In one boat, but in stormy weather
*By Marek Belka and Srobona Mitra**

Hit by a twin storm of drying-out capital inflows and shrinking exports, emerging Europe is going through a deep crisis. The illusion of decoupling has vanished and it is clear now that recovery will not only depend on making the right policy choices at home but also on developments and decisions in the rest of Europe. The continent has evolved rapidly during the last decade, with ever closer financial and trade links bringing about much welcome growth and income convergence. As a result, all of Europe now sits in one boat facing the same rough weather—and emerging and advanced economies will have to jointly coordinate a course out of it. Governments and central banks have taken unprecedented actions to address the crisis, and there are efforts under way to coordinate polices. But much more needs to be done on both accounts.

The crisis has bruised some more than others, putting the spotlight on glaring cross-country policy differences. As the IMF's new Regional Economic Outlook shows, the "halo effect" of EU membership disappeared almost overnight and financial markets started to scrutinize countries for their fundamentals. Countries with higher inflation and current account deficits or those that funded a credit boom by taking crossborder loans were hurt more. These strongly suggest that sound macroeconomic and financial policies are again at a premium. Governments will have to tread carefully when it comes to fiscal stimulus, and many will be required to rein in deficits to regain the confidence in the sustainability of their policies overall. This will also help to prevent excess movements in the exchange rate, which is particularly important in a region where many have borrowed heavily in euro, Swiss francs, and other foreign currencies. Improving policy credibility, for instance by strengthening policy-making institutions supporting fiscal sustainability, is crucial in this regard. Another important item on the to-do list remains structural reform. For instance, flexible labor markets and a positive business environment will help to facilitate the necessary shift of resources into the tradables sector and bolster productivity growth during the adjustment to reduced capital inflows. These policies are all the more important for countries committed to fixed exchange rates which, lacking orderly exit options for now, have little choice but to rein in fiscal policy and accelerate structural change.

But the crisis also has made it clear that economic integration has outpaced the coordination of macroeconomic and financial sector policies in Europe. One area with an urgent need of coordination is the macroprudential regulation of banks. Clearly, emerging Europe's banks were taking big risks when they fueled an exceptional credit and demand boom without creating adequate buffers against downturns. But many of these banks have parents in advanced European countries, and often host supervisors by themselves did not have the means to secure a more prudent behavior. Now, when these banks need to be recapitalized, better supervisory home-host coordination is crucial. Sound bank balance sheets are a precondition for upholding a healthy, sustainable flow of credits to consumers and firms, which, in turn, is needed to underpin demand and growth in most emerging economies. This is one of the reasons why efforts to solve these matters are supported by the International Monetary Fund working together with the European Commission. Another area of coordination are monetary and exchange rate issues. For instance, the ECB has been fairly selective in its currency support to non-euro area countries, and discussions to clarify the euro roadmap for countries with credible policies and sound fundamentals have just begun. Given the strong feedback loops between emerging Europe and the euro area, filling the coordination gap in all of these areas will help to avoid unwanted volatility in currency and financial markets.

The convergence of Europe has been one of the world's great success stories since the fall of the iron curtain—but with this success also came the pain of shared recessions. This is why the crisis is not only a powerful reminder for a return to sound economic policies in emerging economies. It is also an urgent call to establish a coordinated approach to key policies across Europe, including the construction of the much-needed financial stability framework enveloping advanced and emerging economies alike, and a joint effort to prevent disruptive exchange rate movements.

If there is a lasting lesson from the crisis for Europe, it is that a tightly integrated region requires a regional perspective from policy makers. In other words, to plot the course out of the current storm, we will need more Europe and not less.

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