Executive Summary

A soft landing for Europe's economies—bringing inflation back to target with a moderate economic cost in terms of growth—is within reach, but crosswinds could make it difficult to achieve price stability while securing a lasting recovery.

Over the next few quarters, cooling yet still-strong labor markets are expected to support real income growth and consumption. The recovery of consumption will help offset the effects of the needed withdrawal of fiscal support and galvanize investment as monetary policy eases. Against the backdrop of gradually strengthening private demand, durable disinflation will require a rebound in labor productivity, with profit margins returning to precrises levels. In advanced European economies, risks to the soft landing are balanced. For many economies in the Central, Eastern, and Southeastern Europe (CESEE) region, risks are one-sided amid still-high wage growth, stickier core inflation, and persistently high inflation expectations.

Delivering a soft landing is not the only task that needs urgent attention. Europe's per capita income levels are well behind the global frontier, and this gap is not expected to close over the forecast horizon. Productivity growth has slowed, and aging is a major drag. The CESEE region, where private investment was already low before the pandemic and Russia's invasion of Ukraine, has seen relative wage levels rising, pressuring competitiveness. Across the continent, geoeconomic fragmentation is casting a shadow on old growth models. At the same time, rising long-term expenditure pressures due to aging populations, climate ambitions, and ramped-up defense spending call for structural fiscal reforms and add to the urgency of raising growth sustainably.

Meeting these challenges will not be easy. Yet Europe has shown it can overcome even the most severe obstacles when acting decisively and together. With the right policies, policymakers can secure the soft landing and raise medium-term growth prospects.

The pace of *monetary policy* easing needs to match the evolution of underlying inflationary forces. In advanced European economies, a gradual, measured pace of easing is preferable under the baseline, ensuring that monetary conditions do not loosen too fast or too slowly. Many CESEE economies will need to maintain a tight stance for longer to fully rein in inflation. *Fiscal* support from the crises should be fully withdrawn in most of Europe, as shocks continue to fade and economies recover, without undermining public investment and social protection systems. Together with fiscal reforms, consolidation will strengthen fiscal sustainability, rebuild buffers against downside risks that would activate automatic stabilizers, and help create space to address spending needs related to aging, climate, and defense. In some countries, especially in the CESEE region, a less expansionary fiscal policy will help avoid further erosion of competitiveness. Property sector stress and rising bankruptcies could lead to larger-than-expected increases in nonperforming loans. Banks will need capital buffers strong enough to withstand an increase in nonperforming loans while, at the same time, leaving them in a position to support the projected increase in investment. Where pockets of financial vulnerabilities warrant tightening, care should be taken to avoid migration of risks to less-regulated nonbank financial institutions.

Raising potential growth prospects calls for efforts at both the domestic and European levels. Measures should aim to raise labor force participation, prepare the workforce for looming structural shifts, set an enabling environment for private investment, and promote innovation on a level European playing field—especially when it comes to the green transition, including through a strong commitment to carbon pricing. Greater European integration would amplify the effect of these reforms. Formulating an ambitious set of growth-enhancing reforms should be a key priority of a new EU commission. Working together, EU member countries could substantially lift per capita incomes by addressing the remaining internal barriers that hamper the single market. Better capital allocation will require completing the banking and capital markets unions. Measures would include greater harmonization of national rules on taxes and subsidies, improving insolvency regimes, and reducing administrative burdens. There is also further room to lower effective barriers to labor mobility, and to goods and services trade.