Global economic prospects are gradually strengthening, but downside risks remain elevated; the risk of another crisis is still very much present and could well affect both advanced and emerging economies. This was one of the key messages of a presentation of the IMF’s April 2012 World Economic Outlook at the OeNB on April 18, 2012.

Vienna had been chosen as the first venue in a series of presentations of the most recent WEO across Europe, Franz Nauschnigg, Head of the OeNB’s European Affairs and International Organizations Division pointed out, after introducing the main speaker of the event, IMF senior economist John Simon, who had worked for the Reserve Bank of Australia before joining the IMF, where he is responsible for world economic studies at the Research Department.

Simon’s presentation of the WEO included an overview of global as well as regional economic prospects and policies and an analysis of how to deal with household debt. It was followed by a discussion, during which journalists, economists from the OeNB and experts from various economic institutions and commercial banks raised additional topics and exchanged their views.

In his opening remarks, Peter Mooslechner, Director of the OeNB’s Economic Analysis and Research Department, who chaired the event, praised the WEO’s high quality of economic content and stated that the WEO, which is released on the occasion of the IMF’s spring meeting, always starts a new round of discussion. Mooslechner described the current economic situation as fragile, characterized by optimism at a very low level.

John Simon started out by explaining that the major brakes on growth can be found in fiscal consolidation, bank deleveraging and household deleveraging. While household deleveraging is mainly taking place in the U.S.A., bank deleveraging and fiscal consolidation are affecting primarily Europe. Emerging economies are not immune to these developments either, but they still have enough policy room to maintain solid growth. Many of the policy debates revolve around how to best balance the adverse short-term effects of fiscal consolidation and bank deleveraging versus their favorable long-term effects.

Simon analyzed that the two main risks prevailing worldwide are the euro area crisis on the one hand and oil prices on the other. As regards the euro area, Simon stated that the linkages between sovereigns, banks and growth could represent a vicious cycle. Measures should be taken to reduce the links between sovereigns and banks. These measures, when properly introduced, could make a difference were another crisis to take place soon. As to oil prices, Simon pointed out that a disruption in global oil supply heavily affects GDP. Further uncertainty about oil supply disruptions could trigger a much larger price spike.

The IMF’s suggestions as to what can be done to resolve these issues read as simple as: not too much and not too little, as well as not too fast and not too slow: Advanced economies should continue with exceptionally low monetary policy rates and unconventional support, fiscal consolidation and the reform of the financial sector. The most immediate challenge, however, is to contain spillovers from the crisis in the euro area periphery. By adopting a fiscal compact, EU Member States have shown their commitment to dealing with their deficits and debts. In addition, the ECB’s three-year longer-term refinancing operations (LTROs) and the launch
of major product and labor market reforms have helped stabilize conditions in the euro area. In particular, the LTROs have taken pressure off the banks; by replacing private funding with official financing, they have averted a liquidity-driven crisis.

Simon also emphasized the need for a stronger currency union. The firewalls before the crisis were inadequate and hence needed to be strengthened. The recent decision to combine the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) will strengthen the European crisis mechanism and support the IMF’s efforts to bolster the global firewall. The building of the European firewalls, when it is completed, will represent major progress.

Emerging markets still face overheating pressures from strong activity, high credit growth and high commodity prices. There is only limited, if any, need for monetary tightening, while fiscal policy should primarily focus on rebuilding macroeconomic policy room. It is important to further strengthen prudential policies and frameworks to address financial fragility.

As regards the issue of household debt, Simon analyzed whether and why the building of household debt represents a problem and what could be done to fix it. He stated that the Great Recession was particularly severe in economies that experienced a larger run-up in household debt prior to the crisis: the larger the rise in debt, the stronger was the fall in consumption. He then provided some historical evidence of what countries had done in the past in order to tackle the issue of household debt during crises and described different programs run in Scandinavia and in the U.S.A. The toolkit consists of a combination of monetary policy, fiscal stimulus and automatic support to households. However, due to political constraints and complex mortgage markets, it might prove very difficult to achieve comprehensive debt restructuring. The lessons learned show that macroeconomic stimulus as well as a strong financial sector help to deal with household debt.

European firewalls and bank deleveraging were the issues that dominated the questions and answers session of the event, which was well attended and gained substantial media coverage.