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Blanchard on 2011’s four hard truths

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| [Olivier Blanchard](http://www.voxeu.org/index.php?q=node/63)23 December 2011 | [**Print**](http://www.voxeu.org/index.php?q=node/7475) [**Email**](http://www.voxeu.org/index.php?q=forward&path=node/7475)[**Comment**](http://www.voxeu.org/index.php?q=node/7475#comments) [**Republish**](http://www.voxeu.org/index.php?q=node/87) |

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| *2011 was supposed to be the year that saw the back of the Global Crisis. Alas, the crisis is still with us as the North Atlantic banking part of the crisis morphed into the Eurozone crisis, and slow growth in advanced countries once again threatens emerging economies. In this column, IMF chief economist Oliver Blanchard draws the lessons from 2011’s economic and policy developments.*We started 2011 in recovery mode, admittedly weak and unbalanced, but nevertheless there was hope. The issues appeared more tractable: how to deal with excessive housing debt in the US, how to deal with adjustment in countries at the periphery of the Eurozone, how to handle volatile capital inflows to emerging economies, and how to improve financial sector regulation.It was a long agenda, but one that appeared within reach.Yet, as the year draws to a close, the recovery in many advanced economies is at a standstill, with some investors even exploring the implications of a potential breakup of the Eurozone, and the real possibility that conditions may be worse than we saw in 2008.I draw *four main lessons* from what has happened.* First, post the 2008–09 crisis, the world economy is pregnant with multiple equilibria—*self-fulfilling outcomes of pessimism or optimism, with major macroeconomic implications.*

Multiple equilibria are not new. We have known for a long time about self-fulfilling bank runs; this is why deposit insurance was created. Self-fulfilling attacks against pegged exchange rates are the stuff of textbooks. And we learned early on in the crisis that wholesale funding could have the same effects, and that runs could affect banks and non-banks alike. This is what led central banks to provide liquidity to a much larger set of financial institutions.What has become clearer this year is that liquidity problems, and associated runs, can also affect governments. Like banks, government liabilities are much more liquid than their assets – largely future tax receipts. If investors believe they are solvent, they can borrow at a riskless rate; if investors start having doubts, and require a higher rate, the high rate may well lead to default. The higher the level of debt, the smaller the distance between solvency and default, and the smaller the distance between the interest rate associated with solvency and the interest rate associated with default. Italy is the current poster child, but we should be under no illusion; in the post-crisis environment of high government debt and worried investors, many governments are exposed. Without adequate liquidity provision to ensure that interest rates remain reasonable, the danger is there.* Second, *incomplete or partial policy measures can make things worse.*

We saw how perceptions often got worse after high-level meetings promised a solution, but delivered only half of one. Or when plans announced with fanfare turned out to be insufficient or hit practical obstacles.The reason, I believe, is that these meetings and plans revealed the limits of policy, typically because of disagreements across countries. Before the fact, investors could not be certain, but put some probability on the ability of players to deliver. The high-profile attempts made it clear that delivery simply could not be fully achieved, at least not then. Clearly, the proverb, “Better to have tried and failed, than not to have tried at all,” does not always apply.* Third, *financial investors are schizophrenic about fiscal consolidation and growth.*

They react positively to news of fiscal consolidation, but then react negatively later, when consolidation leads to lower growth – which it often does. Some preliminary estimates that the IMF is working on suggest that it does not take large multipliers for the joint effects of fiscal consolidation and the implied lower growth to lead in the end to an increase, not a decrease, in risk spreads on government bonds. To the extent that governments feel they have to respond to markets, they may be induced to consolidate too fast, even from the narrow point of view of debt sustainability.I should be clear here. Substantial fiscal consolidation is needed, and debt levels must decrease. But it should be, in the words of Angela Merkel, a marathon rather than a sprint. It will take more than two decades to return to prudent levels of debt. There is a proverb that actually applies here too: “slow and steady wins the race.”* Fourth, *perception moulds reality.*

Right or wrong, conceptual frames change with events. And once they have changed, there is no going back. For example, nothing much happened in Italy over the summer. But, once Italy was perceived as at risk, this perception did not go away. And perceptions matter. Once the ‘real money’ investors have left a market, they do not come back overnight.A further example is that not much happened to change the economic situation in the Eurozone in the second half of the year. But once markets and commentators started to mention the possible breakup of the Eurozone, the perception remained and it also will not easily go away. Many financial investors are busy constructing strategies in case it happens.Put these four factors together, and *you can explain why the year ends much worse than it started.*Is all hope lost? No, but putting the recovery back on track will be harder than it was a year ago. It will take credible but realistic fiscal consolidation plans. It will take liquidity provision to avoid multiple equilibria. It will take plans that are not only announced, but implemented. And it will take much more effective collaboration among all involved.I am hopeful it will happen. The alternative is just too unattractive. |

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