EDITORIAL
DEALING WITH RISKS

Several shocks have hit OECD economies recently: financial turmoil, cooling housing markets, and higher prices of energy and other commodities. Fortunately, they have occurred at a time when growth was being supported by high employment that boosts income and consumption; by high profits and strong balance sheets that underpin investment and resilience in the face of financial losses and tighter credit; and by still buoyant world trade driven by robust growth in emerging economies. Hence, although near-term growth has been revised down virtually everywhere in the OECD area, the baseline scenario depicted in this *Economic Outlook* is actually not that bad in view of the recent shocks. It represents the outcome that carries the highest probability in the current more uncertain situation and involves:

- Accelerated adjustment in the US housing sector that will drag down growth to low levels in the near term but will not trigger a recession and will only modestly push up unemployment. Over the next two years, inflation will revert to a more comfortable level and the recent fall in the external deficit will be preserved – in both cases despite high oil and commodity prices.
- A partial decoupling of euro area activity from that of the United States, with a limited near-term slowdown in the underlying rate of expansion occurring at a time when capacity constraints were beginning to bite. Once immediate headwinds have faded, growth might return to potential, while headline inflation should ease to desired levels.
- A continued albeit weakened expansion in Japan that remains driven by the external sector but which will eventually lift the economy out of deflation, thereby heralding a more balanced growth pattern.

The trouble is that the probability distribution around this outcome has a fat tail on the downside. The main negative risks include a more pronounced or generalised cooling of housing markets than projected; additional turbulence in financial markets; and further upward pressures on already high commodity prices.

Against this backdrop, economic policy should prepare for the contingencies that could arise. There are several policy areas where appropriate policy settings can help to deal with any such risks.

Well-anchored inflation expectations have allowed a number of central banks to respond flexibly to the financial turmoil, through provision of liquidity to interbank markets as well as through lower interest rates than markets had previously expected. Expectations of low inflation also help the adjustment to higher oil and commodity prices and allows for a monetary policy response to cooling housing markets where necessary. Overall, the confidence that inflation will remain low, built up through a long and sometimes painful process of disinflation, constitutes a major policy asset.

However, the continued anchoring of inflation expectations cannot be taken for granted. Indeed, margins of slack throughout much of the OECD have shrunk and are now small or non-existent – even if their exact size is admittedly uncertain. Moreover, OECD economies are being hit by cost shocks: raw material prices have soared and, partly in connection therewith, the disinflationary effects of manufactured imports from China are fading. If signs were to emerge that inflation expectations are drifting up, it might be necessary to pay a price in terms of lower activity in the short term to preserve this vital policy asset.

Turning to the fiscal side, public finance outcomes have tended to be better than budgeted in the recent past, mostly on account of buoyant receipts. Part of this revenue bonanza is likely to be temporary, reflecting *inter alia* high profits in business activities related to finance and housing (see the chapter on corporate saving and investment). In addition, the current revenue buoyancy may be more cyclical in nature than realised: experience shows that trend growth is typically overestimated at cyclical peaks and therefore the cyclical component of tax revenues is typically under-estimated.

The impetus for fiscal consolidation seems to have already diminished as a result of these windfalls. The OECD projections, which are based on currently legislated or clearly announced policies, show no further progress in reducing the underlying OECD-wide fiscal deficit. This is regrettable, not least in view of expected future spending pressures. Going further, there is a risk that decisions could be taken in countries that cannot afford so to permanently raise spending or reduce taxes on the basis of temporarily high receipts. This would imply a weakening of the underlying budget position. Were the downside risks to growth subsequently to materialise, such weaknesses would likely surface and could impede the full working of the fiscal automatic stabilisers at a time when they were needed. Therefore, fiscal policy needs to stay on the straight and narrow despite buoyant revenues.

The financial model based on origination, securitisation and distribution has allowed credit to flow to agents who might not otherwise have found it and risk to be allocated to those willing to hold it. However, the model also has some deficiencies that have come into the open with the collapse of the sub-prime market in the United States. One such deficiency is the lack of information as to where in the system various risks are concentrated. Moreover, the re-pricing of assets and recognition of losses now that the assessment of risk has changed is proving slow. The combination of uncertainty as to who holds risk and slow recognition of losses has caused liquidity to dry up in some markets.

As long as the process of re-pricing and loss discovery continues, financial markets are likely to remain a source of uncertainty and of vulnerability to shocks. Hence, action to speed up the necessary re-pricing and recognition of losses would be useful. At the same time, regulators and supervisors will need to balance the desire for a rapid restoration of confidence in balance sheets of financial institutions against the risk of triggering a severe retrenchment in credit supply. In due course, the lessons will have to be drawn as to whether and how the regulatory framework around the model needs to change to prevent its malfunctioning in the future.

Countries have been, and will be, hit differently by financial turmoil and housing-related weakness. In such circumstances, the natural response of market economies includes a re-pricing of currencies. As long as such movements do not become a source of instability, they tend to facilitate the necessary adjustment process by redirecting demand to where it has fallen. Recent dollar depreciation is a case in point. The projections rest on the assumption of unchanged exchange rates but were downside risks to manifest themselves to different degrees across countries, this could well be accompanied by exchange rate adjustment. This could lead to concern for activity in countries facing appreciation and for inflation in countries witnessing depreciation. However, such pressures should not be an excuse for interventionist policies since they can usually be compensated to a large extent through monetary policy. In the current circumstances, a striking feature as regards exchange rates is the so far limited appreciation of the renminbi. Given symptoms of overheating and high domestic inflation, faster appreciation would seem to be in China's own interest. It would also allow less emphasis to be put on direct intervention and regulatory instruments to contain inflation, with beneficial effects for the economy going forward. At the same time, it would help shift demand towards other countries where downside risks are currently larger.

Timely and orderly exchange rate adjustments may also help alleviate protectionist pressures in OECD countries. These are a risk not just for trade but also for investment. Given the size of projected current account imbalances, a number of countries – not least oil producers – will be recycling large export earnings and will aim to boost the return on recycled funds by investing through Sovereign Wealth Funds or similar vehicles. Protectionist noises, whether in the trade or investment area, are not helpful for business confidence, especially at a time of significant downward risk. The best response would be progress in a multilateral setting – as regards trade in the Doha Round and as regards investment in a number of fora, including the OECD.

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Conventional signs

$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mb/d	Million barrels per day	Trillion	Thousand billion
. .	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
–	Irrelevant		

Summary of projections

	2007	2008	2009	2007	2008				2009				Fourth quarter		
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2007	2008	2009
								Per cent							
Real GDP growth															
United States	2.2	2.0	2.2	1.3	1.1	1.5	1.8	1.9	2.2	2.5	2.7	2.8	2.6	1.6	2.5
Japan	1.9	1.6	1.8	1.7	1.5	1.6	1.7	1.8	1.8	1.9	1.9	1.9	1.3	1.7	1.9
Euro area	2.6	1.9	2.0	1.7	1.8	1.9	2.0	2.0	2.0	2.0	2.0	2.0	2.2	1.9	2.0
Total OECD	2.7	2.3	2.4	2.0	1.9	2.0	2.2	2.3	2.5	2.6	2.7	2.7	2.6	2.1	2.6
Inflation															
United States	2.6	2.1	2.0	2.4	2.5	2.0	1.9	1.9	2.1	1.9	1.9	2.0	2.5	2.1	2.0
Japan	-0.5	-0.3	0.3	-1.0	-0.2	0.1	0.1	0.3	0.3	0.4	0.5	0.5	-0.8	0.1	0.4
Euro area	2.2	2.2	2.3	2.3	2.3	2.2	2.2	2.2	2.3	2.3	2.3	2.3	2.4	2.2	2.3
Total OECD	2.3	2.1	2.1	2.3	2.3	2.1	2.1	2.0	2.1	2.0	2.0	2.1	2.4	2.1	2.1
Unemployment rate[1]															
United States	4.6	5.0	5.0	4.8	4.8	4.9	5.0	5.1	5.1	5.0	5.0	4.9	4.8	5.1	4.9
Japan	3.8	3.7	3.6	3.8	3.8	3.8	3.7	3.7	3.7	3.6	3.5	3.5	3.8	3.7	3.5
Euro area	6.8	6.4	6.4	6.5	6.5	6.5	6.4	6.4	6.4	6.4	6.4	6.4	6.5	6.4	6.4
Total OECD	5.4	5.4	5.3	5.4	5.4	5.4	5.3	5.3	5.3	5.3	5.3	5.2	5.4	5.3	5.2
World trade growth	7.0	8.1	8.1	8.2	8.0	8.0	8.0	8.0	8.1	8.2	8.2	8.2	7.7	8.0	8.2
Current account balance[2]															
United States	-5.6	-5.4	-5.3												
Japan	4.7	4.8	5.2												
Euro area	0.2	-0.1	-0.2												
Total OECD	-1.4	-1.4	-1.4												
Cyclically-adjusted fiscal balance[3]															
United States	-3.0	-3.4	-3.4												
Japan	-3.4	-3.9	-3.6												
Euro area	-0.6	-0.6	-0.4												
Total OECD	-2.0	-2.2	-2.1												
Short-term interest rate															
United States	5.3	4.6	4.7	5.0	4.8	4.6	4.6	4.6	4.6	4.6	4.7	4.8			
Japan	0.7	0.6	0.9	0.8	0.7	0.6	0.6	0.6	0.7	0.8	0.9	1.2			
Euro area	4.3	4.2	4.1	4.7	4.4	4.2	4.1	4.1	4.1	4.1	4.1	4.1			

Note Real GDP growth, inflation (measured by the increase in the GDP deflator) and world trade growth (the arithmetic average of world merchandise import and export volumes) are seasonally and working-day-adjusted annual rates. The "fourth quarter" columns are expressed in year-on-year growth rates where appropriate and in levels otherwise. Interest rates are for the United States: 3-month eurodollar deposit; Japan: 3-month certificate of deposits; euro area: 3-month interbank rate.

Assumptions underlying the projections include:
- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 12 November 2007; in particular 1$ = 109.38 yen and 0.69 euros;

The cut-off date for other information used in the compilation of the projections is 20 November 2007.

1. Per cent of the labour force.
2. Per cent of GDP.
3. Per cent of potential GDP.

Source: OECD Economic Outlook 82 database.

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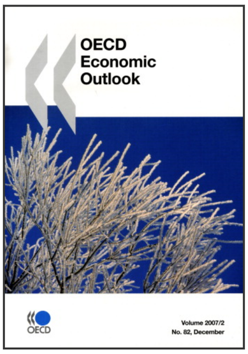

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