Resilience of economies to exogenous shocks

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Countries are subject to economic shocks originating from long-term trends, such as demography, and short-term events, such as financial crises; but healthy economies should be resilient to both. It is important to understand the factors that shape a country’s economic resilience, defined broadly as a country ability to contain long and short-term vulnerabilities as well as its capacity to resist and recover quickly when shocks occur. Ideally, whatever the shock, policies should be such that they help the economy remain close to its welfare potential in a sustainable way, notably in terms of jobs, incomes and quality of life.

Sources of short-term vulnerabilities include financial crises, sovereign debt crises, commodity price fluctuations or volatility. Longer term issues include ageing, declining dynamism, rising inequalities and environmental degradation. Resilience to short-term shocks also has implications for long-term sustainability because large shocks can lead to significant upheaval (as witnessed by the recent financial crisis), increasing risk and uncertainty for households, investors and governments, and have negative effects on the potential for increasing welfare that cannot be easily reversed.

Countries can strengthen the resilience of their economies to shocks through better detection and analysis of structural trends, for instance with an increased focus on long-term scenarios, as well as a better monitoring of macroeconomic and financial vulnerabilities; and by strengthening policy settings to address long-term challenges and mitigate the vulnerabilities that can lead to costly shocks, as well as strengthening policy settings that can help to mitigate the shock impact and speed the recovery.

The OECD identifies five types of short-term vulnerabilities that are most often linked to severe financial crises, deep downturns in economic activity or both:

1. Financial sector imbalances, e.g. excessive leverage, maturity and currency mismatches, high interconnectedness of banks and their common exposures.
2. Non-financial sector imbalances, such as imbalances in the balance sheets of households and non-financial corporations.

3. Asset market imbalances, most notably equity and real estate busts.

4. Public sector imbalances, in particular doubts about the sustainability of public finances that can lead to high risk premiums on government debt.

5. External sector imbalances, such as persisting current account deficits.

Monitoring these country-specific vulnerabilities can be useful in warning of severe recessions and crises and should be an essential part of a country strategy to strengthen resilience. To assist countries, the OECD systematically reports vulnerability indicators in both the Economic Outlook and country Economic Surveys. Vulnerability indicators should be and are complemented with other monitoring tools and in-depth assessments that provide a holistic view of country risks, as even countries without significant domestic or external imbalances can be affected by external shocks through spillovers and contagion through trade, financial and confidence channels.

From a longer-term perspective, the OECD has pointed at three major factors that could continue to generate difficult challenges for the global economy: a slowdown in global growth, mainly related to ageing and deceleration in emerging economies, but also due to uncertainties concerning the rate of innovation and skill development; a tendency for inequalities to continue to rise, partly due to the nature of technical progress that raises the demand for the highly-skilled; and rising economic damages from environmental degradation due among others to climate change.

To raise awareness about these long-term challenges, the OECD has developed long-term scenarios and has increasingly focused on forward-looking analysis in various areas, including productivity, income and wealth inequality and the environment, for example in *The Future of Productivity* and *The Economic Consequences of Climate Change*. 
Policies should be geared towards mitigating the build-up of vulnerabilities and prepare the economy to deal with structural challenges, combining both structural and macroeconomic dimensions and including international co-ordination in some areas. For instance, preventing or soothing the effects of financial crises requires macro-prudential regulation to limit banking sector instability and excessive pro-cyclicality; tax policies that avoid special treatment of housing or corporate debt, to help reduce the risk of asset price bubbles; and monetary and fiscal policies that mitigate the impact of shocks. Structural policies can facilitate worker mobility (e.g. active labour market policies and flexible housing markets) and the turnover of firms (e.g. lifting barriers to entry and competition) thereby improving resilience by accelerating the reallocation of resources across firms and sectors in response to shocks.

Similarly, addressing longer-term challenges requires structural policies – such as those affecting innovation, market experimentation, labour force participation and skill formation – that inject dynamism in markets and make the most of the knowledge economy to sustain both productivity and employment growth in the context of ageing. Policies should also target redistributive mechanisms and education systems to improve equality of opportunities and contain the tendency for inequality to rise. Finally, early action is needed through a policy mix of carbon pricing, reduction of fossil fuel subsidies and other targeted measures to avoid environmental damage that affects future growth potential and welfare.

More international co-operation will also be needed to support global supply chains and trade, to boost the provision of global public goods that are increasingly important – such as basic research, intellectual property rights legislation, competition policy and the climate – and to tax bases that are increasingly mobile across borders, thereby limiting tax avoidance. Co-operation in these areas will help address long-term challenges with positive repercussions on innovation, growth and welfare.

Identifying policy tools to enhance overall resilience is complicated by the existence of trade-offs among policy objectives and interactions in both macroeconomic and structural policy
settings. In times of crisis, macroeconomic policies that aim at reducing the severity of the downturn and stimulate the recovery may have unintended consequences by increasing vulnerabilities down the road. For instance, by increasing public debt ratios or building-up central banks’ balance sheets and generating ample liquidity. Structural policies aimed at sustaining dynamism and knowledge-based growth could at the same time tend to increase earning gaps and favour continued structural adjustment. The consequences for inequality and workers’ well-being will have to be addressed including through fiscal measures, which however will be increasingly constrained by the need to manage public debts.

**Useful links**


OECD work on economic resilience: www.oecd.org/economy/growth/economic-resilience.htm