sup> Such policies, when they address market failures or externalities that horizontal and less-distortionary policies cannot address, may have some role to play and can be important in areas where information and network externalities are sizable. Examples include the public provision of critical infrastructure to reduce fixed costs for users and producers, and targeted tax incentives and funding for basic research that benefits the wider economy but in which markets tend to underinvest because of its

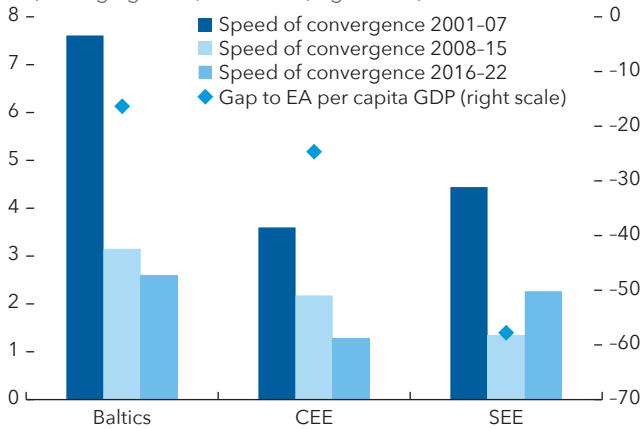
<sup>13</sup> Examples include job search assistance programs, which have been found to have large effects on employment (Caliendo and Schmidl 2016; Card, Kluve, and Weber 2018), increasing skills certification, and strengthening the link between apprenticeship and vocational training through dual education tracks.

<sup>14</sup> See Celasun and others (2023) and IMF (2022, 2023b), which find that active labor market policies, specifically training, and work experience can help improve job transitions into green occupations and reduce adjustment costs.

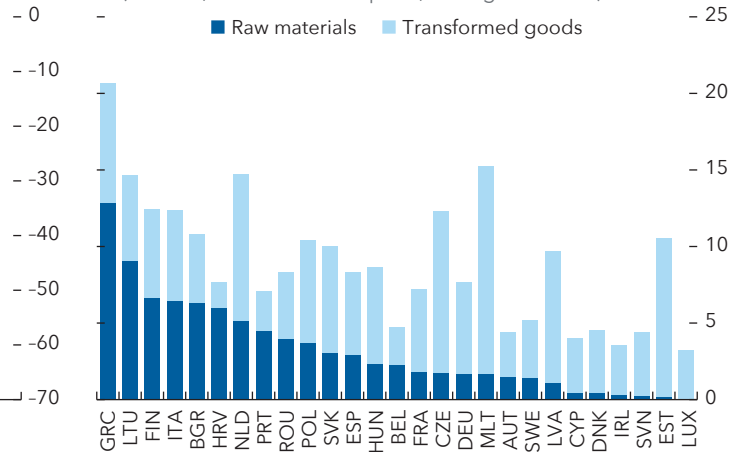
<sup>15</sup> Select examples include (1) the European Chips Act that provides funding (of about €43 billion, similar to the US CHIPS and Science Act of 2022 funding) to bolster the European Union's competitiveness and resilience in semiconductor technologies and applications; (2) the European Union's Foreign Subsidies Regulations, which creates a new regime aimed at combating distortions of competition on the EU internal market caused by foreign subsidies; (3) the European Union's Foreign Direct Investment Regulation, which screens and regulates foreign direct investment into EU member states to safeguard critical infrastructure, technologies, and strategic assets of the EU countries from potential risks posed by foreign investors; and (4) the European Union's Export Control Regulation, which monitors exports, deployment of technical assistance, and transit and transfer of dual-use items.

**Figure 1.12. Convergence and Supply-Side Bottlenecks****1. CESEE GDP per Capita: Speed and Level of Convergence to Euro Area**

(Average growth; difference, right scale)

**2. EU27: Import of Fragile Intermediary Goods from Blocs against UN Russia Resolution ES-11/4**

(Percent, share of total imports, average 2017-19)



Sources: Baba and others (forthcoming); Eurostat; and IMF staff calculations.

Note: In panel 1, "Speed of convergence" is defined as the growth rate of per capita GDP at purchasing power parity relative to the euro area economy (EA19 definition). In each group, the median per capita GDP is considered. Following Korniyenko, Pinat, and Dew (2017), intermediate goods are defined as fragile if they are subject to high centrality of existing or available exporters, and the potential to substitute existing suppliers is low. Country abbreviations are International Organization for Standardization (ISO) country codes. CEE = Central and Eastern Europe; CESEE = Central, Eastern, and Southeastern Europe; EA = euro area; SEE = southeastern Europe.

public good character.<sup>16</sup> However, it is critical for these policies to target market failures and be compliant with the World Trade Organization agreements. Such interventions can otherwise distort market functioning or divert economic resources away from areas of comparative advantage. The recent use of discriminatory trade policies or subsidies to encourage domestic investment carries high economic inefficiency and fiscal costs at the national, European, and global levels (Aiyar and others 2023). In this context, preserving the integrity of the European Union's single market is paramount. Any relaxation of state aid rules should be time bound and assessed carefully to not undermine competition. A common EU approach, with some financing at the EU level, would limit the risks of distortions to competition within the European Union.

On climate change, the European Union should continue to work with other countries to develop a common approach to reducing greenhouse gas emissions. Recent agreements on strengthening Europe's emission trading program are an important step toward achieving the European Union's climate goals. An international carbon price floor that is tiered by country income levels would be the most effective way to achieve emissions reduction commensurate with national targets for most European countries while preserving competitiveness (Chateau, Jaumotte, and Schwerhoff 2022; Parry and others 2021). Without a global system, carbon border adjustments are an important second-best tool to preserve competitiveness and reduce emissions leakage.

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<sup>16</sup> See the April 2021 *World Economic Outlook*, which finds that the private sector underinvests in basic research.



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### Box 1. Monetary Transmission in Europe

Policy rates have risen at a faster pace than in previous tightening cycles (Box Figure 1.1.1, panel 1), but evidence so far suggests a somewhat slower pass-through. Similar to previous episodes, the pass-through from monetary policy rates to bank interest rates on new loan flows, after six months is stronger for loans to nonfinancial corporations (with an elasticity of 0.8) than for mortgages (elasticity of 0.6) and is weakest for sight deposits (elasticity of 0.1) (Box Figure 1.1.1, panel 2). For mortgages, in particular, there is also significant heterogeneity across countries (ranging from 0.1 in Malta to 0.9 in Lithuania), which is closely associated with the share of flexible rate mortgages (Box Figure 1.1.1, panel 3). All retail rate pass-throughs are about 0.2–0.4 percentage point lower than those estimated from past rate increases for the euro area (Box Figure 1.1.1, panel 3), United Kingdom, and select European emerging market economies, depending on the type of rate considered. Structural changes of household and corporate balance sheets could explain the weakening of transmission. These include significant deleveraging, increased cash holdings, higher share of fixed rate mortgages in some countries (Hungary, United Kingdom), and interest-rate caps on mortgage and consumer lending (France, Hungary).

The speed and magnitude of the impact on the real economy remains difficult to assess. Gauging the impact from retail rate increases to domestic demand is complicated by atypical factors of the current business cycle, including the lingering effects of the large commodity price shock and the possible ramifications of the pandemic for the labor market. So far, increases in retail rates have directly affected household and firm budgets through a rise in the share of interest rate expenditure (by about 3–4 percent of gross disposal income and gross value added, respectively; Box Figure 1.1.1, panel 4). Similarly, credit conditions have tightened, and house prices and private construction activity is falling. At the same time, it is possible that the impact of the policy tightening is cushioned, to some extent, by the still-tight labor markets supporting strengthening wage growth, the large amount of excess savings European households accumulated during the pandemic, and relatively strong corporate and bank balance sheets.

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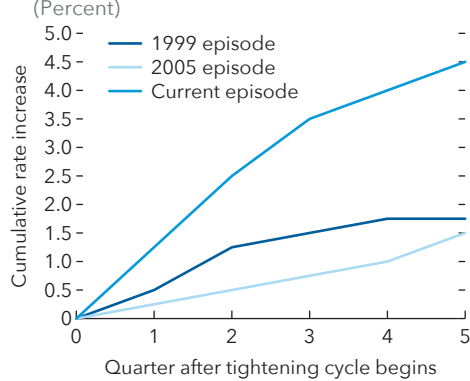
Prepared by Robert Carl Michel Beyer, Ruo Chen, Claire Li, Florian Misch, and Ezgi Ozturk.

Box 1. (continued)

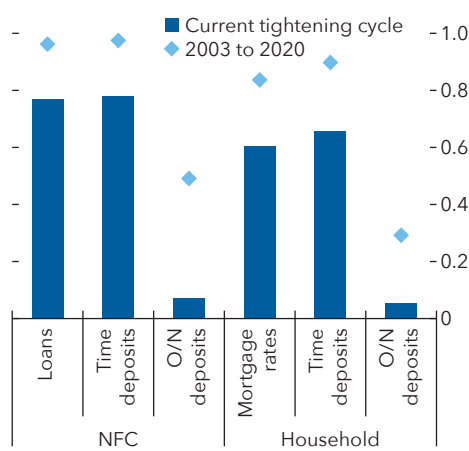
**Box Figure 1.1.1. Monetary Policy Rates and Transmission**

(Percent)

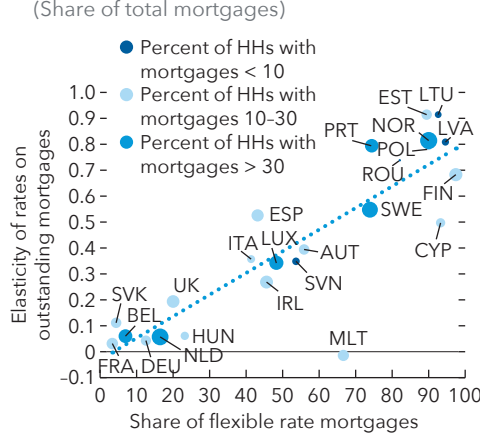
**1. Euro Area: Monetary Policy Rates in Past Tightening Cycles**



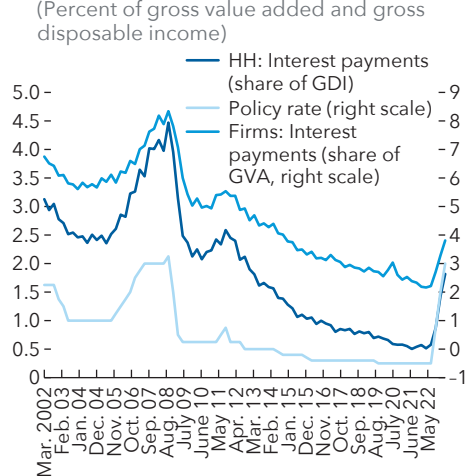
**2. Monetary Policy Pass-Through to Bank Rates**



**3. Monetary Policy Pass-Through to Outstanding Mortgages**



**4. Euro Area: Policy Rate and Interest Expenditures**



Sources: European Central Bank; Haver Analytics; and IMF staff estimates and calculations.

Note: Elasticity in panel 2 defined as the change in rates on new mortgages between the month of first policy hike and 2023:M6 as a ratio to the change in the policy rate. The share of flexible rate mortgages is approximated by the average of the share of new flexible rate mortgages since 2013 for most countries. Pass-through on panel 3 estimated from unbalanced panel regression after six months:  $r_{c,t}^{dl} = \alpha_c + \sum_k \beta^k \Delta r_{c,t-k}^{policy} + \Gamma X_{c,t} + \delta r_{c,t-1}^{dl} + \varepsilon_{c,t}$ . Control for six lagged monetary policy change, country fixed effects, industrial production growth, core inflation, as well as the lagged rate in levels. Country abbreviations are International Organization for Standardization (ISO) country codes. GDI = gross disposable income; GVA = gross value added; HH = household; NFC = nonfinancial corporates; O/N = overnight.

## Box 2. Ukraine

Following the Russian invasion, with growth declining by 29 percent in 2022, a gradual economic recovery is underway in 2023. Amid sustained attacks on Ukraine's infrastructure, the economy began to recover in early 2023, growing by 2.4 percent quarter-over-quarter seasonally adjusted in the first quarter and continued to expand during the second quarter. IMF staff sees overall growth of 1–3 percent for 2023, with some upside risk. The recovery is attributed to increased resilience among firms and households during the war, supported by a rebound in domestic demand and improved consumer and business sentiments (Box Figure 1.2.1). The foreign exchange market has remained broadly stable, helped by sizable international financial support. Despite recent positive outturns, the duration and intensity of the

war present a considerable risk to the economic outlook. Medium-term prospects depend on the outcome of the war, the scale of reconstruction spending, return of migrants, structural reforms and prospects of EU accession.

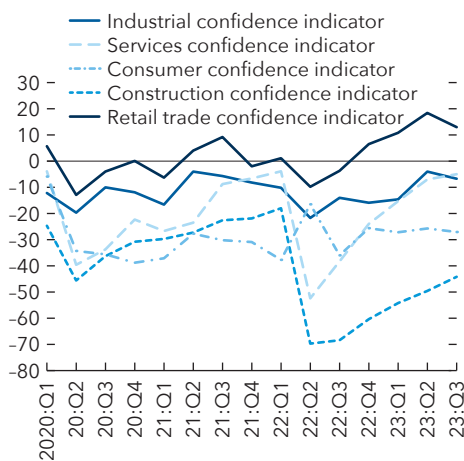
Since July, the National Bank of Ukraine cut the key policy rate by cumulative 500 basis points, to 20 percent, driven by both headline and core inflation falling at a faster rate than expected, and this trend provides the National Bank of Ukraine with room to continue easing its monetary policy in the upcoming months. In August, headline inflation declined to 8.6 percent year over year from 11.3 percent year over year in July and 26.6 percent at the end of 2022. The sharp disinflation reflects easing of supply bottlenecks (including food and fuel), favorable foreign exchange market conditions amid a stronger hryvnia cash exchange rate, and improving inflation expectations.

International reserves outperformed thanks to a better-than-expected current account balance and declining foreign exchange drains. Gross international reserves exceeded \$40 billion at the end of August. At the first review of the

Extended Fund Facility, reserves represented 4.1 months of next year's imports of goods and services. This partly reflects a better-than-expected current account balance. Capital controls have also helped contain financial account outflows. Foreign direct investment inflows totaling about \$2 billion year to date and lower-than-expected foreign exchange outflows from the banking system also helped underpin the strong international reserves position.

The fiscal deficit has deteriorated compared with last year, as higher expenditures more than offset higher revenues. The growth in expenditure was driven largely by defense-related spending, while tax revenues have benefited from the economic recovery. The fiscal deficit continues to be financed predominantly by external financial support.

**Box Figure 1.2.1. Economic Sentiment Indicator**  
(Percent)



Source: State Statistics Service of Ukraine.

## Box 2. Ukraine

The banking system remains operational and liquid, while balance sheets continue to adjust under martial law. Total banking system assets and deposits have increased by 32 percent and 48 percent in the National Bank of Ukraine and the interbank market, respectively. Short-term liquidity ratios were three times higher than minimum requirements on average in May 2023, and banks' core and total capital ratios have grown to 14.3 percent and 23.8 percent, respectively.

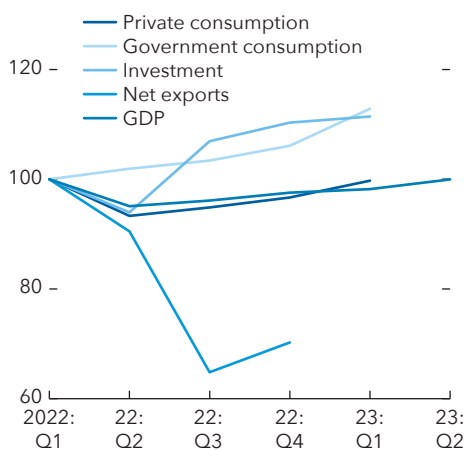
The IMF Executive Board approved the first review under the four-year Extended Fund Facility on June 29, 2023, enabling the disbursement of about \$890 million (special drawing rights of \$663.9 million). All quantitative performance criteria for the end of April and structural benchmarks through the end of June were met. Sustained reform momentum is needed, including in governance and anticorruption frameworks. With spending pressures growing, developing and executing a 2024 budget consistent with fiscal and debt sustainability will be critical. IMF staff will undertake the second review together with the Article IV consultation in the fall of 2023.

### Box 3. Russia

Ramped-up<sup>1</sup> military spending, transfers to households, and strong investment have helped Russia's economy recover from a deep but short-lived contraction. After Western governments imposed sanctions against Russia in response to its invasion of Ukraine, the Russian economy contracted sharply amid short-lived financial turmoil in the second quarter of last year. Since then, however, the economy has recovered steadily and has returned to its prewar level in the second quarter of this year (Box Figure 1.3.1). As a result, IMF staff has revised its 2023 GDP growth forecast to 2.2 percent. The turnaround was initially achieved by improved terms of trade related to high energy prices, followed by a substantial increase in military spending later last year and earlier this year that boosted aggregate demand, supported consumption, and encouraged investment. Expressed in real terms, government consumption and investment were 13 percent and 11 percent higher, respectively, in the second quarter of this year than at the start of the war. Household consumption received support from government handouts and a record level of employment and rising wages that were driven by strong domestic demand and reduced labor supply through conscription and emigration. The tight labor market drove unemployment to a record low of 3 percent in July. By contrast, net exports have contracted on declining gas exports and rising imports. Russia's economy, for now, has managed a turnaround from an export-driven to a domestic demand-driven economy amid sanctions and increasing decoupling from Western economies.

**Box Figure 1.3.1. Russia's Real GDP and Its Components**

(Index, 2022:Q1 = 100)



Sources: Federal State Statistics Service (Rosstat); Haver Analytics; and IMF staff.

and limited access to innovative technology because of the sanctions will take their toll on the economy's growth potential. IMF staff estimates medium-term potential growth at about 1 percent—higher than the estimates at the start of the war but still one-third below prewar potential and substantially lower than before sanctions were imposed after Russia invaded Crimea in 2014. New obstacles to growth come on top of lingering roadblocks to greater prosperity over the coming decades, related to an aging population, stress on infrastructure because of climate change, and potential losses due to reduced global demand for fossil fuels.

Medium-term prospects are less encouraging. Higher fiscal spending will generally allow for a temporary and not a sustained pickup in growth, given its composition. The record-low rate of unemployment, the depreciation of the ruble this year, the rise in inflation, and the Bank of Russia's sizable rate hike of 350 basis points in August are indications of an economy at the edge of its potential. Going forward, the cost of the war in terms of loss of human capital

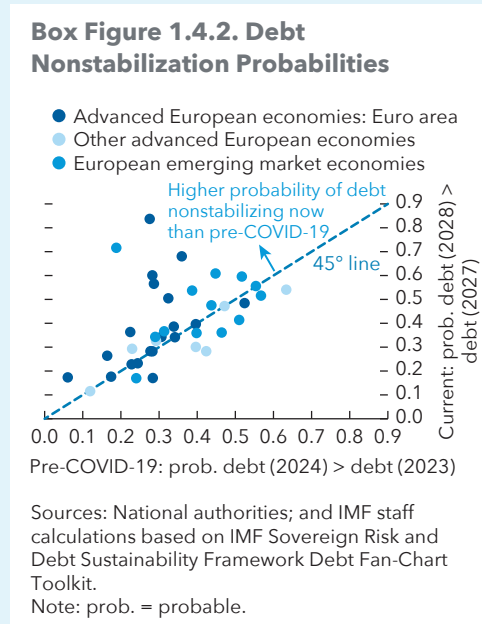
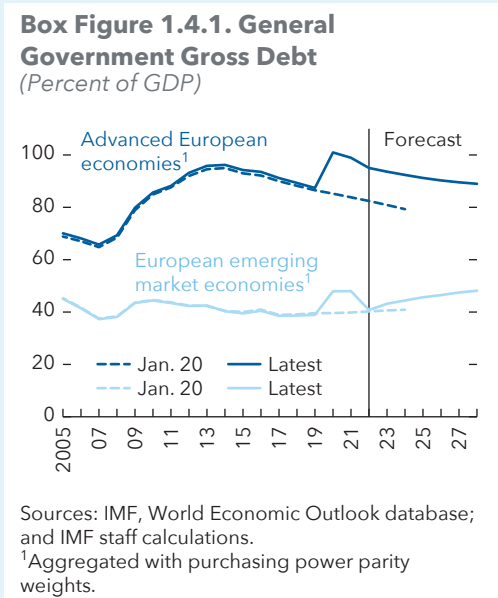
Prepared by Philipp Engler.

### Box 4. Europe: Medium-Term Debt Stabilization Risks

The public debt outlook for European economies has deteriorated in recent years. Fiscal deficits and public debts increased rapidly across advanced and European emerging market economies during the COVID-19 pandemic. Debt-to-GDP ratios have edged down since then, aided by high inflation, but they are projected to follow worse trajectories than previously projected (Box Figure 1.4.1)<sup>1</sup> because of higher primary deficits (likely reflecting, in part, the legacy of support programs introduced during the pandemic and after Russia’s war in Ukraine) and despite more favorable interest growth differentials. Debt stabilization prospects have also weakened, with the probability of debt not stabilizing five years out increasing in most euro area countries and in half of European emerging market economies (Box Figure 1.4.2).

Financing pressures have also increased. Projected gross financing needs as a share of GDP are higher for all but seven countries in the sample, compared with the prepandemic level (Box Figure 1.4.3). This is driven by weaker fiscal balances and higher interest costs, including as debt issued in a low-interest-rate environment is repriced after rollover. Meanwhile, the composition of gross financing needs, concentrated on amortization, limits fiscal flexibility. The reduction in asset purchases of public debt by central banks, including via active quantitative tightening, will also tighten sources of financing. In this context, the size and health of countries’ banking systems as residual financiers to the government will become increasingly important. The fact that gross financing needs as a share of banking sector assets are above prepandemic levels in two-thirds of the countries is concerning.

In these circumstances, debt stabilization could prove challenging, especially if downside risks to growth materialize. Rising real interest rates (as inflation recedes and high nominal interest rates pass through to the debt stock) and, in some countries, persistent primary deficits, mean that sustained growth is projected to become the main debt-reducing driver in the IMF staff’s baseline (Box Figure 1.4.4).

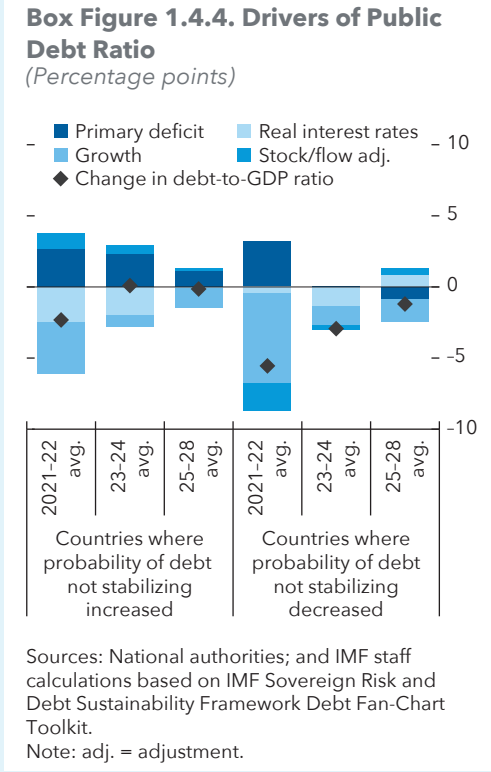
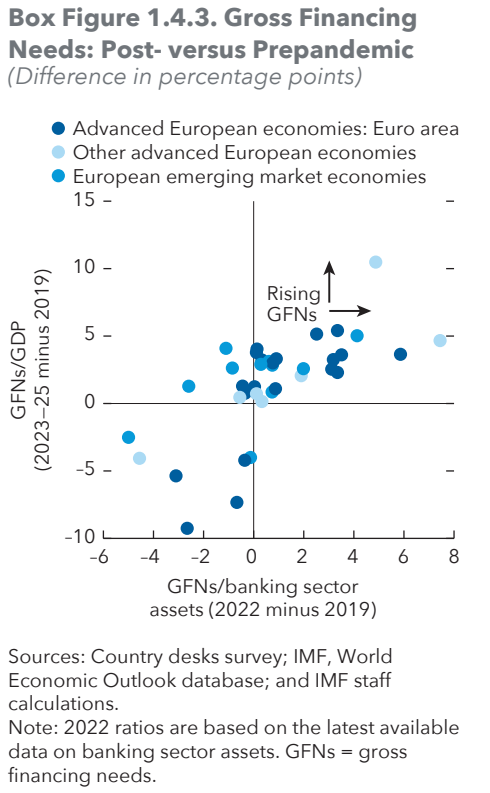


Prepared by Saioa Armendariz, Ezequiel R. Cabezon, Larry Q. Cui, Silvia Domit, and Yu Ching Wong, with research assistance from Santiago Previde and Rohan Srinivas. S. Ali Abbas and Alina Iancu supervised the project.

<sup>1</sup> The figures in this box exclude Andorra, Belarus, Kosovo, Norway, Russia, and Ukraine.



Box 4. (continued)

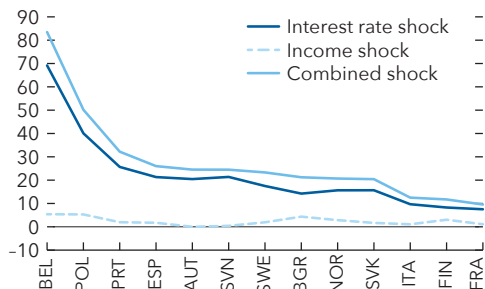




### Box 5. (continued)

availability complicate assessing the impact of the recent tightening of financing conditions. Applying bank stress tests methods to assess credit losses implies that for CRE loans they could already be material in some countries.<sup>2</sup> IMF staff estimated that as of the end of 2021, firms categorized as having elevated credit risk or in default (International Financial Reporting Standards 9, Stages 2 and 3) could account

**Box Figure 1.5.4. Common Equity Tier 1 Depletion Credit Risk Losses in Commercial Real Estate**  
(Basis points)



Sources: European Banking Authority, Risk Dashboard; European Central Bank; Orbis; Organisation for Economic Co-operation and Development; and IMF staff calculations.

Note: The interest rate shock assumes a 300 basis point increase in the commercial real estate benchmark rate, similar to the increase in the EU long-term government bond yield in 2021-23:Q2. The income shock assumes a 10 percent decrease in net operational revenue. The combined shock includes both the interest rate shock and the income shock. Country abbreviations are International Organization for Standardization (ISO) country codes.

for about 15 percent of CRE loans in Europe, ranging from 8 percent in Slovenia to 20 percent in Norway.<sup>3</sup> Loan losses were computed in the CRE portfolio under three illustrative adverse scenarios, reflecting the rise in refinancing risk and lower rents from weaker demand for CRE. Instantaneous shocks are applied to firms' end-of-2021 financial data: (1) a 300 basis point interest rate shock, which corresponds to the increase in European Union long-term government bond yields from end 2021 through the second quarter of 2023,<sup>4</sup> (2) a 10 percent reduction in operational income, and (3) a combination of the two shocks. The amount of expected credit losses depends on the estimated migration of CRE exposures across several credit risk stages in line with International Financial Reporting Standards 9.<sup>5</sup> As credits shift into riskier buckets, banks are required to build additional reserves to absorb future losses. The impact of increased provisions in the CRE portfolio on bank capital could reach 80 basis points of common equity Tier 1 in some countries (Box Figure 1.5.4). Interpretation of cross-country results should consider limitations caused by well-known data gaps (ESRB 2023).

<sup>2</sup> The analysis draws on firm-level data sourced from Orbis, including 275,000 firms operating in 13 countries in Europe. They represent about half of aggregate turnover of firms operating in CRE in those countries. Bank data are sourced from the European Banking Authority's risk dashboard as of the first quarter of 2023. The analysis assumes that the geographic location of banks' CRE exposures is the jurisdiction in which the bank is incorporated at the highest level of consolidation in the country.

<sup>3</sup> To measure loan loss provisions, firms were assigned to credit risk groups in the spirit of International Financial Reporting Standards 9's three-stage model for impairment: stage 1—firms that are able to fulfill their debt repayments in time (interest coverage ratio is greater than or equal to 1); stage 2—firms that face liquidity pressures but are expected to generate profits and are able to post firm collateral to fill their liquidity gap (interest coverage ratio less than 1, expected earnings before income and tax (EBIT) greater than 0, and loan to value less than or equal to 100 percent); and (3) stage 3—firms that have liquidity shortfalls and either post undercollateralized loans (interest coverage ratio less than 1, loan to value greater than 100 percent) or are expected to generate losses (interest coverage ratio less than 1, expected EBIT less than 0).

<sup>4</sup> An increase in benchmark yields raises refinancing costs of outstanding debt and the yield required by investors to compute the property's market value. As of 2021, the capitalization rate is assumed to be 10 percent. This is consistent with most commercial real estate assets trading in the 5-10 percent range and a strong yield considered in the 8-15 percent range.

<sup>5</sup> The impairment model in International Financial Reporting Standards (IFRS) 9 is based on expected credit losses. Under IFRS 9, loans move through stages as credit quality changes. Provisions depend upon the classification of the exposure in stage 1 (performing), stage 2 (significant increase in credit risk), or stage 3 (impaired).

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

|                                   | October 2023 WEO |      |      |      | April 2023 WEO |      |      | Difference |      |      |
|-----------------------------------|------------------|------|------|------|----------------|------|------|------------|------|------|
|                                   | 2022             | 2023 | 2024 | 2025 | 2023           | 2024 | 2025 | 2023       | 2024 | 2025 |
| Europe                            | 2.7              | 1.3  | 1.5  | 2.1  | 0.8            | 1.7  | 2.1  | 0.5        | -0.2 | 0.0  |
| Advanced European Economies       | 3.6              | 0.7  | 1.2  | 1.9  | 0.7            | 1.4  | 2.0  | 0.0        | -0.2 | -0.1 |
| Euro Area                         | 3.3              | 0.7  | 1.2  | 1.8  | 0.8            | 1.4  | 1.9  | -0.1       | -0.2 | -0.1 |
| Austria                           | 4.8              | 0.1  | 0.8  | 1.7  | 0.4            | 1.1  | 1.8  | -0.3       | -0.3 | -0.1 |
| Belgium                           | 3.2              | 1.0  | 0.9  | 1.2  | 0.7            | 1.1  | 1.2  | 0.3        | -0.2 | 0.0  |
| Croatia                           | 6.2              | 2.7  | 2.6  | 2.7  | 1.7            | 2.3  | 2.7  | 1.0        | 0.3  | 0.0  |
| Cyprus                            | 5.6              | 2.2  | 2.7  | 3.0  | 2.5            | 2.8  | 3.0  | -0.3       | -0.1 | 0.0  |
| Estonia                           | -0.5             | -2.3 | 2.4  | 2.7  | -1.2           | 3.2  | 3.6  | -1.1       | -0.8 | -0.9 |
| Finland                           | 1.6              | -0.1 | 1.0  | 1.3  | 0.0            | 1.3  | 1.3  | -0.1       | -0.3 | 0.0  |
| France                            | 2.5              | 1.0  | 1.3  | 1.8  | 0.7            | 1.3  | 1.9  | 0.3        | 0.0  | -0.1 |
| Germany                           | 1.8              | -0.5 | 0.9  | 2.0  | -0.1           | 1.1  | 2.0  | -0.4       | -0.2 | 0.0  |
| Greece                            | 5.9              | 2.5  | 2.0  | 1.4  | 2.6            | 1.5  | 1.4  | -0.1       | 0.5  | 0.0  |
| Ireland                           | 9.4              | 2.0  | 3.3  | 3.2  | 5.6            | 4.0  | 3.6  | -3.6       | -0.7 | -0.4 |
| Italy                             | 3.7              | 0.7  | 0.7  | 1.0  | 0.7            | 0.8  | 1.2  | 0.0        | -0.1 | -0.2 |
| Latvia                            | 2.8              | 0.5  | 2.6  | 3.2  | 0.4            | 2.9  | 3.4  | 0.1        | -0.3 | -0.2 |
| Lithuania                         | 1.9              | -0.2 | 2.7  | 2.6  | -0.3           | 2.7  | 2.6  | 0.1        | 0.0  | 0.0  |
| Luxembourg                        | 1.4              | -0.4 | 1.5  | 2.4  | 1.1            | 1.7  | 2.5  | -1.5       | -0.2 | -0.1 |
| Malta                             | 6.9              | 3.8  | 3.3  | 3.5  | 3.5            | 3.5  | 3.5  | 0.3        | -0.2 | 0.0  |
| Netherlands, The                  | 4.3              | 0.6  | 1.1  | 1.5  | 1.0            | 1.2  | 1.5  | -0.4       | -0.1 | 0.0  |
| Portugal                          | 6.7              | 2.3  | 1.5  | 2.1  | 1.0            | 1.7  | 2.1  | 1.3        | -0.2 | 0.0  |
| Slovak Republic                   | 1.7              | 1.3  | 2.5  | 2.8  | 1.3            | 2.7  | 2.9  | 0.0        | -0.2 | -0.1 |
| Slovenia                          | 2.5              | 2.0  | 2.2  | 2.6  | 1.6            | 2.1  | 2.8  | 0.4        | 0.1  | -0.2 |
| Spain                             | 5.8              | 2.5  | 1.7  | 2.1  | 1.5            | 2.0  | 2.0  | 1.0        | -0.3 | 0.1  |
| Nordic Economies                  | 3.0              | 0.8  | 1.1  | 1.7  | 0.4            | 1.5  | 2.1  | 0.4        | -0.4 | -0.4 |
| Denmark                           | 2.7              | 1.7  | 1.4  | 1.2  | 0.0            | 1.0  | 1.4  | 1.7        | 0.4  | -0.2 |
| Iceland                           | 7.2              | 3.3  | 1.7  | 2.2  | 2.3            | 2.1  | 2.3  | 1.0        | -0.4 | -0.1 |
| Norway                            | 3.3              | 2.3  | 1.5  | 1.2  | 2.1            | 2.5  | 1.8  | 0.2        | -1.0 | -0.6 |
| Sweden                            | 2.8              | -0.7 | 0.6  | 2.4  | -0.5           | 1.0  | 2.6  | -0.2       | -0.4 | -0.2 |
| Other European Advanced Economies | 4.0              | 0.8  | 1.2  | 2.1  | 0.2            | 1.4  | 2.3  | 0.6        | -0.2 | -0.2 |
| Andorra                           | 8.8              | 2.1  | 1.5  | 1.5  | 1.3            | 1.5  | 1.5  | 0.8        | 0.0  | 0.0  |
| Czech Republic                    | 2.3              | 0.2  | 2.3  | 2.9  | -0.5           | 2.0  | 3.4  | 0.7        | 0.3  | -0.5 |
| Israel                            | 6.5              | 3.1  | 3.0  | 3.3  | 2.9            | 3.1  | 3.4  | 0.2        | -0.1 | -0.1 |
| San Marino                        | 5.0              | 2.2  | 1.3  | 1.3  | 1.2            | 1.0  | 1.3  | 1.0        | 0.3  | 0.0  |
| Switzerland                       | 2.7              | 0.9  | 1.8  | 1.2  | 0.8            | 1.8  | 1.2  | 0.1        | 0.0  | 0.0  |
| United Kingdom                    | 4.1              | 0.5  | 0.6  | 2.0  | -0.3           | 1.0  | 2.2  | 0.8        | -0.4 | -0.2 |

|   | October 2023 WEO |      |      |      | April 2023 WEO |      |      | Difference |      |      |
|---|------------------|------|------|------|----------------|------|------|------------|------|------|
|   | 2022             | 2023 | 2024 | 2025 | 2023           | 2024 | 2025 | 2023       | 2024 | 2025 |
| European Emerging Market Economies  | 0.8              | 2.4  | 2.2  | 2.5  | 1.2            | 2.4  | 2.4  | 1.2        | -0.2 | 0.1  |
| Central Europe  | 5.0              | 0.4  | 2.4  | 3.4  | 0.4            | 2.6  | 3.6  | 0.0        | -0.2 | -0.2 |
| Hungary   | 4.6              | -0.3 | 3.1  | 3.3  | 0.5            | 3.2  | 3.3  | -0.8       | -0.1 | 0.0  |
| Poland  | 5.1              | 0.6  | 2.3  | 3.4  | 0.3            | 2.4  | 3.7  | 0.3        | -0.1 | -0.3 |
| Eastern Europe  | -4.4             | 2.2  | 1.3  | 1.5  | 0.4            | 1.3  | 1.0  | 1.8        | 0.0  | 0.5  |
| Belarus   | -3.7             | 1.6  | 1.3  | 0.6  | 0.7            | 1.2  | 1.0  | 0.9        | 0.1  | -0.4 |
| Moldova   | -5.0             | 2.0  | 4.3  | 5.0  | 2.0            | 4.3  | 5.0  | 0.0        | 0.0  | 0.0  |
| Russia  | -2.1             | 2.2  | 1.1  | 1.0  | 0.7            | 1.3  | 1.0  | 1.5        | -0.2 | 0.0  |
| Ukraine   | -29.1            | 2.0  | 3.2  | 6.5  | -3.0           | .    | .    | 5.0        | .    | .    |
| Southeastern European EU Member States  | 4.4              | 2.1  | 3.7  | 3.7  | 2.2            | 3.6  | 3.6  | -0.1       | 0.1  | 0.1  |
| Bulgaria  | 3.4              | 1.7  | 3.2  | 3.0  | 1.4            | 3.5  | 2.9  | 0.3        | -0.3 | 0.1  |
| Romania   | 4.7              | 2.2  | 3.8  | 3.8  | 2.4            | 3.7  | 3.8  | -0.2       | 0.1  | 0.0  |
| Southeastern European Non-EU Member States  | 3.2              | 2.5  | 3.2  | 3.9  | 2.1            | 3.2  | 3.9  | 0.4        | 0.0  | 0.0  |
| Albania   | 4.8              | 3.6  | 3.3  | 3.4  | 2.2            | 3.3  | 3.4  | 1.4        | 0.0  | 0.0  |
| Bosnia and Herzegovina  | 4.1              | 2.0  | 3.0  | 3.0  | 2.0            | 3.0  | 3.0  | 0.0        | 0.0  | 0.0  |
| Kosovo  | 3.5              | 3.8  | 4.0  | 4.0  | 3.5            | 3.9  | 3.9  | 0.3        | 0.1  | 0.1  |
| Montenegro  | 6.1              | 4.5  | 3.7  | 3.2  | 3.2            | 3.0  | 3.0  | 1.3        | 0.7  | 0.2  |
| North Macedonia   | 2.1              | 2.5  | 3.2  | 3.5  | 1.4            | 3.6  | 3.9  | 1.1        | -0.4 | -0.4 |
| Serbia  | 2.3              | 2.0  | 3.0  | 4.5  | 2.0            | 3.0  | 4.5  | 0.0        | 0.0  | 0.0  |
| Türkiye   | 5.5              | 4.0  | 3.0  | 3.2  | 2.7            | 3.6  | 3.0  | 1.3        | -0.6 | 0.2  |
| <i>Memorandum</i>   |                  |      |      |      |                |      |      |            |      |      |
| World   | 3.5              | 3.0  | 2.9  | 3.2  | 2.8            | 3.0  | 3.2  | 0.2        | -0.1 | 0.0  |
| Advanced economies  | 2.6              | 1.5  | 1.4  | 1.8  | 1.3            | 1.4  | 1.8  | 0.2        | 0.0  | 0.0  |
| Emerging market and developing economies  | 4.1              | 4.0  | 4.0  | 4.1  | 3.9            | 4.2  | 4.0  | 0.1        | -0.2 | 0.1  |
| European emerging market economies excluding Belarus, Russia, Türkiye and Ukraine | 4.5              | 1.1  | 2.9  | 3.5  | 1.1            | 3.0  | 3.6  | 0.0        | -0.1 | -0.1 |
| European Union  | 3.6              | 0.7  | 1.5  | 2.1  | 0.7            | 1.6  | 2.2  | 0.0        | -0.1 | -0.1 |
| United States   | 2.1              | 2.1  | 1.5  | 1.8  | 1.6            | 1.1  | 1.8  | 0.5        | 0.4  | 0.0  |
| China   | 3.0              | 5.0  | 4.2  | 4.1  | 5.2            | 4.5  | 4.1  | -0.2       | -0.3 | 0.0  |
| Japan   | 1.0              | 2.0  | 1.0  | 0.6  | 1.3            | 1.0  | 0.6  | 0.7        | 0.0  | 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 2023 WEO |      |      |      | April 2023 WEO |      |      | Difference |      |      |
|-----------------------------------|------------------|------|------|------|----------------|------|------|------------|------|------|
|                                   | 2022             | 2023 | 2024 | 2025 | 2023           | 2024 | 2025 | 2023       | 2024 | 2025 |
| Europe                            | 15.2             | 10.4 | 9.3  | 7.2  | 10.4           | 6.3  | 4.6  | 0.0        | 3.0  | 2.6  |
| Advanced European Economies       | 8.4              | 5.8  | 3.3  | 2.2  | 5.6            | 3.0  | 2.1  | 0.2        | 0.3  | 0.1  |
| Euro Area                         | 8.4              | 5.6  | 3.3  | 2.2  | 5.3            | 2.9  | 2.2  | 0.3        | 0.4  | 0.0  |
| Austria                           | 8.6              | 7.8  | 3.7  | 2.5  | 8.2            | 3.0  | 2.2  | -0.4       | 0.7  | 0.3  |
| Belgium                           | 10.3             | 2.5  | 4.3  | 2.1  | 4.7            | 2.1  | 1.7  | -2.2       | 2.2  | 0.4  |
| Croatia                           | 10.7             | 8.6  | 4.2  | 2.5  | 7.4            | 3.6  | 2.2  | 1.2        | 0.6  | 0.3  |
| Cyprus                            | 8.1              | 3.5  | 2.4  | 2.2  | 3.9            | 2.5  | 2.2  | -0.4       | -0.1 | 0.0  |
| Estonia                           | 19.4             | 10.0 | 3.8  | 3.2  | 9.7            | 4.1  | 3.5  | 0.3        | -0.3 | -0.3 |
| Finland                           | 7.2              | 4.5  | 1.9  | 2.0  | 5.3            | 2.5  | 2.2  | -0.8       | -0.6 | -0.2 |
| France                            | 5.9              | 5.6  | 2.5  | 2.0  | 5.0            | 2.5  | 2.1  | 0.6        | 0.0  | -0.1 |
| Germany                           | 8.7              | 6.3  | 3.5  | 2.2  | 6.2            | 3.1  | 2.3  | 0.1        | 0.4  | -0.1 |
| Greece                            | 9.3              | 4.1  | 2.8  | 2.2  | 4.0            | 2.9  | 2.3  | 0.1        | -0.1 | -0.1 |
| Ireland                           | 8.1              | 5.2  | 3.0  | 2.4  | 5.0            | 3.2  | 2.4  | 0.2        | -0.2 | 0.0  |
| Italy                             | 8.7              | 6.0  | 2.6  | 2.2  | 4.5            | 2.6  | 2.1  | 1.5        | 0.0  | 0.1  |
| Latvia                            | 17.2             | 9.9  | 4.2  | 3.3  | 9.7            | 3.5  | 2.8  | 0.2        | 0.7  | 0.5  |
| Lithuania                         | 18.9             | 9.3  | 3.9  | 3.0  | 10.5           | 5.8  | 4.1  | -1.2       | -1.9 | -1.1 |
| Luxembourg                        | 8.1              | 3.2  | 3.3  | 2.2  | 2.6            | 3.1  | 3.4  | 0.6        | 0.2  | -1.2 |
| Malta                             | 6.1              | 5.8  | 3.1  | 2.2  | 5.8            | 3.4  | 2.3  | 0.0        | -0.3 | -0.1 |
| Netherlands, The                  | 11.6             | 4.0  | 4.2  | 2.2  | 3.9            | 4.2  | 2.1  | 0.1        | 0.0  | 0.1  |
| Portugal                          | 8.1              | 5.3  | 3.4  | 2.4  | 5.7            | 3.1  | 2.5  | -0.4       | 0.3  | -0.1 |
| Slovak Republic                   | 12.1             | 10.9 | 4.8  | 2.3  | 9.5            | 4.3  | 2.5  | 1.4        | 0.5  | -0.2 |
| Slovenia                          | 8.8              | 7.4  | 4.2  | 3.1  | 6.4            | 4.5  | 3.3  | 1.0        | -0.3 | -0.2 |
| Spain                             | 8.3              | 3.5  | 3.9  | 2.1  | 4.3            | 3.2  | 2.0  | -0.8       | 0.7  | 0.1  |
| Nordic Economies                  | 7.6              | 5.9  | 3.4  | 2.5  | 5.8            | 2.6  | 2.3  | 0.1        | 0.8  | 0.2  |
| Denmark                           | 8.5              | 4.2  | 2.8  | 2.1  | 4.8            | 2.8  | 2.2  | -0.6       | 0.0  | -0.1 |
| Iceland                           | 8.3              | 8.6  | 4.5  | 3.6  | 8.1            | 4.2  | 2.7  | 0.5        | 0.3  | 0.9  |
| Norway                            | 5.8              | 5.8  | 3.7  | 2.6  | 4.9            | 2.8  | 2.6  | 0.9        | 0.9  | 0.0  |
| Sweden                            | 8.1              | 6.9  | 3.6  | 2.7  | 6.8            | 2.3  | 2.2  | 0.1        | 1.3  | 0.5  |
| Other European Advanced Economies | 8.4              | 6.9  | 3.5  | 2.1  | 6.5            | 3.1  | 1.9  | 0.4        | 0.4  | 0.2  |
| Andorra                           | 6.2              | 5.2  | 3.5  | 2.0  | 5.6            | 2.9  | 2.0  | -0.4       | 0.6  | 0.0  |
| Czech Republic                    | 15.1             | 10.9 | 4.6  | 2.1  | 11.8           | 5.8  | 2.7  | -0.9       | -1.2 | -0.6 |
| Israel                            | 4.4              | 4.3  | 3.0  | 2.5  | 4.3            | 3.1  | 2.8  | 0.0        | -0.1 | -0.3 |
| San Marino                        | 5.3              | 5.9  | 2.5  | 2.0  | 4.6            | 2.7  | 1.8  | 1.3        | -0.2 | 0.2  |
| Switzerland                       | 2.8              | 2.2  | 2.0  | 1.7  | 2.4            | 1.6  | 1.3  | -0.2       | 0.4  | 0.4  |
| United Kingdom                    | 9.1              | 7.7  | 3.7  | 2.1  | 6.8            | 3.0  | 1.8  | 0.9        | 0.7  | 0.3  |

|   | October 2023 WEO |      |      |      | April 2023 WEO |      |      | Difference |      |      |
|---|------------------|------|------|------|----------------|------|------|------------|------|------|
|   | 2022             | 2023 | 2024 | 2025 | 2023           | 2024 | 2025 | 2023       | 2024 | 2025 |
| European Emerging Market Economies  | 30.2             | 20.4 | 22.3 | 17.9 | 21.0           | 13.9 | 10.2 | -0.6       | 8.4  | 7.7  |
| Central Europe  | 14.4             | 13.1 | 6.4  | 4.5  | 13.1           | 5.9  | 4.2  | 0.0        | 0.5  | 0.3  |
| Hungary   | 14.5             | 17.7 | 6.6  | 4.3  | 17.7           | 5.4  | 4.2  | 0.0        | 1.2  | 0.1  |
| Poland  | 14.4             | 12.0 | 6.4  | 4.5  | 11.9           | 6.1  | 4.1  | 0.1        | 0.3  | 0.4  |
| Eastern Europe  | 14.5             | 6.3  | 6.9  | 4.4  | 8.2            | 4.8  | 4.1  | -1.9       | 2.1  | 0.3  |
| Belarus   | 15.2             | 4.7  | 5.7  | 4.2  | 7.5            | 10.1 | 7.1  | -2.8       | -4.4 | -2.9 |
| Moldova   | 28.6             | 13.3 | 5.0  | 5.0  | 13.8           | 5.0  | 5.0  | -0.5       | 0.0  | 0.0  |
| Russia  | 13.8             | 5.3  | 6.3  | 4.0  | 7.0            | 4.6  | 4.0  | -1.7       | 1.7  | 0.0  |
| Ukraine   | 20.2             | 17.7 | 13.0 | 8.6  | 21.1           | .    | .    | -3.4       | .    | .    |
| Southeastern European EU Member States  | 13.6             | 10.2 | 5.2  | 3.3  | 9.8            | 5.0  | 3.7  | 0.4        | 0.2  | -0.4 |
| Bulgaria  | 13.0             | 8.5  | 3.0  | 2.1  | 7.5            | 2.2  | 2.1  | 1.0        | 0.8  | 0.0  |
| Romania   | 13.8             | 10.7 | 5.8  | 3.6  | 10.5           | 5.8  | 4.2  | 0.2        | 0.0  | -0.6 |
| Southeastern European Non-EU Member States  | 11.9             | 9.0  | 4.4  | 3.1  | 9.2            | 4.2  | 3.1  | -0.2       | 0.2  | 0.0  |
| Albania   | 6.7              | 4.8  | 4.0  | 3.2  | 5.0            | 3.4  | 3.0  | -0.2       | 0.6  | 0.2  |
| Bosnia and Herzegovina  | 14.0             | 5.5  | 3.0  | 2.7  | 6.0            | 3.0  | 2.7  | -0.5       | 0.0  | 0.0  |
| Kosovo  | 11.7             | 4.7  | 3.1  | 2.3  | 5.5            | 2.6  | 2.2  | -0.8       | 0.5  | 0.1  |
| Montenegro  | 13.0             | 8.3  | 4.3  | 2.6  | 9.7            | 5.0  | 2.9  | -1.4       | -0.7 | -0.3 |
| North Macedonia   | 14.2             | 10.0 | 4.3  | 2.2  | 9.2            | 3.5  | 2.3  | 0.8        | 0.8  | -0.1 |
| Serbia  | 12.0             | 12.4 | 5.3  | 3.5  | 12.2           | 5.3  | 3.5  | 0.2        | 0.0  | 0.0  |
| Türkiye   | 72.3             | 51.2 | 62.5 | 52.5 | 50.6           | 35.2 | 24.9 | 0.6        | 27.3 | 27.6 |
| <i>Memorandum</i>   |                  |      |      |      |                |      |      |            |      |      |
| World   | 8.7              | 6.9  | 5.8  | 4.6  | 7.0            | 4.9  | 3.9  | -0.1       | 0.9  | 0.7  |
| Advanced economies  | 7.3              | 4.6  | 3.0  | 2.2  | 4.7            | 2.6  | 2.1  | -0.1       | 0.4  | 0.1  |
| Emerging market and developing economies  | 9.8              | 8.5  | 7.8  | 6.2  | 8.6            | 6.5  | 5.2  | -0.1       | 1.3  | 1.0  |
| European emerging market economies excluding Belarus, Russia, Türkiye and Ukraine | 14.1             | 11.9 | 5.8  | 4.0  | 11.7           | 5.5  | 3.9  | 0.2        | 0.3  | 0.1  |
| European Union  | 9.3              | 6.5  | 3.6  | 2.4  | 6.3            | 3.3  | 2.4  | 0.2        | 0.3  | 0.0  |
| United States   | 8.0              | 4.1  | 2.8  | 2.4  | 4.5            | 2.3  | 2.1  | -0.4       | 0.5  | 0.3  |
| China   | 1.9              | 0.7  | 1.7  | 2.2  | 2.0            | 2.2  | 2.2  | -1.3       | -0.5 | 0.0  |
| Japan   | 2.5              | 3.2  | 2.9  | 1.9  | 2.7            | 2.2  | 1.6  | 0.5        | 0.7  | 0.3  |

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