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Statement by Angel Gurría
Secretary-General Organisation for Economic Co-operation and Development
On behalf of the Organisation for Economic Co-operation and Development

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This statement concerns item 2 (The Global Economy and Financial Markets—Outlook, Risks, and Policy Responses) of the provisional agenda of the International Monetary and Financial Committee meeting.

Macroeconomic outlook and policies

The OECD is currently updating its *Economic Outlook* projections in view of their release on 24 May 2007. Our assessment at this time is summarised below.

The global expansion is undergoing a process of rebalancing. The US economy has shifted into lower gear whilst the robustness of the recovery in Continental Europe has been confirmed. Meanwhile, growth in much of Asia is holding up well. Oil prices have remained jittery. Financial conditions are on the whole still favourable.

US growth has been running below potential since mid-2006. Household consumption has been supported by high levels of wealth and lower oil prices but shrinking residential investment has been dragging down real GDP growth by over one percentage point. Exports have increased faster than imports, making for a substantial positive contribution from the external sector. Growth is projected to remain sub-par over the near term, weighed down by the ongoing adjustment in the housing sector but supported by the sustained job creation witnessed to date and by export market buoyancy.

Activity in the euro area has outpaced that in the United States in recent quarters, with growth above potential and largely driven by domestic demand. The German recovery has been particularly vigorous and the Italian economy has picked up. Euro-area growth is likely to have moderated somewhat in the first quarter of this year, partly on account of the value-added-tax hike in Germany, but should remain solid. Business sentiment continues to be upbeat overall, and faster job creation should support household incomes and consumption. In the United Kingdom, growth has been stable around trend and is projected to remain so.

The Japanese expansion – the longest albeit not the strongest in half a century – is on track, notwithstanding the volatility of the statistics. Growth is driven by business investment, based on high corporate profits, and exports, which have been boosted by a very weak exchange rate. Japan's growth pattern remains unbalanced, however, with household consumption still lacklustre, reflecting muted wage developments, despite relatively low unemployment.

Outside the OECD area, growth should remain robust in China, India and Russia, while picking up in Brazil. It is likely to remain in or close to double digits in China, with continued subdued inflation and a very large current account surplus. The Indian economy has accelerated in recent years and is now displaying some overheating symptoms, not least owing to infrastructure bottlenecks. As in China, the monetary stance has been tightened somewhat and growth is expected to ease a bit, from 9 to 8%. Growth is set to slow marginally in Russia, from close to 7 to close to 6%, and is projected to gather strength in Brazil, to around 4½ per cent.

Although recent developments have surprised on the bright side in Europe, helping to return domestic demand to more appropriate levels, imbalances remain in the world economy: housing markets may have to cool further in the United States and a number of other economies, and current account imbalances have reached unprecedented magnitudes, notwithstanding the recent stabilisation of the US external deficit. Strong uncertainties and volatility still surround the outlook for energy prices.

Turning to inflation developments and monetary policy, the US Federal Reserve has kept its policy rate on hold since mid-2006. Headline inflation has eased, as energy prices changed course, but core inflation is still on the high side. However, subdued growth should help dampen inflationary pressures. In the euro area, accommodation has been largely withdrawn, consistent with higher-than-expected growth, while underlying inflation has been edging up to around 2%. In Japan, policy rates have been recently raised in a context where deflation is nonetheless lingering on.

Fiscal outcomes have generally been more favourable than budgeted in 2006, thanks to the abundant revenues stemming from buoyant activity and/or asset prices. Compared with previous such episodes, more of the corresponding windfalls appears to have been reflected in consolidation. In most countries, however, additional efforts – notably on the spending side – are required to restore fiscal margins of manoeuvre. In particular, in the face of rapidly ageing populations, pension and health care system reforms are a matter of urgency.

Financial markets

Financial markets have remained buoyant, underpinned by still low interest rates and abundant liquidity. Low interest rates have encouraged increasing leverage, notably in hedge funds and private equity. Plentiful liquidity has fuelled the appetite for risk, resulting in very narrow spreads, low yields on emerging market debt, and rising equity prices.

The persistently low long-term interest rates partly stem from high saving and exchange rate intervention in Asia and huge pension fund demand for long-duration bonds (driven by liability-matching requirements). Stop-gap policies to mop up excess liquidity by raising reserve requirements on banks and other tax-like measures – at a time when profits are needed to trade out of bad loans and to compete with global banks – may not be sustainable.

Financial market volatility recently made a come-back, mainly in relation to sub-prime mortgage market developments in the United States. Spreads rose at the junk end, but the spill-over to other markets was limited, and there was no liquidity crisis: on the whole, markets seem to have absorbed this shock well. However, this episode may be a harbinger of more turmoil, particularly if it were to lead to investor complacency, and it remains unclear how the system would respond to a future large risk event, such as the emergence of inflation, or a major debt default affecting financial intermediaries.

Against this backdrop, financial markets should be encouraged to carry out much of their own supervision. While the securitisation process within leveraged activities is generally sound, there is a need to ensure that concentrations of risk in large institutions are adequately capitalised. Also, one lesson from the current travails in the sub-prime mortgage sector is that financial literacy, particularly in the lower-income brackets, must be significantly upgraded. The OECD is coordinating efforts to address this widespread problem. Finally, as private pensions become a greater part of retirement income, policy makers should provide for an environment conducive to the development of new financial instruments (not least to manage longevity risks) as well as adequate regulation, including funding rules for which the OECD will shortly release international policy recommendations. It is also important to improve financial education and awareness in this area, especially insofar as investment and longevity risks are shifting to households.