* Column title, "Equilibrium"
* Suggested story title: Growth Resuming, But Dangers Remain
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Growth Resuming, but Dangers Remain

Towards the end of last year, the euro area went through another acute crisis. Market worries about fiscal sustainability in Italy and Spain led to a sharp increase in sovereign yields. With the value of some of the banks' assets in doubt, questions arose as to whether those banks would be able to convince investors to roll over their loans. Worried about funding, banks froze credit. Confidence decreased, and activity slumped. Strong policy responses turned things around. Elections in Spain and the appointment of a new prime minister in Italy gave some reassurance to investors. The adoption of a fiscal compact showed the commitment of EU members to dealing with their deficits and debt. Most important, the provision of unprecedented amounts of liquidity at low interest rates for 3 years by the European Central Bank (ECB) removed short-term bank rollover risk, which in turn decreased pressure on sovereign bonds.

With the passing of the crisis, and some good news about the U.S. economy, some optimism has returned. As argued by Mr. Blanchard, the IMF's Economic Counselor, in the latest World Economic outlook (available at: http://www.imf.org/external/pubs/ft/weo/2012/01/index.htm), however, optimism should remain tempered. Even absent another European crisis, most advanced economies still face major brakes on growth. And the risk of another crisis is still very much present and could well affect both advanced and emerging economies.

One must wonder why, with nominal interest rates expected to remain close to zero for some time, demand is not stronger in advanced economies. The reason is that they face, in varying combinations, two main brakes on growth: fiscal consolidation and bank deleveraging. Both reflect needed adjustments, but both decrease growth in the short term. Fiscal consolidation is in effect in most advanced economies. Fiscal consolidation will be subtracting roughly 1 percentage point from advanced economy growth this year, with growth for this group of countries now projected at 1.4 percent in 2012.

Bank deleveraging is affecting primarily Europe and the evidence suggests that it is contributing to a tighter credit supply. Our best estimates are that it may subtract another 1 percentage point from euro area growth this year. Emerging Economies (EEs) are not immune to these developments. Low advanced economy growth has meant lower export growth for EEs. And financial uncertainty, together with sharp shifts in risk appetite, has led to volatile capital flows. For the most part, however, EEs have enough policy room to maintain solid growth. As is typically the case, such a statement masks heterogeneity across countries. Some countries need to watch overheating, while others still have a negative output gap and can use policy to sustain growth.

Turning to risks, geopolitical tension affecting the oil market is surely a risk. The main one, however, remains another acute crisis in Europe. The building of the firewalls, when it is completed, will represent major progress. If and when needed, funds can be mobilized to help some countries survive the effects of adverse shifts in investor sentiment and give them more time to implement fiscal consolidation and reforms. By themselves, however, firewalls cannot solve the difficult fiscal, competitiveness, and growth issues some of these countries face. Bad news on the macroeconomic or political front still carries the risk of triggering the type of dynamics we saw last fall.

Turning to policy, many of the policy debates revolve around how best to balance the adverse short-term effects of fiscal consolidation and bank deleveraging versus their favorable long-term benefits. In the case of fiscal policy, the issue is complicated in some instances by the pressure from markets for immediate fiscal consolidation. The right strategy remains the same as before. While some immediate adjustment is needed for credibility, the search should be for credible long-term commitments—through a combination of decisions that decrease trend spending and put in place fiscal institutions and rules that automatically reduce spending and deficits over time. Insufficient progress has been made along these lines, especially in the United States and in Japan.

In the case of bank deleveraging, the challenge is twofold. As with fiscal policy, the first challenge is to determine the right speed of overall deleveraging. The second is to make sure that deleveraging does not lead to a credit crunch, either at home or abroad. Turning to policies aimed at reducing risks, the focus is clearly on Europe. Measures should be taken to decrease the links between sovereigns and banks, from the creation of euro level deposit insurance and bank resolution to the introduction of limited forms of Eurobonds, such as the creation of a common euro bill market. Taking one step back, perhaps the highest priority, but also the most difficult to achieve, is to durably increase growth in advanced economies, and especially in Europe. Low growth makes for harder fiscal adjustment and higher risks along the way. For the moment, the focus should be on measures that increase demand. Looking forward, however, the focus should also be on measures that increase potential growth. The Holy Grail would be measures that do both. There are probably few of those. More realistically, the search must be for reforms that help in the long term but do not depress demand in the short term. Identifying these reforms, and addressing their potentially adverse short-term effects, should be very high on the policy agenda.

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