OECD Economic Outlook
Volume 2010/1

Chapter 1

GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Overview

The recovery is strengthening albeit slowly and unevenly

The global recovery has become increasingly widespread over the past year, despite progressing at variable speeds across countries and regions. Global output growth is expected to be around 4¾ per cent this year and in 2011, above the growth rate experienced in the decade prior to the onset of the crisis (Table 1.1). In the non-OECD economies, especially in Asia, the recovery is likely to remain buoyant, with the strong macroeconomic policy response to the financial crisis being rolled back only gradually, and a limited direct exposure to the crisis itself and to the associated lingering effects. Sustaining and broadening the recovery is proving somewhat more challenging in many OECD economies, despite the favourable backdrop from strong external demand, the progressive, if fragile, normalisation of financial conditions and the effects of strong, albeit diminishing, macroeconomic policy stimulus. Headwinds stem from the legacies of the crisis, such as weak private and public balance sheets, high unemployment and the increasingly urgent need for fiscal consolidation. The annual rate of output growth in the OECD area is expected to be around 2¾ per cent over the year to the fourth quarter

Table 1.1. **A gradual recovery from widespread recession**

OECD area, unless noted otherwise

	Average 1997-2006	2007	2008	2009	2010	2011	2009 q4	2010 q4	2011 q4
					Per cent				
Real GDP growth[1]	2.8	2.8	0.5	-3.3	2.7	2.8	-0.6	2.7	3.0
United States	3.2	2.1	0.4	-2.4	3.2	3.2	0.1	3.0	3.4
Euro area	2.3	2.7	0.5	-4.1	1.2	1.8	-2.1	1.5	1.9
Japan	1.1	2.4	-1.2	-5.2	3.0	2.0	-1.4	2.7	2.2
Output gap[2]	0.2	1.4	-0.3	-5.1	-3.8	-2.6			
Unemployment rate[3]	6.5	5.6	6.0	8.1	8.5	8.2	8.5	8.5	8.0
Inflation[4]	2.8	2.3	3.2	0.6	1.6	1.3	0.9	1.6	1.3
Fiscal balance[5]	-2.1	-1.2	-3.3	-7.9	-7.8	-6.7			
Memorandum Items									
World real trade growth	7.1	7.3	3.2	-11.0	10.6	8.4	-2.8	9.6	8.6
World real GDP growth[6]	3.7	5.1	2.8	-0.9	4.6	4.5	1.5	4.7	4.8

1. Year-on-year increase; last three columns show the increase over a year earlier.
2. Per cent of potential GDP.
3. Per cent of labour force.
4. Private consumption deflator. Year-on-year increase; last 3 columns show the increase over a year earlier.
5. Per cent of GDP.
6. Moving nominal GDP weights, using purchasing power parities.

Source: OECD Economic Outlook 87 database.

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of 2010, and to strengthen a little further to 3 per cent over 2011. Growth should remain more robust in the United States, and Asia-Pacific countries with strong trade linkages to the non-OECD economies, than elsewhere.

Risks remain substantial on both sides

The risks around the projection remain substantial, despite the better-than-expected outcomes in the early stages of the recovery. Many risks are inter-related, with more favourable outcomes in one area helping to diminish downsides in others. On the upside, current growth impulses in the OECD area are relatively strong, boosted by temporary influences from stock-building and fiscal stimulus, and the momentum created could carry forward to a greater extent than anticipated. And the spill-over effects from continued buoyant growth in non-OECD Asia could be stronger for the OECD economies, especially the United States and Japan. However, there are also associated downside risks from such developments, with excessively strong growth in non-member economies adding to upward pressures on commodity prices, and possibly engendering an abrupt policy tightening. Nonetheless, the principal downside risk stems from the strengthened concerns about public-debt sustainability in some OECD countries. The associated solvency and liquidity risks have already disrupted some financial markets considerably, especially in Europe, with high and rising risk premia on high-risk countries and evidence of contagion, raising the prospect of more widespread instability if confidence were to weaken further due to a failure to produce and implement credible fiscal plans. To some extent related, another downside risk stems from the possibility that longer-term inflation expectations could become unanchored in the OECD economies, contrary to what is assumed in the central projection.

The unwinding of crisis-induced policies will be challenging

Monetary, fiscal, and financial authorities across the world responded to the crisis by providing extraordinary support to aggregate demand and the financial system. In many non-OECD economies and a handful of OECD economies, economic slack is disappearing rapidly and the required, marked monetary policy normalisation has already begun. Elsewhere, the exit from crisis-induced macroeconomic policies has yet to begin in earnest, with the exception of those economies having to undertake sharp fiscal consolidation as a result of market concerns about debt sustainability. The challenges arising from the need to normalise fiscal, monetary and financial policies over the medium term will be compounded by the synchronicity of fiscal consolidation needs across a large majority of OECD countries and many non-member economies. This differentiated yet synchronised pattern of normalisation across policies and countries heightens the importance of domestic policies in one domain taking due account of policy settings in other domains and countries. It also raises the possibility of exchange rate movements and the exposure of vulnerabilities in the financial sector.

Economic policy requirements are:

Against this background, the policy requirements at present and in the longer term are as follows:

... to ensure actively that fiscal credibility is maintained...

- In those countries that have not yet begun the consolidation process, public finances need to start being brought credibly onto a sound footing by next year at the latest. The pace of fiscal consolidation in those countries that have a choice should be sufficient to ensure continued credibility and avoid the risk of destabilising increases in long-term interest rates while, as far as possible, remaining commensurate with the subdued real recovery. With public debt burdens continuing to rise even after consolidation begins, it is essential that all countries have detailed medium-term fiscal consolidation plans setting out the actions to be taken in the years ahead. Plans need to be established where they are currently missing (*e.g.* Japan), made more detailed to strengthen their credibility (*e.g.* Germany, Italy) and made more ambitious where planned consolidation targets fail to stabilise public debt ratios (*e.g.* the United States) or do so only at very high levels. The present projections for 2011 include only concrete, known consolidation measures and, in many cases, seem to involve an insufficient degree of tightening, with consolidation needing to be accelerated to avoid destabilising debt dynamics. Moreover, inside the euro area, procedures need to be strengthened to prevent and address continued longer-term sovereign debt problems.

... to normalise policy rates at a pace contingent on the recovery....

- The process of unwinding some of the exceptional monetary policy measures has started and the exit strategies of monetary authorities are being clarified, though recent turbulence in euro area financial markets has resulted in the introduction or re-introduction of crisis measures. The challenge will be to implement exit strategies at a pace that is consistent with both short and long-term macroeconomic stability, and especially to ensure that inflation expectations remain anchored, without jeopardy to financial stability. The normalisation of policy interest rates should commence in most OECD economies in the course of this year, Japan being an exception, where continued deflation warrants keeping rates close to zero until 2012 or later. In some non-OECD countries, including China and India, further tightening of monetary policy is required to arrest inflationary pressures and reduce the risk of asset bubbles. Exchange rate appreciation could alleviate some of the pressure on Chinese monetary policy in the near term while greater exchange rate flexibility would allow the monetary authorities more scope to address domestic inflation pressures.

... to continue to strengthen the resilience of financial institutions and markets...

- The momentum needs to be reinforced to establish, under the auspices of the G20, internationally consistent rules and regulations for financial markets that strengthen the stability of the global financial system. Articulating more clearly the respective roles of monetary and prudential policies in dealing with future credit and asset price developments is also important.

... and implement structural reforms to raise potential output and narrow global imbalances

- Labour and product market reforms need to be implemented to raise potential output, support innovation and prevent high unemployment from becoming structural. The development of social security and services in China and other Asian economies fulfils an important social goal in its own right and would reduce the need for precautionary saving. In other countries with current account surpluses, different types of structural reforms would allow resources to flow from exposed to sheltered sectors, while in deficit countries, pension reforms and the removal of tax incentives to consume would increase saving. All in all, together with fiscal consolidation, reductions in policy-induced distortions to saving and investment decisions would strengthen growth and narrow global imbalances.

Forces acting on OECD economies

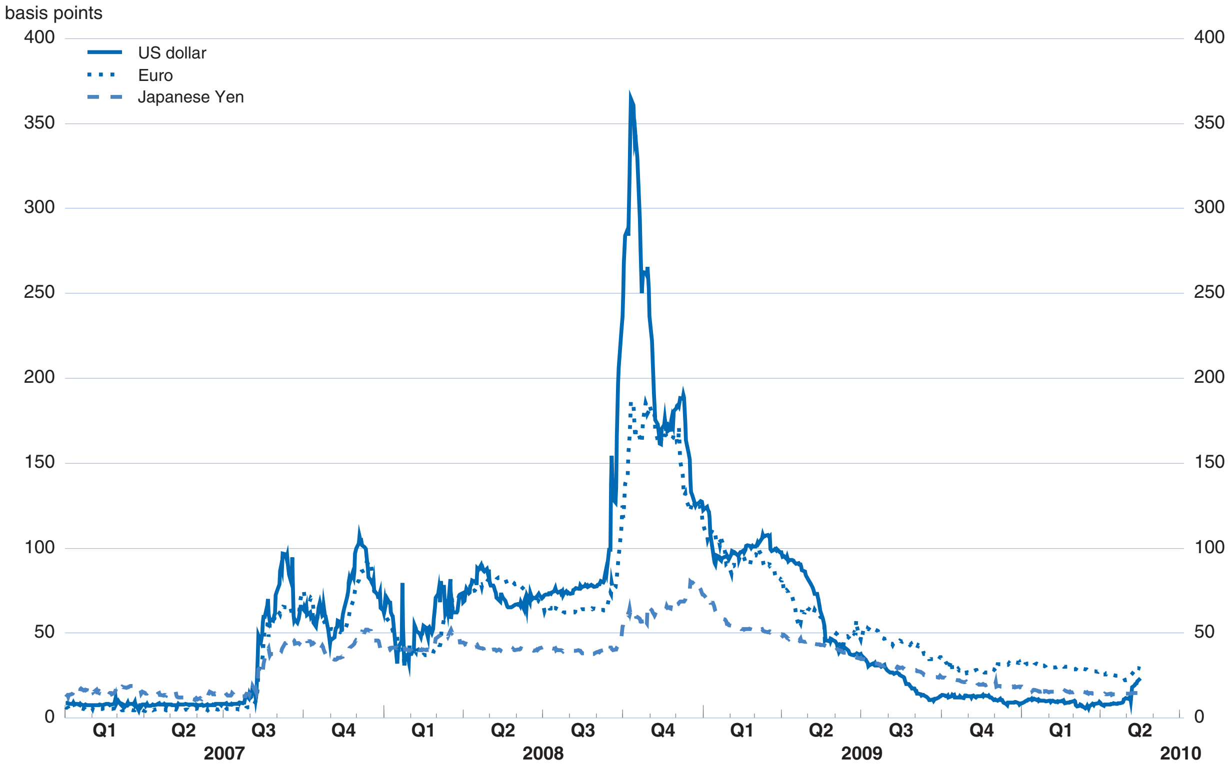
Financial market developments

Banks have strengthened their balance sheets...

Tensions increased in interbank markets in the first half of May as concerns intensified about fiscal sustainability in certain euro area countries (Figure 1.1). Even so, spreads between three-month interbank

Figure 1.1. **Money market spreads have remained low**

Three-month spreads, last observation: 17 May 2010



Note: Spread between three-month interbank rates (EURIBOR in the euro area, LIBOR in the United States and Japan) and overnight swap rates.

Source: Datastream and Bloomberg.

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and expected average overnight rates remained at low levels compared with the situation during the crisis). These narrow spreads, combined with near zero policy interest rates, imply that banks' borrowing costs have been very low in nominal terms and, outside Japan, negative in real terms. Audited accounts for 2009 show that, in the environment of low funding costs and reduced competition following the crisis, major banks earned large amounts of net income from interest margins and investment banking activities (Table 1.2). On the cost side, the major banks increased personnel compensation expenditure back to 2007 levels, despite reductions in the number of employees and despite high bank income resulting, to a large extent, from public policies. Banks have also taken large charge-offs and loan-loss provisions, but profits have, nonetheless, been sizable. As banks made relatively modest dividend payments and raised large amounts of equity from the markets, they increased their capital positions in 2009 and improved the quality of capital by converting some of their hybrid liabilities into equity. For a group of very large OECD banks that have published audited 2009 accounts, tangible common equity made up 3.3% of their tangible assets at the end of 2009 against 1.9% a year earlier.

Table 1.2. **Selected accounting indicators at top global banks**

Billion euros, except otherwise mentioned

	2007	2008	2009
Net interest revenue	184	237	257
Other operating income (mainly investment banking revenue)	271	108	287
Personnel compensation	170	155	173
Loan-loss provisions	48	103	145
Charge-offs[1]	29	52	85
Profits after tax	93	-2	61
Dividend payments[2]	36	31	10
Profits/equity (%)	12.2	-0.2	6.2

Note: The indicators cover the 15 banking groups that have reported audited accounts for 2009 among the 24 largest in the OECD area (BBVA, Banco Santander, Bank of America, Barclays, BNP Paribas, Citigroup, Crédit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Société Générale, Standard Chartered and UBS).

1. This indicator excludes BBVA, BNP Paribas, Crédit Agricole, Goldman Sachs, Société Générale, Standard Chartered and UBS for lack of data.
2. This indicator excludes BNP Paribas, Crédit Agricole, Credit Suisse and UBS for lack of data.

Source: Bankscope.

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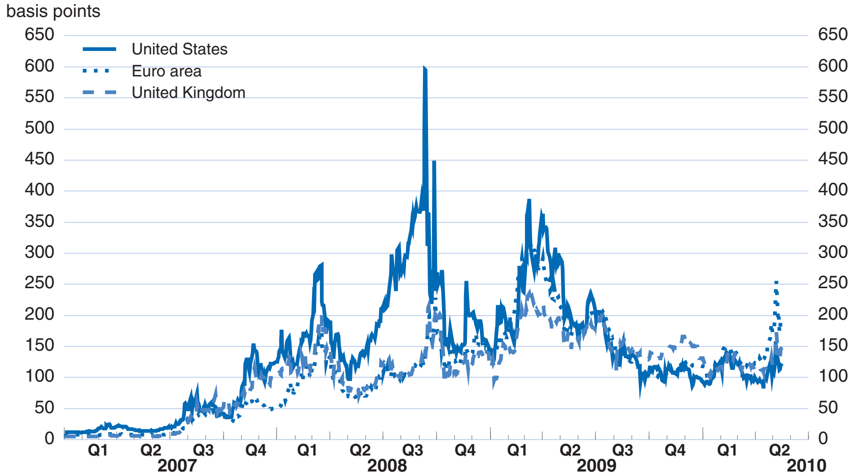
... but still remain vulnerable

Banks nonetheless remain vulnerable, as is apparent from the fact that CDS spreads on their bonds remain well above pre-crisis levels and have proved sensitive to shocks from concerns about public finances and debt sustainability in Dubai and subsequently Greece and other euro area countries (Figure 1.2). First, banks are likely to continue to suffer continued losses from the lagged effects of the downturn, especially on commercial-property loans. Second, after an extended period of extremely low interest rates, some banks have accumulated considerable

Figure 1.2. **Bank credit default swap rates have backed up**

Last observation: 17 May 2010



Note: Banking sector 5-year credit default swap rates.

Source: Datastream.

StatLink http://dx.doi.org/10.1787/888932303727

exposure to interest-rate and roll-over risks as a result of borrowing nearly free short-term funds to purchase higher-yielding long-dated assets. Third, prices on bank assets may fall if and when central banks start selling assets purchased during the crisis or revert back to more normal collateral arrangements for the provision of liquidity. On the other hand, emergency measures announced on 9/10 May 2010 to address financial market turbulence in the euro area have diminished significantly the risks of losses on banks' holdings of Greek and southern European assets (Box 1.1).

Box 1.1. **Banking risks from Greece**

Fears about the ability of the Greek government to fulfil its obligations to bond holders mounted after the new government revealed, upon taking office in October 2009, that the public deficit had previously been grossly understated. The cost of insuring Greek sovereign bonds against credit losses rose as the country's initial fiscal consolidation plans failed to convince investors. In particular, the confirmation that the ECB planned to revert back to its normal rules for eligible collateral when the temporary relaxation of requirements expires at the end of 2010, with the implication that Greek sovereign bonds, if downgraded again by credit agencies, could not serve as collateral for borrowing from the ECB, was followed by a significant increase in bond yields. Although CDS spreads on Greek government bonds and bond yield differentials relative to Germany came down on the announcements in March of more demanding consolidation plans, a joint IMF-euro area standby facility and a new, more flexible ECB collateral framework, they rose again to exceptionally high levels in April and early May as concerns intensified about the long-term solvency of Greece beyond the horizon of the IMF-euro area package. They then fell sharply following the announcement of emergency measures on 9/10 May, but still remained elevated in mid-May.

Box 1.1. **Banking risks from Greece** *(cont.)*

Banks' holdings of Greek and southern European assets

	France	Germany	United States
Holdings of Greek assets:			
Amount ($bn)	78.8	45.0	16.6
Share in the total external claims of the banking sector (%)	2.1	1.4	0.7
Share in total banking sector assets (%)	0.8	0.5	0.1
Banking sector capital and reserves ($bn)	354.0	413.0	1 410.0
Holdings of Greek, Portuguese and Spanish assets:			
Amount ($bn)	334.9	330.4	79.3
Share in the total external claims of the banking sector (%)	9.1	10.1	3.2
Share in total banking sector assets (%)	3.6	3.7	0.6

Note: Figures for exposure to Greece and total external claims correspond to end December 2009 for BIS reporting banks; data on banking sector assets and capital and reserves refer to the latest available observation in *OECD Banking Statistics:* end-2008 for Germany and end-2007 for France and the United States.

Sources: BIS Locational and Consolidated Banking Statistics April 2010 and *OECD Banking Statistics 2009*

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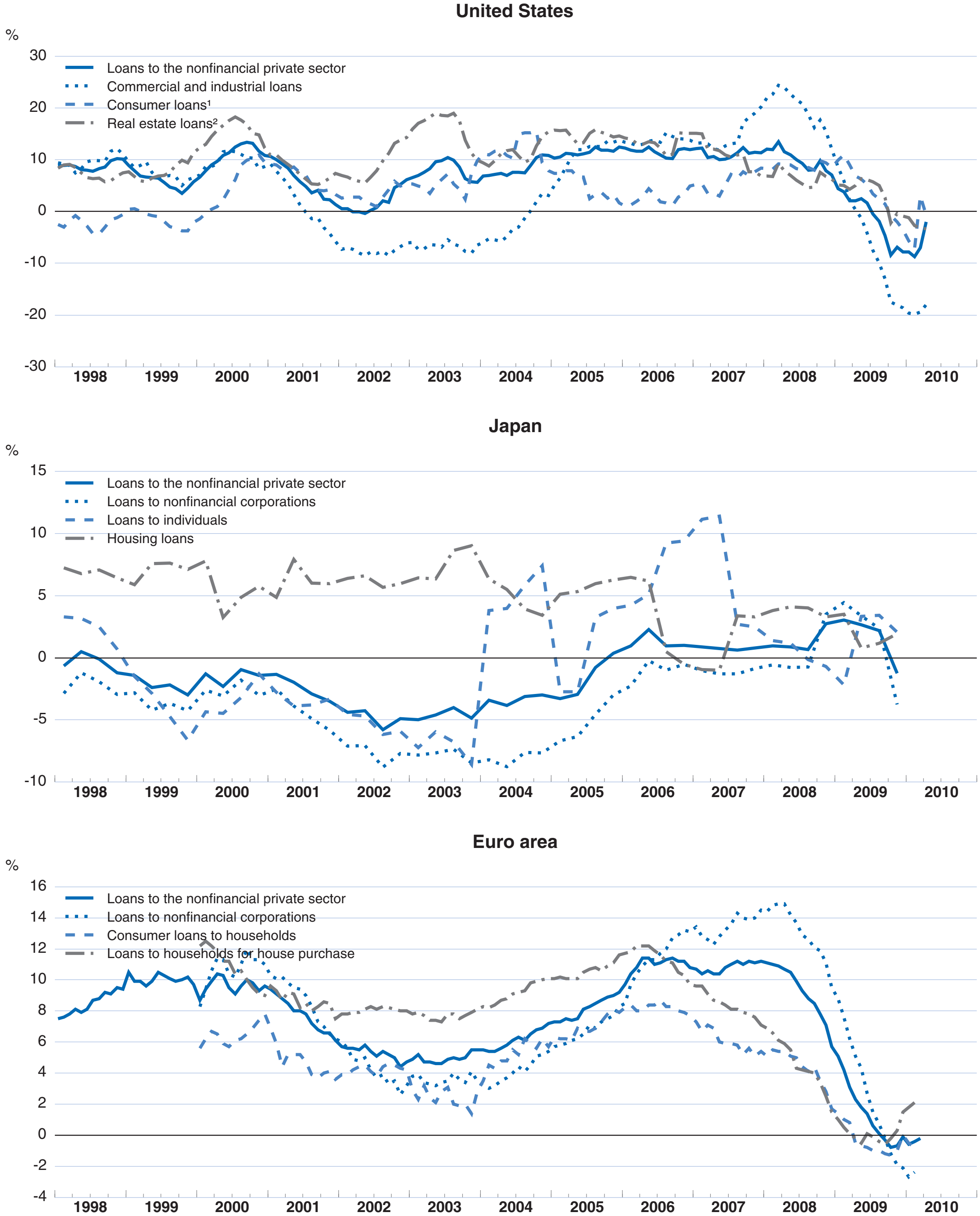
These developments had created concern that the possibility of a default in Greece could generate losses that might destabilise the banking sectors of creditor countries. Among OECD countries, France, Germany and the United States have the largest banking sector exposures to Greece (see Table). These exposures do not relate solely to government bonds but include other claims, which can represent significant amounts, such as in the case of France where the largest bank owns Greece's fifth largest lender. Greek-based assets held by French, German and especially US banks nonetheless amount to relatively small shares of their total external exposure and *a fortiori* of their total assets. A hypothetical loss on these assets would consume an amount of banking sector capital which would remain manageable. Concern has also been expressed about the risk of contagion. If, hypothetically, losses were to arise also on assets based in Portugal and Spain, two countries that are seen to share some – albeit certainly not all – of Greece's fundamental fiscal challenges, the impact on the capital of French and German banks could be more challenging. The risk of commercial banking sector losses has fallen since the announcement of the emergency measures on 9/10 May.

Bank lending activity is still very weak though lending conditions seem to be easing

With the recovery progressing, bank lending conditions appear to be easing. The net percentage of banks reporting tighter lending conditions, the level of which (but not its accumulated values) has been found to be a good predictor of US activity, has continued to decline for all categories of borrowers in the United States and the euro area. Nonetheless, bank lending activity remains very weak, although there are tentative signs of stabilisation in some categories of lending in recent months (Figure 1.3). So far, the downturn in credit to the non-financial private sector is not surprising given that the fall in activity, and especially investment, naturally reduces the demand for borrowed funds. A risk going forward is that a possible lack of credit availability might slow the recovery. In terms of prices, banks and other institutions in most countries have been passing part of the fall in their funding costs on to their clients in the form of lower lending rates.

Figure 1.3. **Bank lending remains weak**

Year-on-year growth rate



Note: Data refer to all commercial banks for the United States; to monetary financial institutions (MFIs) for the euro area; to all banks for Japan. Year-on-year growth rates are calculated from end-of-period stocks. For the euro area, these are adjusted for reclassifications, exchange rates variations and any other changes which do not arise from transactions.

1. United States data for April 2010 concerning consumer loans have been modified to take into account a change of concept.
2. The definition of real estate loans for the United States is broader than housing loans as it includes also loans related to commercial real estate. Moreover, both for the United States and for Japan, real estate / housing loans can include loans to the corporate sector.

Source: Thomson Financial.

StatLink http://dx.doi.org/10.1787/888932303746

Markets for corporate bonds and equities have been buoyant…

Capital markets have strengthened since March 2009, but have been very sensitive to sovereign debt concerns in recent months, especially in Europe. Corporate bond markets are buoyant, although the fall in yields for all categories of borrowers came to a halt at the end of 2009 in the context of the Dubai and euro area bond turmoil. Large non-financial corporations have proved capable of raising ample funds from the bond markets, with issuance in the year to March being 59%, 21% and 26% above its ten-year average in the euro area, the United Kingdom and the United States, respectively. Equity has been an important source of funding for businesses: issuance in 2009 by non-financial businesses was 34%, 28% and 12% above its five-year average in the euro area, the United Kingdom and the United States, respectively.[1] Until recently, global equity markets were resilient to sovereign debt concerns in the euro area, but they fell as confidence sagged at the end of April 2010 and early May, led by prices of financial companies hit by concerns related to exposures to Greek debt instruments.

… but currencies have exhibited large movements recently

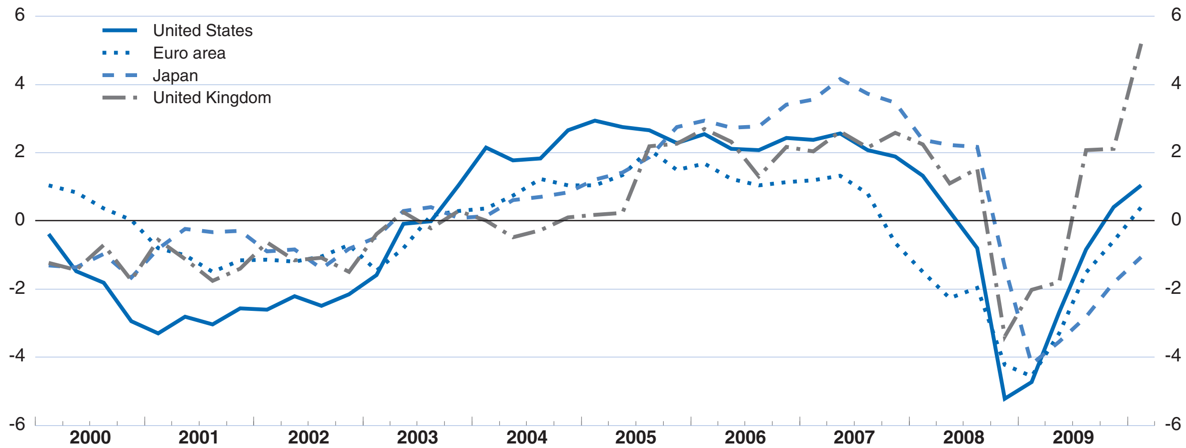
Concerns about public debt sustainability in Greece and some other euro area countries have also pushed down the euro exchange rate. From the start of the year to mid-May, the euro depreciated *vis-à-vis* the US dollar by about 13½ per cent, more than reversing the appreciation in 2009. In real effective terms, the decline in the euro exchange rate has also been significant, with a fall of close to 10% in the same period.

Overall, financial conditions have improved in OECD countries…

The OECD financial conditions indices (FCIs) provide estimates of the effect on activity from changes in real interest rates, bond spreads, credit conditions, real exchange rates and wealth[2] (Figure 1.4). The FCIs, which incorporate information up to end-April, have risen strongly across the OECD area, particularly in the United Kingdom where they have reached very high levels. Half of the upward revision in the euro area and the United Kingdom is due to effective exchange rate depreciation and the rest to domestic factors. Compared with the assumed path for FCIs underpinning the *OECD Economic Outlook No. 86* projections, the current levels of FCIs, if their effects were applied mechanically holding everything else constant, would translate into upward revisions to the projected level of activity over the coming four to six quarters of 0.6 to 1¼ per cent in the euro area and the United Kingdom, with the United States and Japan broadly unchanged.[3]

1. The historical average is taken over five rather than ten years to avoid the last year of the dotcom bubble. In the United States, where monthly information is available, equity issuance in the twelve months to February was 16% over its five-year average.
2. The FCIs use equity and house prices to approximate changes in wealth where and when financial accounts are not available.
3. These effects are based on relationships estimated on past history, before the financial crisis.

Figure 1.4. **Financial conditions indices have improved markedly**



Note: A unit decline in the index implies a tightening in financial conditions sufficient to produce an average reduction in the level of GDP by 1/2 to 1% after four to six quarters. See details in Guichard *et al.* (2009).

Source: Datastream; and OECD calculations.

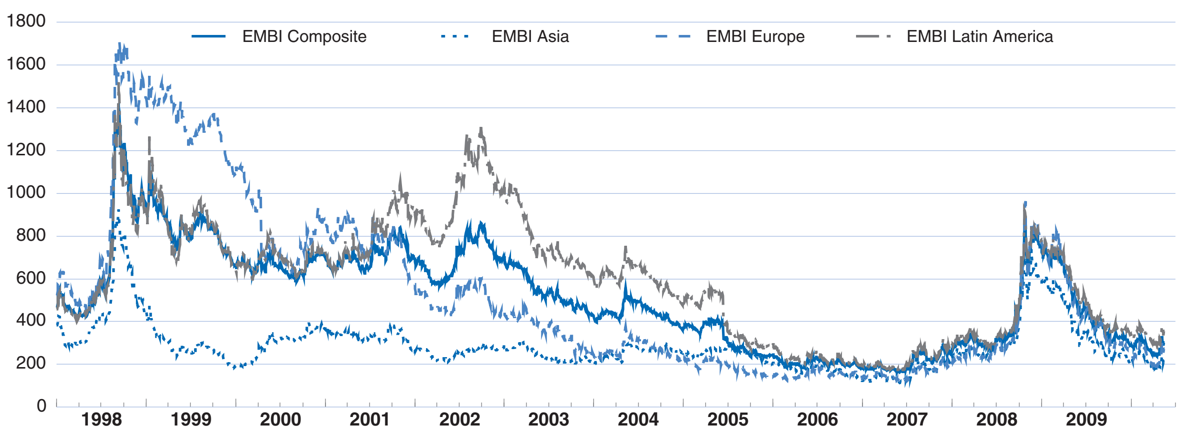
StatLink http://dx.doi.org/10.1787/888932303765

... with emerging markets resilient to sovereign debt concerns in the euro area

Outside the OECD area, financial markets in emerging economies have proved relatively resilient to the bond turmoil episodes related to Dubai and the euro area. Bond spreads in emerging markets are still well below historical averages, although they increased somewhat at the end of April and the beginning of May (Figure 1.5). Outside China, stock markets have risen during the first half of the year, despite falling in January and February. These price developments have occurred as net capital movements into emerging markets have fluctuated between inflows and outflows since the end of November 2009. The relative resilience of emerging markets could suggest that the strong

Figure 1.5. **Emerging market bond spreads are low in historical comparison**

Last observation: 17 May 2010



1. Spreads show yield difference in basis points over US Treasury bonds.

Source: JP Morgan.

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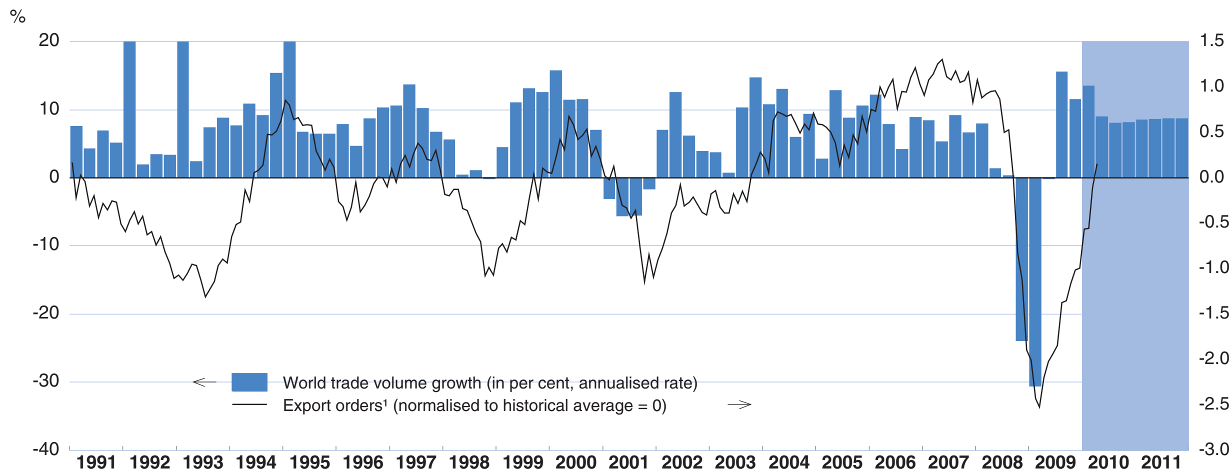
improvement of financial indicators observed through 2009 might be attributable not just to carry-trade strategies (where investors borrow short-term funds at very low rates in advanced countries to buy high-yielding instruments in developing countries) but also to fundamentals (including in some cases higher commodity prices). More recently, capital inflows have surged in several emerging markets, and the tendency for their currencies to appreciate has been moderated by foreign exchange intervention in some of them.

Other factors acting on OECD economies

World trade growth is robust

Global trade growth has strengthened markedly since mid-2009, with trade volumes rising at an annualised rate of over 10% in the latter half of last year and the first quarter of 2010 (Figure 1.6; Box 1.2). Even with this rebound, the volume of world trade remained around 5-6% below the pre-crisis peak at the end of the first quarter. Recent monthly trade and global indicators suggest that trade growth should remain robust for some time, and, even if it slows somewhat from the exceptionally rapid pace during the initial bounce-back from the recession lows, it could be somewhat stronger than in the current projections. Global export orders in the manufacturing sector have rebounded to pre-crisis levels, and coincident indicators of trade flows, such as air freight shipments and global information technology (IT) activity, continue to grow rapidly, regaining pre-crisis levels. Trade in the emerging economies has risen at twice the pace of that in the advanced economies, reflecting in part strong domestic demand growth as a result of policy stimulus as well as their relative specialisation in tradeables sectors and key role in global supply chains. These developments have helped support external demand in the OECD economies, although less than proportionately to world trade growth, given the increased intensity of trade amongst non-OECD economies.

Figure 1.6. **Global trade and export orders have bounced back**



1. Balance of respondents reporting an increase and a decrease in export orders.

Source: OECD, Main Economic Indicator database; OECD Economic Outlook 87 database; and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932303803

Box 1.2. **The world trade rebound**

After an unprecedented collapse at the end of 2008, world trade has strongly rebounded starting in the second half of 2009 and is projected to reach pre-crisis levels before the end of 2010. As trade plays an important role in the current economic recovery, understanding the factors behind the collapse and the fast recovery is important to help assess the risks of the current trade projections.

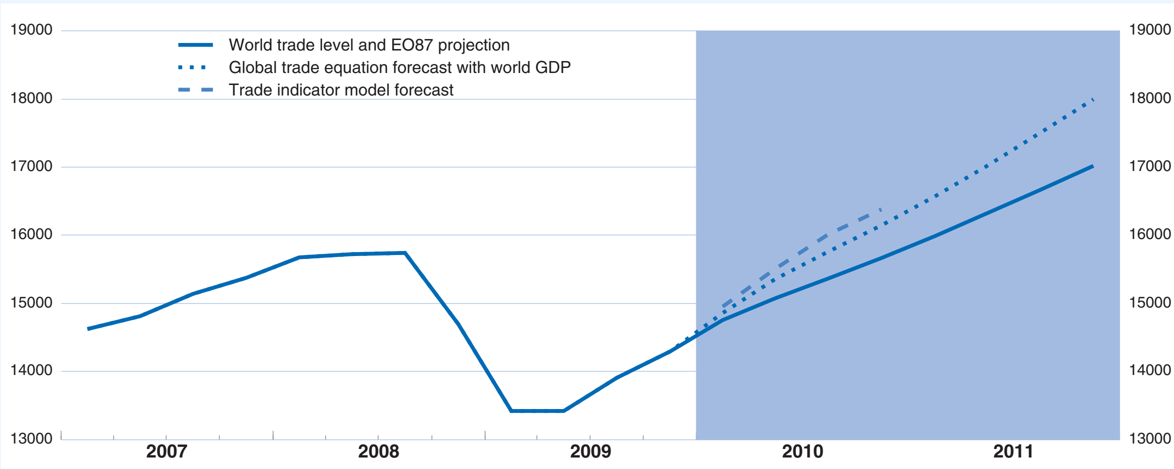
Recent OECD research (Cheung and Guichard, 2009) has investigated the drivers of the world trade collapse. The results suggest that the sharp drop in world demand explains most of the trade collapse at the end of 2008 and early 2009. However, tight credit conditions amplified the short term response which likely reflects two effects: first, the credit crunch has directly affected trade finance by reducing the availability and increasing the costs of trade credit, guarantees and insurance;[1] second, trade-intensive sectors are also among the most credit-sensitive sectors (*e.g.* motor vehicles and investment goods). Thus the financial crisis may have made the downturn particularly trade intensive.

The strong rebound in world trade starting in the second half of 2009 in turn appears to be driven by a reversal of the above factors. A strong recovery in output growth both in OECD and non-OECD countries accounts for most of the recovery. In addition, composition effects likely played a role, as an important part of this output recovery was driven by a rebound in demand for trade-intensive capital and durable goods. The considerable improvement in financial conditions might explain part of the pick-up in demand in these credit-sensitive sectors. Temporary factors, such as the normalisation of trade-intensive stockbuilding and fiscal stimulus programmes directed towards the durable consumption goods sector (*e.g.* car scrappage schemes), are additional factors underpinning the rebound. As the upturn in the inventory cycle starts to fade and many of the fiscal programmes either have been, or will start to be, phased out, this rebound is likely to moderate unless there is a strong pick-up in private final demand.

Going forward, world trade is projected to grow on average by 10½ per cent over the course of 2010, before moderating to about 8½ per cent in 2011 (see figure below).[2] Although the expansion is broad-based over the projection period, trade in the non-OECD countries is expected to accelerate most strongly. Two benchmark models point to possible upside risks to the current projections. An equation linking global trade to world GDP growth and financial conditions predicts higher growth of close to 13% in 2010 and 11½ per cent in 2011.[3] Moreover, several recent high-frequency indicators, such as world industrial production, export orders and shipping prices when combined in an indicator model, point to even faster growth of trade in 2010 of about 14%, with particular strength in the first half of the year.

World trade

Billions 2005 US dollars



Source: OECD Economic Outlook 87 database; and OECD calculations.

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1. See also IMF (2009) and Dorsey (2009).
2. These projections are based on a bottom-up approach that aggregates country-specific estimates of export and import volumes (Pain *et al.*, 2005).
3. Financial conditions are assumed to stay at the level of the last observation over the projection period. The same model based on OECD growth (not shown) predicts lower trade growth of about 9% in 2010 and 8% in 2011.

Growth is robust in the major non-OECD economies

The upturn in activity in the non-OECD economies remains buoyant, reflecting the impact of expansionary monetary policy and fiscal stimulus, and has broadened steadily over the past year despite the subdued growth of external demand from the OECD economies. Growth in non-OECD Asia has remained stronger than elsewhere, especially in China where GDP rose by an estimated annualised rate of over 15% in the first quarter of 2010, helped by the relative size and rapid implementation of the macroeconomic policy stimulus enacted there. Infrastructure expenditure has risen by almost 6% of GDP since the start of 2009 as a result of the two-year, investment-focused fiscal stimulus package, and private consumption has become increasingly buoyant, aided by strong wage and credit growth, although the first steps towards monetary policy normalisation have begun. This is also the case in India, but past reductions in policy rates and ongoing expansionary fiscal policies continue to support private domestic demand. Moreover, agricultural output should rebound from the weak drought-induced levels seen in late 2009. The upturn in activity in Russia and South Africa continues to lag that in non-OECD Asia, but has gained momentum, especially in Russia, helped by rising external demand and higher international commodity prices. Strong external commodity demand has also reinforced the already robust domestic demand growth in Brazil and Indonesia arising from past policy easing.

Household balance sheets are improving

Unusually for the early stages of a recovery, the growth of consumption has been relatively subdued in most OECD countries since mid-2009. Household saving rates have risen from pre-crisis levels as households adjusted to the weaker state of their balance sheets immediately after the crisis. Debt reduction is continuing, and this alongside the recovery in asset prices and more elevated saving rates is helping to rebuild balance sheets. It is likely that the process of balance-sheet repair will need to continue for some time, though its pace is uncertain. The increase in saving rates already experienced in the major economies is close to that which might be expected, given past relationships between saving and wealth. On the basis of the net financial asset position of households at the end of 2009, it would be reasonable to expect a sustained increase in the saving rate of roughly 2½ percentage points in the United States, ½ percentage point in Japan, and 1 percentage point in both the euro area and the United Kingdom from the levels immediately prior to the crisis.[4] Reflecting, in particular, asset price developments over the past year, these estimates are around ½ percentage point lower in the United States and Japan, ¼ percentage point lower in the euro area and 1¼ percentage point lower in the United Kingdom than equivalent estimates based on balance-sheet positions in mid-2009 (OECD, 2009). On this basis, and assuming that pre-crisis saving rates reflected wealth at that point, saving rates in the United States,

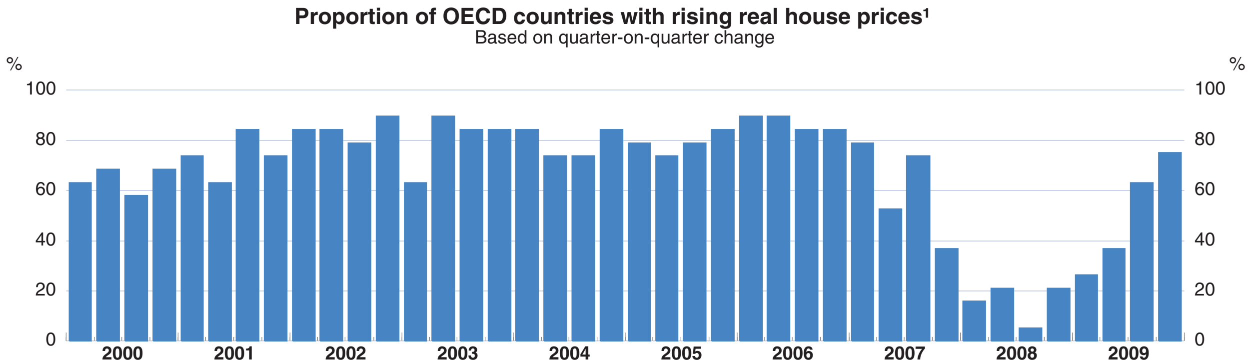
4. The basis for these calculations is described in OECD (2009, Box 1.1).

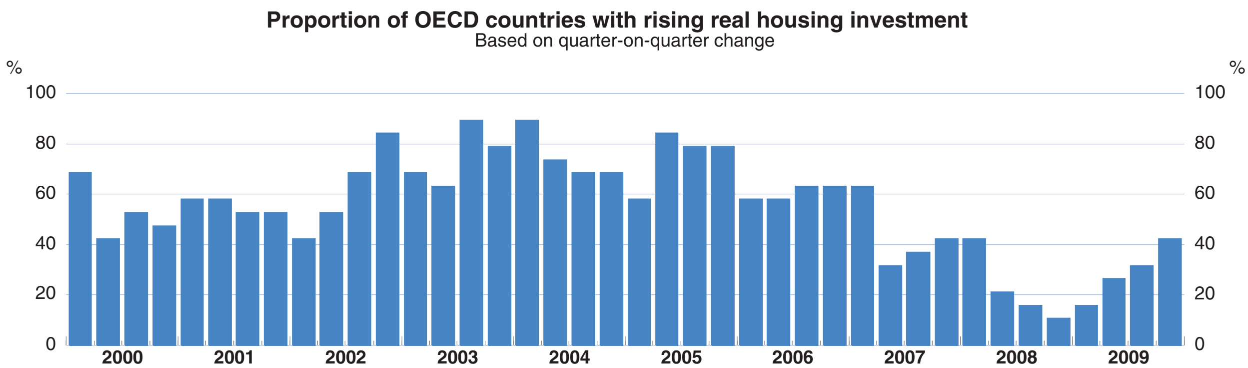
Japan and the euro area are now broadly consistent with the rates required to rebuild balance sheets over the medium term, while in the United Kingdom it is higher, implying faster balance-sheet repair. Tighter credit conditions and still fragile labour-market conditions are also serving to damp expenditure, although lower-than-expected unemployment rates have reduced the need for additional precautionary saving.

The housing market upturn is broadening...

Housing markets have continued to recover, with increasingly widespread growth in real house prices and a more moderate rebound in housing investment expenditures (Figure 1.7). The rise in house prices which, if sustainable, offers welcome support to household balance sheets, has been especially marked in Canada, Australia, Norway, Finland and Switzerland, where the annual rate of growth of real house prices has been positive since mid-2009. Outside the OECD, housing markets have also been buoyant recently, especially in parts of China, with attendant risks that a destabilising house price bubble might develop, fuelled by strong mortgage credit growth. Such concerns are limited at present in most OECD economies, given still weak credit developments and general economic slack. The volume of transactions has, nonetheless, clearly

Figure 1.7. **The housing market recovery is broadening**





1. House prices deflated by the private consumption deflator. Calculation based on 19 countries (19 available in 2009q3 and 16 available in 2009q4).

Source: OECD Economic Outlook 87 database; and various national sources, see Table A.1 in Girouard, N., M. Kennedy, P. van den Noord and C. André (2006), "Recent house price developments: the role of fundamentals", OECD Economics Department Working Papers, No. 475.

StatLink http://dx.doi.org/10.1787/888932303841

turned up since a year ago, though the improvement in sales in the United States has been noticeably irregular, reflecting the anticipated expiration and subsequent extension of the temporary tax credit for new homebuyers.

... but some downside risks remain

Although maintenance of low policy interest rates should provide further impetus to housing demand in OECD countries, considerable downside risks remain. In the United States, the number of foreclosures has continued to rise even as the economic cycle has turned up. Furthermore, house prices remain elevated relative to incomes and rents in many economies, with the exception of the largest three (Table 1.3). This in part reflects the present low interest rate environment, which underlines the downside risks for house prices if policy becomes less supportive.

Table 1.3. **Real house prices remain at historically high levels in some countries**

	Per cent annual rate of change				*Level relative to long-term average*[1]		
	2001-2007	**2008**	**2009**[2]	**Latest quarter**[3]	**Price-to-rent ratio**	**Price-to-income ratio**	**Lastest available quarter**
United States	4.6	-6.0	-4.2	-5.8	110	94	Q4 2009
Japan	-3.4	-2.0	-1.5	-1.2	66	63	Q3 2009
Germany	-2.5	-1.1	-1.1	-1.8	70	64	Q4 2009
France	9.5	-1.5	-7.0	-4.4	139	126	Q4 2009
Italy	5.4	-1.4	-3.1	-3.3	118	111	Q3 2009
United Kingdom	8.6	-3.8	-9.1	-1.7	142	143	Q4 2009
Canada	8.4	-2.8	3.9	18.0	193	138	Q4 2009
Australia	7.8	0.7	0.3	11.0	169	151	Q4 2009
Belgium	6.8	1.0	-0.3	1.4	161	149	Q4 2009
Denmark	7.9	-7.4	-14.1	-7.7	129	130	Q4 2009
Finland	5.8	-2.9	-1.4	9.3	154	106	Q4 2009
Ireland	7.2	-11.2	-16.0	-20.9	177	107	Q3 2009
Netherlands	2.4	0.8	-2.8	-4.7	141	148	Q4 2009
Norway	6.8	-4.6	-0.5	11.3	161	127	Q4 2009
New Zealand	11.6	-7.7	-4.1	4.1	144	159	Q4 2009
Spain	10.5	-3.4	-7.0	-6.7	162	143	Q4 2009
Sweden	7.6	0.3	-2.1	3.5	177	124	Q4 2009
Switzerland	1.7	0.4	5.3	6.7	89	92	Q4 2009
Euro area[4,5]	4.5	-1.6	-4.0	-3.6	119	108	
Total of above countries[5]	4.1	-3.7	-3.6	-2.7	114	101	

Note: House prices deflated by the Private Consumption Deflator.
1. Long-term average = 100, latest quarter available.
2. Average of available quarters where full year is not yet complete.
3. Increase over a year earlier to the latest available quarter.
4. Germany, France, Italy, Spain. Finland, Ireland and the Netherlands.
5. Using 2005 GDP weights.

Source: Girouard *et al.* (2006); and OECD.

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Housing investment is beginning to support growth

Housing investment has now begun to turn up in around a third of the OECD countries with available data. In others, notably Japan and most euro area economies, investment volumes are continuing to contract, but at a diminishing rate, thereby reducing the drag on activity growth. In the OECD as a whole, as of the fourth quarter of 2009, the ratio of housing investment to GDP had contracted by approximately 2 percentage points from its most recent peak prior to the crisis, and was below the average level of the past three decades. Provided the upturns in house prices and housing demand continue, investment levels should pick up further, although the upturn may be delayed in countries such as Spain, Ireland and Greece, where a large overhang of unsold properties remains, and activity and labour markets are relatively weak. Going forward, OECD-wide housing investment is expected to rise relative to GDP from the second quarter of 2010 onwards, led by strong growth in the United States, Canada, Australia and Japan.

Business investment has begun to recover…

The decline in business investment was exceptionally rapid during the recession. By the end of 2009, OECD-wide investment was around 3% of GDP below its pre-recession peak, and well below the average investment intensity of the previous three decades. Even though some decline in investment intensity might persist if the crisis results in a durable increase in risk premia, normal cyclical forces and the pick-up in trade have now started to lift business investment, especially in machinery and equipment. Corporate profitability has bounced back, particularly in the United States, external funding conditions have improved and there are comparatively few aggregate balance-sheet constraints for non-financial corporate businesses (Box 1.3). Investment intention surveys have begun to turn up and capital-goods orders and shipments in the OECD are continuing to strengthen, as are global shipments of semi-conductors, pointing to an ongoing strengthening in investment. In part this reflects strong demand from outside the OECD, but investment volumes have also already begun to rise in the United States, Japan, Korea and Australia. Nonetheless, the near-term recovery in investment may be damped by several factors, with capacity utilisation still close to historical lows in industrial sectors, vacancy rates remaining high in many commercial property markets and continued pressures on banks to rebuild their balance sheets. Still, there is considerable scope for business investment to increase as the recovery gains momentum.

… and restocking continues to support growth

The upturn in the inventory cycle has provided a sizable boost to growth in recent quarters (Figure 1.8), with firms steadily reducing the scale of their destocking. As a result, survey-based assessments that had previously indicated excessive stock levels are now approaching longer-term averages. In the near term, the inventory cycle could continue to support growth, with firms beginning to re-stock actively to bring inventory-sales ratios more closely into line with their longer-term trend. Nonetheless, the impetus to growth from such adjustments appears likely to fade gradually in the rest of this year.

Box 1.3. **Corporate balance sheets and business investment**

Business investment has plummeted through the course of the recession in the major economies, more rapidly than seen during past downturns, albeit not more strongly in relation to the decline in output.

- In the United States, business investment fell from the peak in the second quarter of 2008 to the trough (the third quarter of 2009) by more than 20%. This compares with an average drop of slightly above 10% in previous major recessions.
- Japanese investment continued to decline sharply even after the trough in GDP in the first quarter of 2009, and dropped overall by almost 25% from the first quarter of 2008 to the trough in the third quarter of 2009.
- In the euro area, business investment plummeted by about 18% until the fourth quarter of 2009, and is projected to have fallen further until a trough in the first quarter of this year. Relative to the fall in GDP, the decline in investment in the current recession is more moderate than in earlier recessions.
- In the United Kingdom, the decline in business investment has been marked in relation to GDP compared with previous recessions. After having increased in the first quarter of 2008, investment has since dropped by more than 25%.

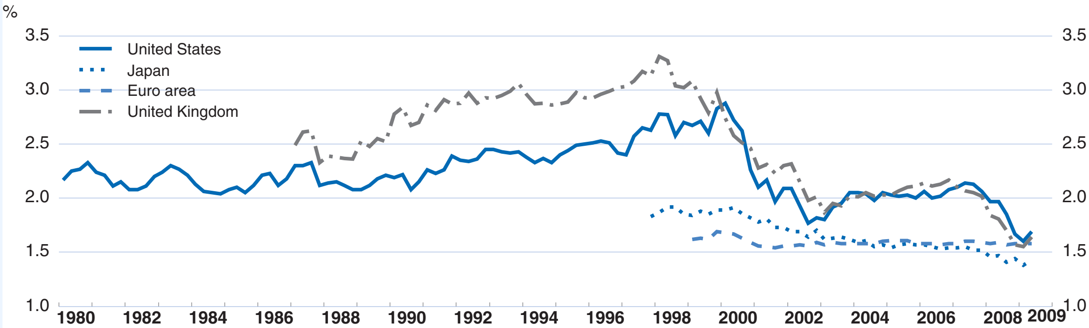
In past recessions it has often been the case that business investment has been sensitive to vulnerabilities in corporate balance sheets (IMF, 2003; Benito and Young, 2007). In the most recent recession, balance sheet pressures also appear to have been present in the non-financial corporate sector, at least by some metrics (see figure). Debt leverage has risen to historically high levels in many economies, whether expressed relative to the market value of equity or as a share of total financial liabilities.[1] However, this possibly exaggerates underlying pressures, since it reflects largely the sharp decline in equity prices, as can be seen when debt is expressed relative to total financial assets. By this metric, the upturn in leverage is less pronounced, although it remains more marked in Japan and the euro area, suggesting that balance sheet pressures could be continuing to hold back corporate investment in these economies. Total financial liabilities have remained low relative to total financial assets in all economies, as has the ratio of short-term loans to liquid assets (not shown).

Financial conditions have already begun to improve for many firms in recent months, and balance-sheet vulnerabilities should fade gradually. Both developments should help to stimulate investment, over and above the effects induced by the recovery in real activity. To gauge the effect that improved financial conditions and balance sheets might have on business investment, some simple back-of-the-envelope calculations can be done. These suggest that, all else equal, an improvement in credit conditions (a sub-component of the OECD financial conditions index) of the magnitude seen, on average, over the past year would, using representative effects estimated in empirical studies, raise investment over the medium term by around 2¾ per cent in the United States, 1¼ per cent in Japan, 2% in the euro area and 2½ per cent in the United Kingdom. Similarly, if the debt-to-equity ratio were to decline to the average level prevailing between 2002 and 2006, investment in the medium term could be boosted by around 3¾ per cent in the United States, and 2½ per cent in both the euro area and the United Kingdom.[2] There would be little effect in Japan, as the debt-to-equity ratio is not too different from the average over 2002-06. These effects are over and above the effects that the recovery in activity will have directly.

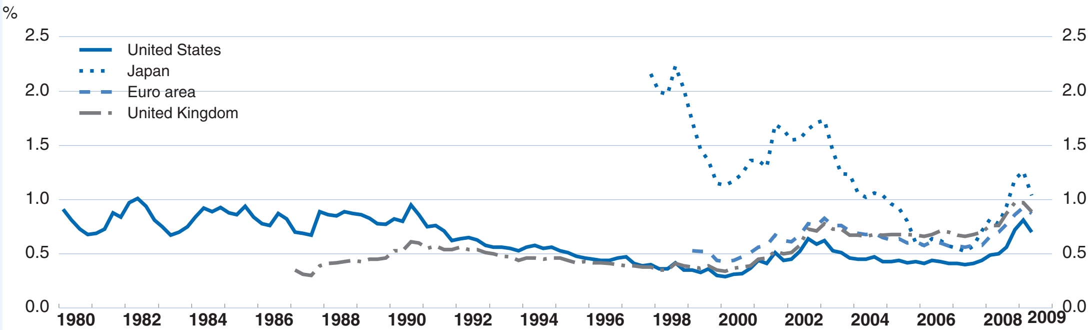
1. Debt is defined as bank loans plus non-equity securitites liabilities.
2. An average estimate of the semi-elasticity for credit conditions is taken from Guichard *et al.* (2009). The debt-to-equity elasticity is taken from Davis (2010).

Box 1.3. **Corporate balance sheets and business investment** *(cont.)*

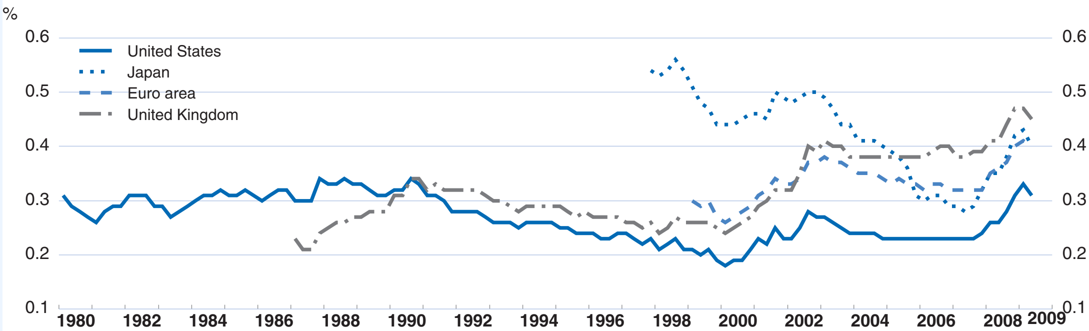
Ratio of financial liabilities to financial assets



Ratio of debt to equity



Ratio of debt to total financial liabilities



Ratio of debt to total financial assets

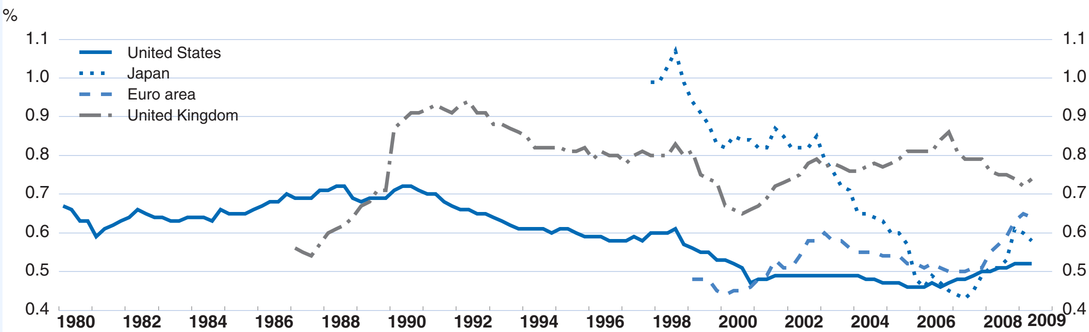


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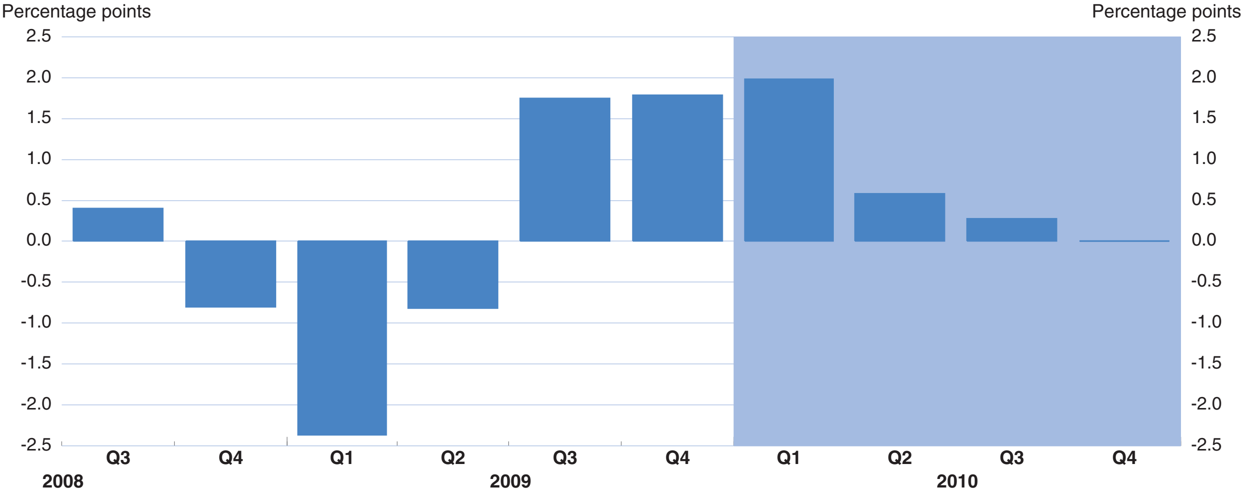
Figure 1.8. **The upturn in the inventory cycle will soon fade**

Contribution to quarterly real OECD GDP growth at annualised rates



Source: OECD Economic Outlook 87 database.

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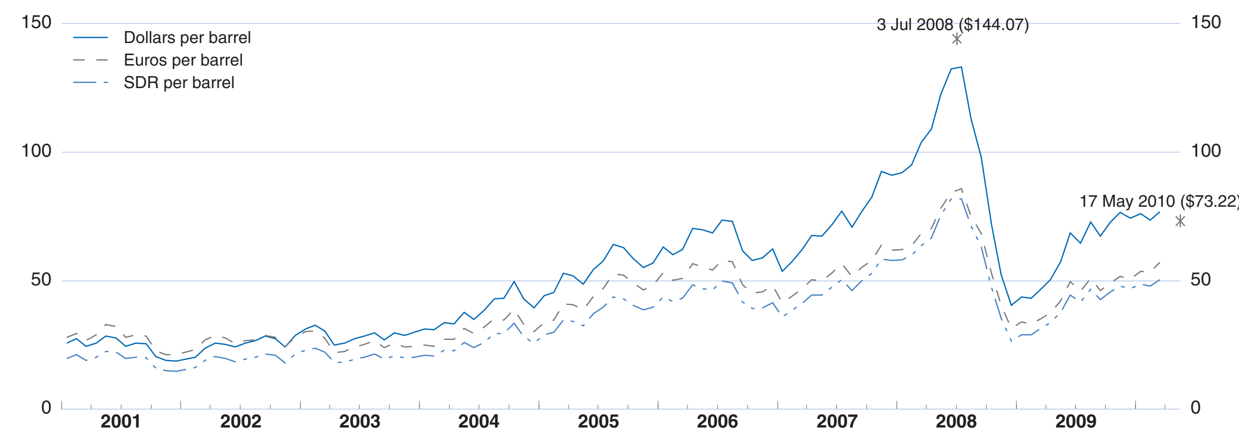
Commodity prices have rebounded

Oil prices rebounded up until late April, in tandem with signs of strengthening in world economic activity (Figure 1.9), although they eased a little in the first half of May. Non-OECD Asia and Middle East countries account for most of the increase in oil demand observed in the course of 2009 and into 2010. OECD demand has continued to trend down. The projections presented here are based on the standard technical assumption that the Brent price stays close to its level before the cut-off for information, in this case $80 per barrel. Non-oil commodity prices have also strengthened since their 2009 lows, reaching levels close to those prevailing prior to the crisis. Prices of non-oil commodities are assumed to stabilise around their levels in mid-May.

Figure 1.9. **Oil prices have recovered**

Brent crude price



Source: Datastream; and IMF, Exchange Rates data.

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Growth prospects

Growth remained solid in the first quarter…

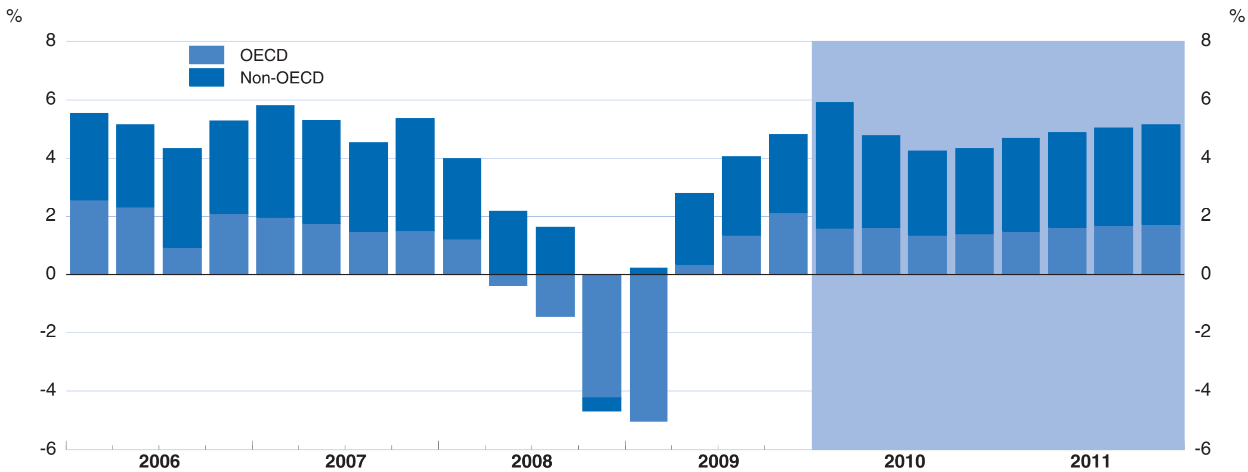
Output growth remained robust in the global economy in the first quarter of 2010, helped by an exceptionally rapid expansion in many non-OECD economies. However, growth eased somewhat in the OECD economy, although it remained above trend in the United States and, most probably, Japan. While there are signs that private consumption and investment are beginning to turn up in an increasing number of OECD countries, the underlying strength of the recovery in private domestic demand remains hard to gauge, with activity continuing to be supported by varying combinations of policy-induced demand and temporary cyclical factors, such as the bounce-back in world trade and the upturn in the inventory cycle.

… and is set to gradually gather pace…

Looking ahead, world GDP growth should remain buoyant (Figure 1.10), with the non-OECD economies continuing to account for the lion's share of global growth. GDP growth in the OECD economies is projected to continue to strengthen modestly over the next eighteen months, provided that policy stimulus is withdrawn in a gradual manner (Box 1.4), that non-policy elements of financial conditions remain at their current normalised levels, and that inflation expectations remain well-anchored. The upward momentum of the recovery is likely to be damped by the fading of temporary cyclical factors and fiscal support measures and the advent of fiscal consolidation in 2011, or more immediately in those countries where strong market pressure has already prompted consolidation. In addition, headwinds from balance-sheet pressures and subdued income growth seem likely to continue to weigh on private-sector activity for some time. Nonetheless, forward-looking business survey measures have continued to strengthen (Figure 1.11), and labour-

Figure 1.10. **Global growth will be led by the non-OECD economies**

Contribution to annualised quarterly world real GDP growth



Note: Calculated using moving nominal GDP weights, based on national GDP at purchasing power parities.

Source: OECD Economic Outlook 87 database.

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Box 1.4. **Policy and other assumptions underlying the projections**

Fiscal policy assumptions are based as closely as possible on legislated tax and spending provisions (current policies or "current services"). Where policy changes have been announced but not legislated, they are incorporated if it is deemed clear that they will be implemented in a shape close to that announced. The rapid pace of fiscal policy changes in May 2010 means that the assumptions on public finances underlying the projections may not capture all of the most recent policy initiatives. For the present projections, the implications are as follows:

- For the United States, fiscal projections are based on the Administration's 2011 budget plan adjusted to a national accounts basis and for weaker GDP growth. Non-defence discretionary outlays (15% of total outlays) are held constant in real terms in 2011. In these projections the funds disbursed under the Housing and Economic Recovery Act and the Troubled Asset Relief Program (TARP) have some impact on the government financial balance. Since the federal government purchased assets at prices higher than those available in the private market, the difference between purchase and estimated values has been recorded as capital transfers by the BEA.
- For Japan. the projections are based on the fiscal year (FY) 2010 budget plan, including changes in taxation. Spending and tax policies in FY 2011 are assumed to follow the manifesto of the current government. The pension contribution rate will continue to rise each year under the FY 2004 reform.
- For Germany, the two fiscal stimulus packages, as well as a scheduled increase in the tax deductibility of health and long-term care contributions and the Act to Accelerate Economic Growth (*Wachstumsbeschleunigungsgesetz*) introduced at the beginning of 2010, have been built into the projections. For France, the combination of the economic stimulus package, the VAT rate cut on restaurant meals, the elimination of the *Taxe professionnelle* (a tax on business) and the *Emprunt National* (a public loan to finance medium-term public investment) is assumed to induce a widening of the cyclically-adjusted general government deficit by over 2 percentage points of GDP between 2008 and 2010. Given the self-reversing aspects of some of the announced measures, the freezing of certain state expenditures and the postponement *sine die* of the carbon tax and the announced cuts in tax expenditure, the cyclically-adjusted general government deficit is expected to decrease by around ½ percentage point of GDP in 2011. In Italy, the 2010 budget embodied quite tight expenditure restraint, but little underlying fiscal consolidation. The projections here assume that equally low expenditure growth is maintained in 2011. The government's medium-term fiscal plans envisage underlying fiscal consolidation of between 0.5 and 1% of GDP for 2011, including reductions in expenditure on education and transfers to sub-national government, but these have yet to be enacted in legislation and are not taken into account in the projections.

Policy-controlled interest rates are set in line with the stated objectives of the relevant monetary authorities, conditional upon the OECD projections of activity and inflation, which may differ from those of the monetary authorities. The interest-rate profile is not to be interpreted as a projection of central bank intentions or market expectations thereof.

- In the United States, the target federal funds rate is assumed to remain constant at ¼ per cent until close to the end of 2010 as there is substantial slack in the economy. Subsequently, the rate is tightened, reaching 3¾ per cent by the end of 2011, after which the pace of normalization is assumed to slow to reach a neutral level by the time the output gap closes beyond the horizon of the short-term projections.
- In the euro area, the main policy rate is assumed to remain unchanged until close to the end of 2010, before rising to 2% by the end of the projection horizon.
- In Japan, the short-term policy interest rate is assumed to remain at 10 basis points for the entire projection horizon, as consumer prices continue to fall.

Box 1.4. Policy and other assumptions underlying the projections *(cont.)*

The projections assume unchanged exchange rates from those prevailing on 10 May 2010: $1 equals ¥93.28, € 0.78 (or equivalently, € 1 equals $1.28) and CNY 6.83.

Over the projection period, the price for a barrel of Brent crude is assumed to be at a level close to $80. Non-oil commodity prices are assumed to stabilise around current levels.

The cut-off date for information used in the projections is 12 May 2010. Details of assumptions for individual countries are provided in Chapter 2 ("Developments in individual OECD countries") and Chapter 3 ("Developments in selected non-member economies").

market indicators have stabilised earlier, and at more favourable levels, than previously expected. The key features of the economic outlook for major economies and world trade are as follows:

... in the United States...

- Growth has been robust in the United States in recent quarters, driven by policy stimulus, the upturn of the inventory cycle and a gradual recovery in private final demand. Growth is expected to remain buoyant in the second quarter of 2010, before easing back a little for a time as the inventory adjustment ends and policy normalisation gets underway. Improved financial conditions, strong corporate profit growth and the upturn in final demand will help private investment to strengthen further, although housing and commercial property investment will be damped somewhat by excess supply from still-high foreclosures and high vacancy rates. Private consumption growth will remain somewhat subdued, held back by ongoing balance-sheet adjustment and moderate income growth. Unemployment is projected to continue falling slowly, with the rate expected to decline to 8½ per cent by the end of 2011, with considerable labour market slack still left at that point.

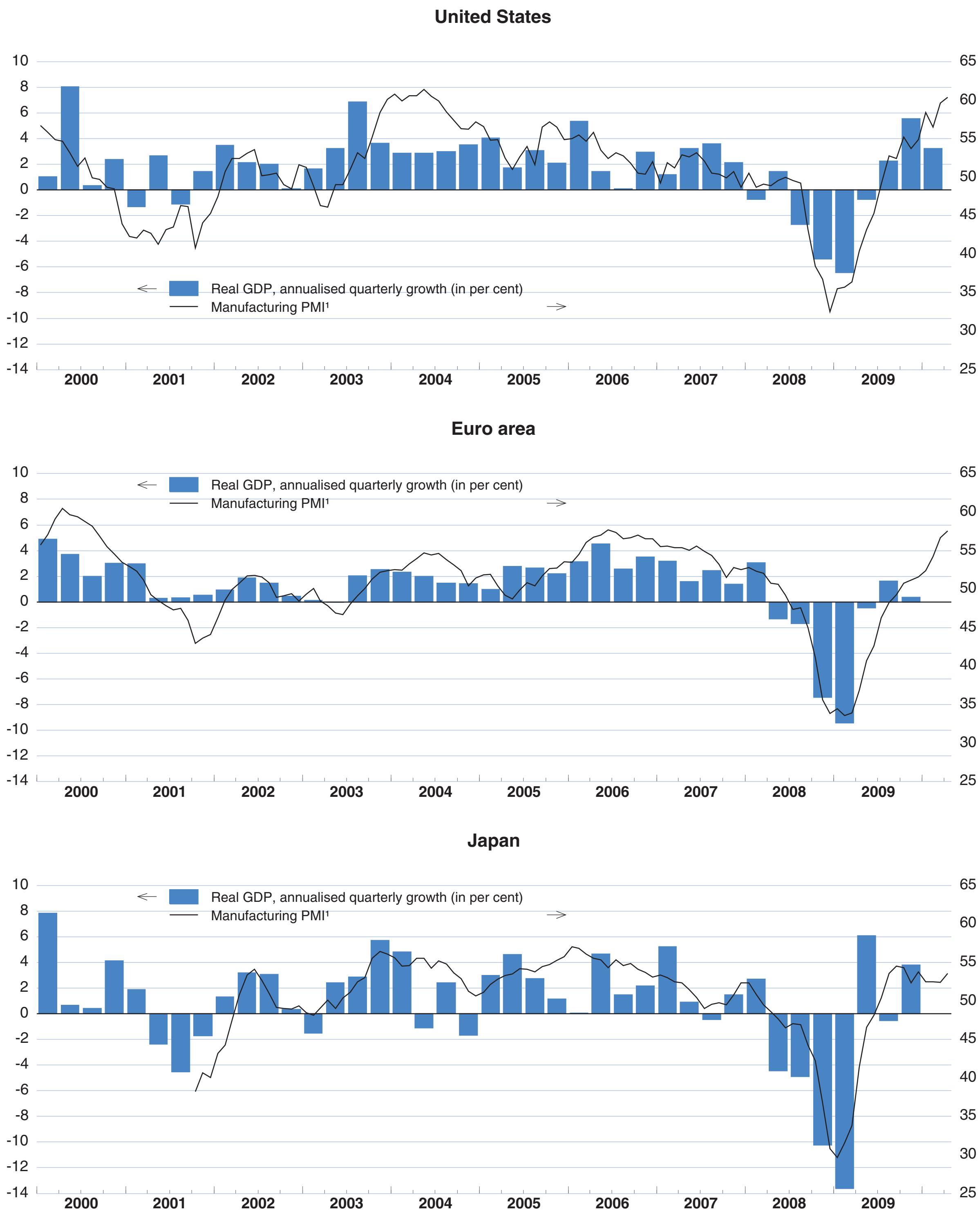
... Japan...

- Growth appears to have remained strong in the first quarter in Japan, helped by an upturn in the inventory cycle and continued vigorous external demand, especially from other Asian economies. The appreciation of the real exchange rate in recent months, and a pick-up in imports as private sector demand recovers, should, however, damp the contribution of net exports to growth. Business investment should continue to strengthen, helped by the recovery in corporate profits, while labour-market weakness will continue to bear down on private consumption. With the government having yet to present a medium-term strategy, the fiscal stance is taken to remain expansionary through 2011, with public consumption growth remaining high relative to most other OECD economies. The unemployment rate is expected to remain close to current levels throughout the projection period.

... and the euro area

- The recovery in the euro area has been more subdued than elsewhere, with unusually severe winter weather damping activity in the first quarter. On the assumption that recent financial turmoil will not

Figure 1.11. **Business confidence has rebounded**



1. Purchasing Managers' Index: summary composite index based on the seasonally adjusted diffusion indices for five of the manufacturing survey indicators.

Source: Markit Economics Limited; and OECD Economic Outlook 87 database.

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durably affect confidence, ongoing macroeconomic policy support and strong external demand should help activity to pick up through this year. Even so, private sector final demand is not expected to strengthen until 2011, held back by modest income growth, continued balance sheet adjustments by households and banks, and excess capacity in some sectors. Unemployment may peak only at the end of this year, before starting to edge down in 2011. The fiscal stance is expected to tighten by around ½ percentage point in 2011, with higher net debt interest payments offsetting partially the reduction in the underlying primary deficit. Notwithstanding the new emergency measures by the European Community and the ECB on 9/10 May to strengthen economic and financial stability in Europe and the subsequent announcements of additional near-term fiscal consolidation in some member states, concerns about debt sustainability, and associated liquidity and solvency risks seem likely to keep intra-area sovereign debt spreads elevated, with consequential adverse effects on private sector borrowing rates and activity.

Activity in the non-OECD area should remain buoyant...

- The Chinese economy is projected to continue to expand rapidly, with growth exceeding 11 per cent in 2010, before easing to just below 10 per cent in 2011 as the impact of policy stimulus begins to fade. Activity in India should also remain strong in the near term, helped by the expected rebound in agricultural output, before moderating to around trend rates as policy stimulus is removed. In Brazil, domestic demand is expected to grow vigorously until the latter half of 2010, but should moderate thereafter as policy stimulus is withdrawn, although some support will remain from strong public infrastructure spending next year. Growth is expected to have remained strong in Russia in the early part of this year, aided by the large rise in oil prices since early 2009, but should moderate gradually towards trend rates by 2011, with policy stimulus starting to be withdrawn.

... and so should world trade

- World trade growth is expected to remain robust over the next two years (Table 1.4), led by continued strong expansion in trade in the Asian economies, Russia and Brazil. Trade growth in OECD Europe remains comparatively sluggish, picking up more substantially only in 2011. As noted above, the global trade profile is somewhat weaker than that which would emerge from a model that related global trade to global GDP developments and, in the near term, from what would be implied by various high-frequency indicators.

Labour market conditions will improve only slowly

Considerable slack remains in national labour markets. In the OECD, over the two years to the first quarter of 2010, the numbers unemployed rose by over 16 million, employment fell by 2¼ per cent and many more workers were working shorter hours than before the crisis. But the rise in unemployment has been smaller than initially anticipated, and the unemployment rate in the OECD area may now have peaked at just over 8½ per cent. Nonetheless, there remains considerable scope in Japan and

Table 1.4. **World trade remains robust and imbalances will widen gradually**

	2007	2008	2009	2010	2011
Goods and services trade volume	Percentage change from previous period				
World trade[1]	7.3	3.2	-11.0	10.6	8.4
of which: OECD	5.5	1.2	-12.2	8.3	7.4
OECD America	4.7	0.3	-12.8	10.3	7.9
OECD Asia-Pacific	7.7	3.3	-13.2	12.4	9.5
OECD Europe	5.4	1.1	-11.8	6.5	6.7
China	17.1	6.5	-3.9	25.3	11.8
Other industrialised Asia[2]	6.9	7.3	-10.4	18.9	11.2
Russia	14.6	7.0	-17.2	18.1	8.4
Brazil	12.5	8.5	-11.0	11.7	8.5
Other oil producers	12.0	8.1	-5.3	5.3	8.3
Rest of the world	10.3	6.9	-10.5	1.7	8.4
OECD exports	6.3	1.9	-12.0	8.6	7.6
OECD imports	4.8	0.5	-12.5	7.9	7.2
Trade prices[3]					
OECD exports	8.4	9.1	-9.0	0.7	0.0
OECD imports	8.0	11.1	-11.1	1.9	0.1
Non-OECD exports	8.2	14.3	-14.4	9.3	1.5
Non-OECD imports	7.3	11.4	-9.0	6.0	1.6
Current account balances	Per cent of GDP				
United States	-5.2	-4.9	-2.9	-3.8	-4.0
Japan	4.9	3.3	2.8	3.3	3.5
Euro area	0.4	-0.8	-0.3	0.3	0.8
OECD	-1.3	-1.6	-0.7	-0.8	-0.7
China	10.6	9.4	6.1	2.8	3.4
	$ billion				
United States	-727	-706	-420	-560	-618
Japan	213	157	144	169	182
Euro area	54	-102	-38	32	101
OECD	-523	-702	-270	-338	-326
China	372	426	297	154	212
Other industrialised Asia[2]	152	90	125	87	81
Russia	77	102	49	106	92
Brazil	2	-28	-24	-55	-59
Other oil producers	364	495	64	343	367
Rest of the world	-128	-195	-77	-50	-80
Non-OECD	838	891	433	584	614
World	315	189	164	247	288

Note: Regional aggregates include intra-regional trade.
1. Growth rates of the arithmetic average of import volumes and export volumes.
2. Chinese Taipei; Hong Kong, China; Malaysia; Philippines; Singapore; Vietnam; Thailand; India and Indonesia.
3. Average unit values in dollars.
Source: OECD Economic Outlook 87 database.

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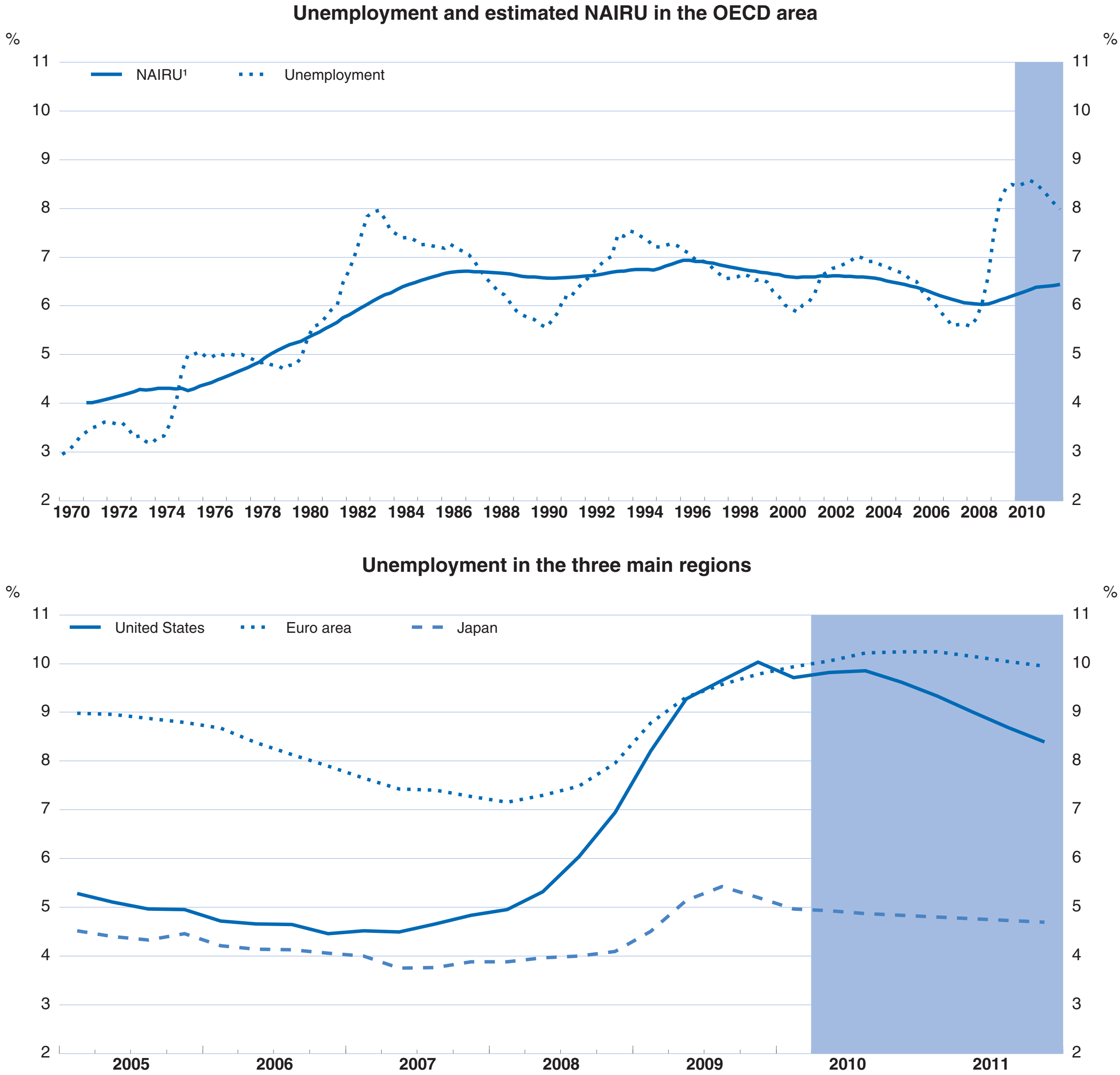
some European economies to meet increases in output by raising cyclically-low working hours and productivity, rather than by expanding net job creation. Thus, with economic growth picking up only modestly, prospects for strong employment growth in these economies appear remote (as discussed in Chapter 5). By contrast, US firms have shed large amounts of labour during the downturn and may therefore have to increase their hiring relatively strongly in the upturn. With participation rates holding up somewhat better than in past downturns, declines in the

OECD-wide unemployment rate in the next eighteen months may be modest (Figure 1.12; Table 1.5). Indeed, some economies, notably in Europe, could even experience rising unemployment for a time, especially if the employment preserved through reduced average working hours proves to be unsustainable over the longer term. Even with somewhat stronger job creation through 2011, with employment projected to rise by around 1% that year, considerable labour-market slack will endure. Based

Figure 1.12. **Unemployment will come down only slowly in the OECD**

Percentage of labour force



1. NAIRU is based on OECD Secretariat estimates.

Source: OECD Economic Outlook 87 database.

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Table 1.5. **Labour market conditions will turn up slowly**

	2006	2007	2008	2009	2010	2011
	Percentage change from previous period, seasonally adjusted at annual rates					
Employment						
United States	1.9	1.1	-0.5	-3.8	0.0	2.0
Japan	0.4	0.5	-0.4	-1.6	0.0	0.0
Euro area	1.6	1.8	1.0	-1.8	-0.9	0.0
OECD	1.7	1.5	0.6	-1.8	0.2	1.0
Labour force						
United States	1.4	1.1	0.8	-0.1	0.5	1.0
Japan	0.1	0.2	-0.3	-0.5	-0.2	-0.2
Euro area	0.9	0.9	1.1	0.3	0.0	0.0
OECD	1.1	1.0	1.0	0.5	0.6	0.6
Unemployment rate	Per cent of labour force					
United States	4.6	4.6	5.8	9.3	9.7	8.9
Japan	4.1	3.8	4.0	5.1	4.9	4.7
Euro area	8.3	7.4	7.5	9.4	10.1	10.1
OECD	6.1	5.6	6.0	8.1	8.5	8.2

Source: OECD Economic Outlook 87 database.

StatLink http://dx.doi.org/10.1787/888932305931

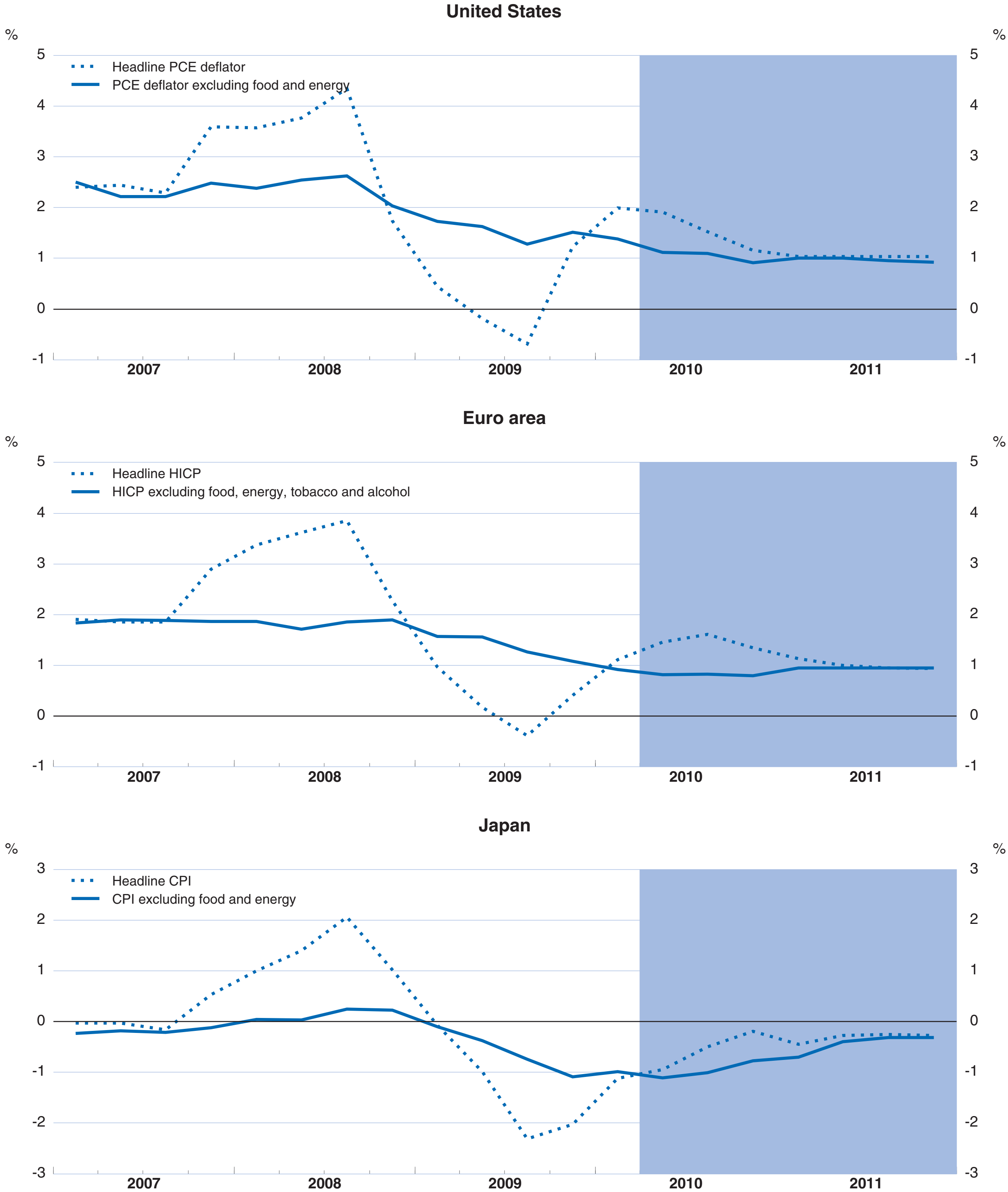
on past experience, there continues to be a risk that at least part of the rise in unemployment since the crisis began will prove long-lasting.

Downward pressures on core inflation have continued....

The upward pressures on headline inflation in recent months, resulting largely from higher global commodity prices, should be close to peaking in most major OECD economies under the assumption of no further changes in commodity prices (Figure 1.13). However, headline inflation is continuing to rise in a few economies, such as the United Kingdom, in part because of price level adjustment following indirect tax increases. Core inflation, abstracting from the direct effects of commodity price inflation, and statistical measures of underlying inflation have continued to moderate in most economies, albeit relatively slowly, reflecting the present high degree of economic slack. The annual rate of core inflation has edged down close to 1¼ per cent in the United States this year and has now slipped below 1% in the euro area. In Japan, the pace of deflation appears to have stabilised around an underlying rate of 1%. Labour-cost pressures are minimal, with unit labour costs having fallen especially sharply in the United States, helped by the surge in labour productivity growth, and in Japan. The comparatively modest downward drift of core inflation, given the large negative output gaps that are estimated to exist at present, may reflect the relative stability of inflation expectations, at least until recently, as well as possible asymmetries in the impact of economic slack at very low rates of inflation and high levels of slack. Another possibility is that output gaps are smaller than assumed in the current projections. Outside the OECD area, higher food costs have also added to inflation pressures in China and India, with some indications of wider inflation pressures in the latter economy. In

Figure 1.13. **Underlying inflation is set to remain subdued**

12-month percentage change



Note: PCE deflator refers to the deflator of personal consumption expenditures, HICP to the harmonised index of consumer prices and CPI to the consumer price index.

Source: OECD Economic Outlook 87 database.

StatLink http://dx.doi.org/10.1787/888932303974

Brazil, a rapid reduction in spare capacity has pushed up headline inflation.

… and core inflation should remain subdued over the next two years

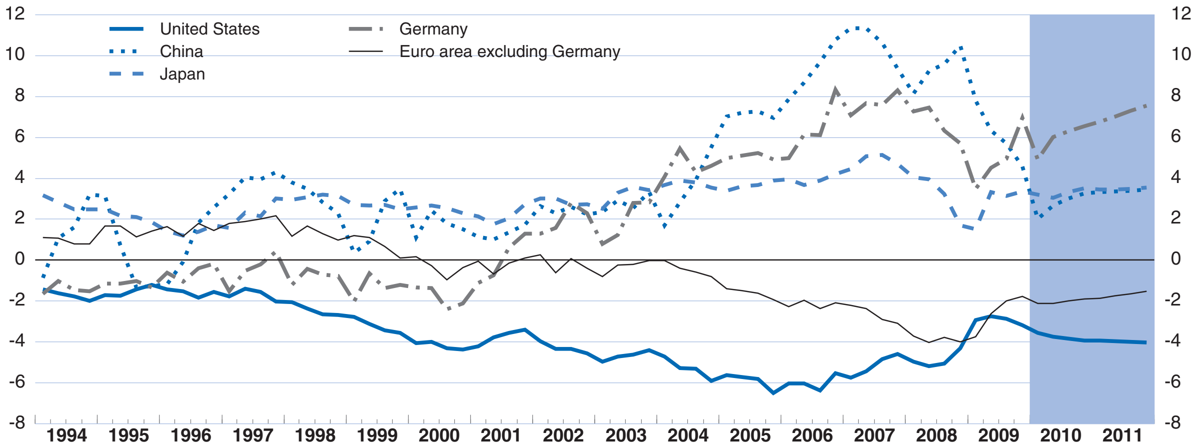
Ongoing economic slack, projected to diminish only slowly, seems likely to continue to damp inflationary pressures for some time to come, provided that longer-term inflation expectations do not become unanchored. Even so, only small further reductions in core inflation are anticipated, despite the size of the negative output gap at present. In the United States, the annual rate of core inflation is projected to drift down to average close to 1% in the latter half of this year and in 2011. Core inflation in the euro area is expected to remain at just under 1% throughout the next eighteen months. In Japan, deflation is expected to persist. Whilst the building up of deflationary pressures remains a possibility, the likelihood of such an outcome seems limited. At present, longer-term inflation expectations remain anchored at rates relatively close to explicit or implicit inflation objectives of the monetary authorities in Japan and the euro area, but are now somewhat above inflation objectives on some measures in the United Kingdom and the United States, raising a risk that inflation could surprise on the upside in these economies.

Global imbalances have begun to widen slowly…

The recession, and the associated decline in oil prices, helped to generate a considerable narrowing in global current account imbalances (Figure 1.14; Table 1.4). This period of adjustment has now ended in many OECD countries, with imbalances having already begun to widen somewhat as global trade, activity and commodity prices have picked up since mid-2009. In particular, the early stages of recovery have seen the external deficit of the United States widen by over ½ per cent of GDP, mainly reflecting terms-of-trade losses, while the trade surpluses of Japan and Germany have risen. Amongst the non-OECD economies, the trade

Figure 1.14. **Global imbalances will widen modestly**

Current account balance, in per cent of GDP



Source: OECD Economic Outlook 87 database.

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surplus of the major oil-producing economies has also risen, but the Chinese current account surplus declined to around 6% of GDP in 2009, well below the size of the surplus in 2007. The surplus appears to have declined further through 2009 and into 2010, and the monthly trade balance even moved temporarily into deficit in the early part of this year, on the back of strong import volume growth and a decline in the terms of trade, despite a recovery in export volume growth.

… and this appears likely to continue as the recovery progresses

The gradual impetus towards wider imbalances seems likely to continue through the course of 2010 and 2011 (Figure 1.14; Table 1.4). In particular, the relative strength of domestic demand in the United States is projected to further widen the US external deficit by around ¾ per cent of GDP by the end of next year. The German and, to a lesser extent, the Japanese surpluses are projected to increase, helped by the relative exposure of domestic exporters to the upturn in demand for capital goods, especially in fast-growing Asian markets and a pick-up in the income from assets held abroad by domestic residents. Moreover, the trade deficit of the rest of the euro area should continue to narrow, even though some internal imbalances are expected to persist (Box 1.5). The Chinese current account surplus is expected to rise by around ¾ per cent of GDP over the next eighteen months, as domestic demand growth begins to ease and net export volumes strengthen further. Overall, trade imbalances are set to move closer to their estimated underlying levels over the projection period.[5]

Risks remain substantial

Although the economic recovery has now been underway for a year, and is proving to be somewhat more robust than anticipated earlier, the short-term risks around the forecast remain considerable. The nature of the upside and downside risks are quite different. The principal upside risk is that the momentum of the recovery in all OECD economies turns out to be stronger than projected, helped along by the ongoing buoyancy of the non-OECD economies and the normalisation of financial conditions. The fuel for such a development could come from a faster bounce-back of business investment to more normal levels and from stronger growth in household consumption against the background of improved balance sheets and reduced uncertainty about labour market prospects. In contrast, downside risks are largely associated with the possibility of particular events that could check the recovery, in some cases quite significantly. In particular, new tail-risks have arisen from the growing concerns about longer-term debt sustainability in some countries and the associated widening in sovereign risk spreads. On either side, risks remain inter-related, with more favourable outcomes in one area of

5. The underlying balance estimates assume a closing of the output gap and an oil price of just under $80 per barrel. The estimates for 2011 are that the United States has a trade deficit of 4½ per cent of GDP, while Japan, the euro area and China have respective trade surpluses of 1.3, 0.5 and 5 per cent of GDP. See Cheung *et al.* (2010).

Box 1.5. **Addressing imbalances within the euro area**

The financial crisis and its aftermath have exposed many of the deep-seated problems resulting from the decade-long build-up of underlying imbalances in the euro area. Many euro area countries that have lost competitiveness over the past decade are now facing a need to tackle both a sizable structural fiscal deficit and a shortfall of private-sector saving, reflected in a still sizable external deficit.

Some diversity of economic performance, including current account balances is natural, also in a common currency area, reflecting different development levels and differences in structural factors, such as demographic developments. However, a striking characteristic of the first decade of the euro area, at least until recently, has been the extent to which such imbalances have been able to persist. Moreover, they have in some cases reflected policy settings which were not sustainable over the long term, combined with more protracted adjustment processes inside the monetary union (Hoeller et al, 2004). The challenge now is to ensure that policies are implemented which can help excessive imbalances to be unwound at the lowest possible cost.

This will not be easy, however, as cumulated shifts in underlying cost competitiveness since the start of monetary union and changes in domestic saving and investment patterns cannot be quickly reversed. At the same time, these will have to be the adjustment parameters in a situation where cross-country labour mobility is limited. The problems in Greece are the most visible and the most urgent that need to be tackled, not least to minimise the risks of financial contagion, but action is needed elsewhere as well. Fiscal consolidation will be part of the solution, with the needs for consolidation generally larger in the countries with external deficits. At the same time, tackling the imbalances effectively, and in a way that ensures that all countries do not try to improve price and cost competitiveness simultaneously, is likely to require structural reforms in all countries.

Adjustment may be facilitated by undertaking structural reforms that are, in any case, desirable to improve economic performance and living standards in the countries concerned. Possible measures include:

- *Greater price and wage flexibility*. Structural reforms to enhance wage and price flexibility, especially in countries that have lost price and cost competitiveness over the past decade, would speed up and strengthen competitiveness effects and help to ensure that necessary price adjustments take place at reasonably low unemployment rates. Measures to reduce the non-wage components of labour compensation could help to improve competitiveness by damping the growth of unit labour costs, although care is needed in the timing of their introduction to ensure that offsetting measures do not weaken domestic incomes excessively rapidly.
- *Changing private investment patterns*. Structural reforms in surplus countries could usefully be introduced to improve incentives to undertake domestic fixed capital investment and thus enhance growth prospects. For instance, the recent *OECD Economic Survey of Germany* (OECD, 2010a) suggests that Germany may be able to boost its investment rate, which is currently relatively low, by introducing policies to reduce regulatory barriers in sheltered sectors to encourage additional business investment, including from foreign investors, and generally shift resources towards currently less developed parts of the economy. In deficit countries, reforms should focus initially on strengthening tradable sectors, for example by taking steps to further reduce administrative burdens on business. In addition, distortions in non-tradable sectors that have resulted in excessive investment in the past decade should be eliminated.
- *Retirement reform in surplus and deficit countries*. High saving rates in surplus countries, related in part to demographic developments and reforms that have cut old-age replacement rates, could be lowered if the need for credible long-lasting fiscal consolidation was met, at least in part, by reforms to delay retirement. The corollary for deficit countries is that reforms to postpone retirement may be a particularly effective way of achieving medium-term consolidation without undue prejudice to near-term demand, although it would do less to tackle underlying saving and investment imbalances.

Box 1.5. **Addressing imbalances within the euro area** *(cont.)*

The process needed for external deficit countries to regain some of the foregone price and cost competitiveness over the past decade is likely to take some time. As a hypothetical illustration of the lengthy adjustments required for some countries to regain competitiveness, suppose that the annual rate of inflation in all euro area countries will be 2%, apart from in Greece, Portugal, Spain and Ireland, where the annual rate will be zero. Given the respective sizes of these economies, this would imply an area-wide inflation rate close to 1.6% per annum. Maintaining such differentials for five years, would change relative prices in these two groups by close to 10½ per cent, correcting much of the swing in real exchange rates since 1999 (see figure). However, an adjustment occurring through prolonged low inflation, or even some deflation, in deficit countries would tend to exacerbate the difficulties some of these countries face in dealing with their high and rising public debt burdens. And deflation could be difficult to achieve, given the high downward nominal wage rigidity in some countries, including Greece (ECB, 2009).

Intra-euro area competitiveness

Harmonised consumer prices relative to other euro area countries, 1993 = 1

Note: The indicators are calculated using a double-weighted trade matrix for 2000 covering the 13 countries that are currently members of both the euro area and the OECD. Results for Slovakia are not shown in the charts or discussed in the text because of the particular nature of the starting point of 1993, which in this country corresponds to the early stages of the transition to a market economy.

Source: OECD Economic Outlook 87 database; and OECD calculations.

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risk, and in one economy, leading to more favourable outcomes in others. At present, key risks include:

There is a marked downside risk of financial market contagion…

- Ongoing market concerns about public debt sustainability in particular countries, with associated rises in bond rates and risk premia, highlight the renewed risks of contagion in financial markets, as demonstrated by developments in the euro area in early May. In countries with high debt burdens and heavy short-term debt issuance, widening spreads on government debt could result in enforced fiscal contractions with strong negative demand effects or, at the limit and in cases where no outside assistance is forthcoming, in solvency problems. In countries not suffering from acute fiscal pressures, the consequence of higher bond spreads for activity would still be negative. To provide an order of magnitude, simulations on the OECD global macroeconomic model (Hervé *et al.*, 2010) indicate that the impact of a simultaneous 100 basis points increase in risk premiums in all countries would be to reduce output growth by around ½ a percentage point in both the first and second years of the increase in risk premiums. Near-term sovereign debt risks have dissipated in Europe since early May, but long-run concerns about debt sustainability remain, with associated downside risks for the projections.

… and from higher commodity price inflation

- There remains a risk that the strong recovery in non-OECD economies that have a relatively high demand for raw materials could place upward pressure on commodity prices. It is unlikely, however, that oil prices will be driven up to record levels similar to those seen in mid-2008, not least because OPEC appears unlikely to tighten oil supply again in the near future. The impact of higher oil prices would in any case be limited, provided any upward price adjustment remained modest. A 10% increase in oil prices would reduce activity in the major OECD economies by around 0.1 percentage point after a year, with inflation pushed up by 0.2 percentage point. Monetary policy would not need to respond to such a change given the present low inflation environment.

Inflation expectations could become unanchored

- A downside risk is that long-term inflation expectations become unanchored and drift upwards. If so, monetary policy accommodation would need to be reversed more quickly, damping demand growth at a time when fiscal consolidation is getting underway.

On the upside, non-OECD growth could be more robust

- Inherent growth dynamics in the non-OECD economies could be more robust than projected, even as these countries moderate their accommodative macroeconomic policies. Stronger demand growth in the emerging economies would help to support activity in the OECD economies. An increase of 2-3% in the level of domestic demand in the non-OECD economies would, under unchanged macro policies, raise output in the first year by around one quarter of a percentage point in the major OECD economies. Such a scenario could also impart downside risks, however, given the associated possibility of a need for abrupt policy reversal in the non-OECD economies in response to inflation and asset price pressures.

Uncertainty remains about the impact of policy normalisation

More generally, economic developments in recent months have in some respects been surprisingly good. In particular, the fall in prices of many assets has been much smaller than earlier feared, and equity prices for non-financial companies have recovered to pre-crisis levels. However, there has been little deleveraging in the private sector as yet. This raises concern about a return to the pre-crisis situation with the associated fragilities, especially given the strong role of macroeconomic policy in bringing about such an outcome and the concomitant sensitivity to a normalisation of policies.

Policy responses and requirements

Policy decisions remain interlinked

The overall policy stance needs to reflect current and anticipated economic developments. Where the process has not already begun, consolidation of the public finances should start by next year at the latest, based on credible and well-articulated medium-term consolidation plans to restore fiscal soundness. The pace of consolidation in those countries that have a choice, should be sufficient to ensure continued credibility and to avoid damaging increases in long-term interest rates while, as far as possible, being commensurate with the pace of the recovery and the initially limited scope for monetary policy accommodation. Most central banks will need to have begun the normalisation of policy interest rates by the end of this year, with the pace of normalisation subsequently dependent on the outlook for inflation, including the behaviour of inflation expectations and the impact of prospective fiscal consolidation on macroeconomic conditions. These factors call for exit proceeding at different speeds across countries. The synchronous nature of the exit may place some limits on the pace of exit, especially as actions to tighten policies in one country will affect others. International coordination will be required when government interventions are rolled back in financial markets and new regulatory and supervisory arrangements are introduced.

Fiscal policy

Fiscal positions have deteriorated markedly

Fiscal positions have deteriorated markedly in the aftermath of the crisis, albeit less than previously expected. The OECD area-wide fiscal deficit is projected to stabilise at 7.8% of GDP in 2010, more than three quarters of which is estimated – with a large margin of error in current circumstances – to be structural (Table 1.6).[6] In 2011, fiscal balances are projected to improve by 1% of GDP on average, with roughly half of the

6. The structural component is based on potential output estimates, and output gap estimates, along the lines described in *OECD Economic Outlook*, No. 85. Given the uncertainties about the impact of the crisis on potential output levels, growth in the recent past and in the near future, estimates of structural and cyclical components of budget balances are particularly uncertain at present.

Table 1.6. **Fiscal positions will begin to improve in 2011**

Per cent of GDP/Potential GDP

	2007	2008	2009	2010	2011
United States					
Actual balance	-2.8	-6.5	-11.0	-10.7	-8.9
Underlying balance[2]	-3.3	-5.9	-8.5	-8.9	-8.1
Underlying primary balance[2]	-1.4	-4.2	-7.0	-7.1	-5.7
Gross financial liabilities	61.9	70.4	83.0	89.6	94.8
Japan					
Actual balance	-2.4	-2.1	-7.2	-7.6	-8.3
Underlying balance[2]	-3.5	-3.3	-5.7	-6.3	-6.8
Underlying primary balance[2]	-2.8	-2.4	-4.7	-5.0	-5.2
Gross financial liabilities	167.0	173.8	192.9	199.2	204.6
Euro area					
Actual balance	-0.6	-2.0	-6.3	-6.6	-5.7
Underlying balance[2]	-1.3	-1.8	-3.5	-4.1	-3.6
Underlying primary balance[2]	1.4	0.8	-1.1	-1.6	-0.9
Gross financial liabilities	71.0	75.8	86.3	92.4	96.7
OECD[1]					
Actual balance	-1.2	-3.3	-7.9	-7.8	-6.7
Underlying balance[2]	-2.3	-3.7	-6.1	-6.3	-5.8
Underlying primary balance[2]	-0.4	-2.0	-4.5	-4.5	-3.6
Gross financial liabilities	73.0	79.0	90.3	95.8	99.8

Note: Actual balances and liabilities are in per cent of nominal GDP. Underlying balances are in per cent of potential GDP. The underlying primary balance is the underlying balance excluding the impact of net debt interest payments.

1. Total OECD excludes Mexico and Turkey.
2. Fiscal balances adjusted for the cycle and for one-offs.

Source: OECD Economic Outlook 87 database.

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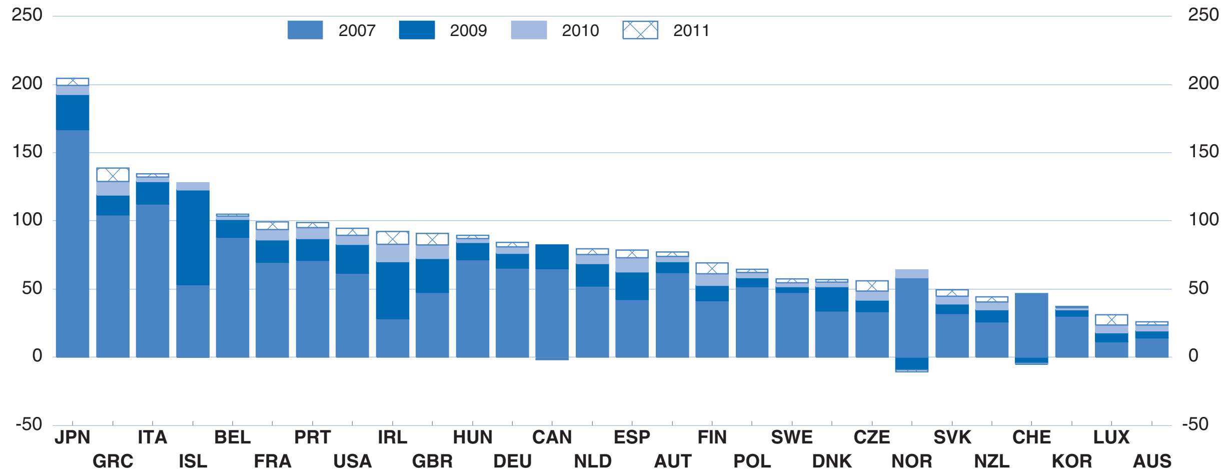
improvement accounted for by the cyclical upswing, and the remainder by improvements in underlying balances. The 2011 deficit projection is nearly 1 per cent of GDP below that in the previous *Economic Outlook*.

Consolidation is scheduled to begin in 2011...

Temporary parts of the fiscal stimulus programmes are set to be withdrawn in 2011 in most countries. Underlying balances are projected to improve more strongly, by 1% of GDP or more, in a few countries (Greece, Iceland, Portugal and Spain). Even so, underlying deficits remain deep across the OECD area, exceeding the 2007 pre-crisis level by 3½ per cent of GDP on average. In the euro area as a whole, a modest aggregate improvement is projected, although underlying balances could even deteriorate in a few countries (Italy, Finland, Ireland and Luxembourg). Indeed, reflecting the integration of only concrete policy measures in the current projections, structural balances for the euro area countries improve by about a third of the amount indicated by governments in their EU Stability Programmes issued in early 2010. For Japan, the expansionary stance in 2011 reflects the government's commitment to a variety of new spending programmes, with consolidation measures yet to be announced. Debt-to-GDP ratios will continue to rise across the OECD area, reaching just under 100% of GDP on average in 2011, almost 30 percentage points higher than in 2007 (Figure 1.15).

Figure 1.15. **Government debt heads higher**

Per cent of GDP



Source: OECD Economic Outlook 87 database.

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... but should be more ambitious in many countries

Against the background of the subdued recovery and the risks around it, the projected neutral fiscal stance is appropriate in most countries for this year. However, in the countries where evidence of a stronger-than-expected recovery is cumulating (as is the case in Canada, Korea and Norway), the authorities may wish to use scope for moving the start of consolidation into 2010. Countries at risk of losing confidence in financial markets also need to strengthen government finances more rapidly. In 2011, when, on current projections, the recovery will have gathered strength, the weak state of public finances calls for consolidation in most countries. The announcement of credible consolidation plans should allow retrenchment to progress at a measured pace initially so as not to undermine the recovery, though countries with strong growth and countries with high public deficits and debt should consolidate at a faster pace. In many cases, projected consolidation measures in 2011 seem to involve an insufficient degree of tightening; the further fiscal stimulus planned in a few countries is not warranted.

Weak public finances risk destabilising financial markets

Inadequate consolidation efforts in countries with high deficits and debt would risk adverse reactions in financial markets, with investors demanding high interest rates as compensation for higher default risk. Empirical studies indicate that interest rate reactions are more likely when public debt is high and that the risk premium increases with higher debt ratios. In general, the projections assume that when government indebtedness passes a threshold of 75% of GDP, long-term interest rates increase by 4 basis points for every additional percentage point increase in the debt-to-GDP ratio.[7] The link

7. An important exception is Japan which has seen a substantial increase in indebtedness over the last two decades with, so far, little obvious effect on interest rates probably because of the high proportion of debt which is financed domestically. The responsiveness of interest rates to debt is assumed to be only one-quarter that for other countries.

between the state of public finances and government bond yields has been vividly displayed in the turbulence surrounding Greece and, to a lesser extent, some other southern European economies in recent months. To resolve this crisis, Greece will have to implement agreed consolidation steps without delay to ensure the medium-term stability of public finances and to adhere to the conditions that have been set for receiving emergency loans. Both Spain and Portugal have also taken action to speed up consolidation.

Mechanisms to address fiscal crisis in the euro area need to be strengthened

Mounting concerns about public debt sustainability culminated in strong financial market turbulence in the euro area in early May, which led to the announcement of a series of co-ordinated measures between the EU member countries, the International Monetary Fund and the European Central Bank (Box 1.6). These have reduced the short-term risk of contagion in financial markets, but have addressed concerns about long-run solvency risks only insofar as it is known that lending will be subject to conditionality. Several important issues remain to be clarified,

Box 1.6. **The European support package**

Faced with rapidly rising turbulence in euro area financial markets stemming from concerns about the longer-term sustainability of sovereign debt positions, the European Community, the IMF and the ECB announced a package of support measures on May 9/10. These measures came on top of a series of already-agreed bilateral three-year loans to Greece, worth € 110 billion. There were two broad elements in the support package – additional financial support backed jointly by member governments and the IMF, for liquidity loans to governments at risk, and new actions by the ECB to help ensure financial stability in the euro area.

The European Community and the IMF announced the creation of a new European stabilisation mechanism, capable of providing up to € 500 billion of financial assistance over a three-year period, with up to € 250 billion of matching funding from the IMF. These funds, plus the loans for Greece are equivalent to close to 9½ per cent of euro area GDP. The interest rate charged on the new funds appears likely to be similar to that charged on the bilateral loans to Greece, at around 5%. The new stabilisation mechanism has two parts:

- The establishment of a new Special Purpose Vehicle (SPV), able to make loans to euro area states in need of assistance of up to € 440 billion, subject to strong conditionality. These loans are to be guaranteed by euro area member states (in proportion to their voting rights at the ECB). The SPV is due to last for 3 years and will raise funding on the markets, backed by government credit guarantees (€ 660 billion is just over 7¼ per cent of euro area GDP). It will likely take some time to put this measure, and the modalities under which it will operate, fully into place. In particular, technical work needs to be undertaken by the European Commission to set up the SPV, and the loan guarantees will need legislative approval by member states.
- A financial stabilisation mechanism providing loans or credit lines of up to € 60 billion, operated by the European Commission and available to help all EU member states in financial need. Funding for this facility is raised in the markets by the European Commission, using the EU budget as collateral, as with the existing medium-term balance-of-payments facility for non euro area member states, which has already been used to help Latvia, Hungary and Romania in the past two years. The additional € 60 billion funding is backed by all EU member states and is available subject to strong conditionality, and in the context of joint EU/IMF support.

Box 1.6. **The European support package** *(cont.)*

The ECB announced that it would:

- Begin to purchase private and government debt securities on the secondary markets (*i.e.* not directly from member governments), in those segments which are "dysfunctional". This would not amount to quantitative easing, as actions would be taken to sterilise all such purchases, preventing any direct impact on the monetary base.
- Re-activate measures to supply unlimited three- and six-month liquidity to banks. The three-month liquidity is to be provided using a fixed rate procedure, whereas the rate for the six-month liquidity operation will be fixed *ex post* at the average minimum bid rate of the main refinancing operations over the life (the six-month interval) of the operation.
- In addition to these measures, a range of bilateral currency swap arrangements with the US Federal Reserve was also announced, including with the ECB. This raises the availability of US dollar denominated funding for European financial institutions.

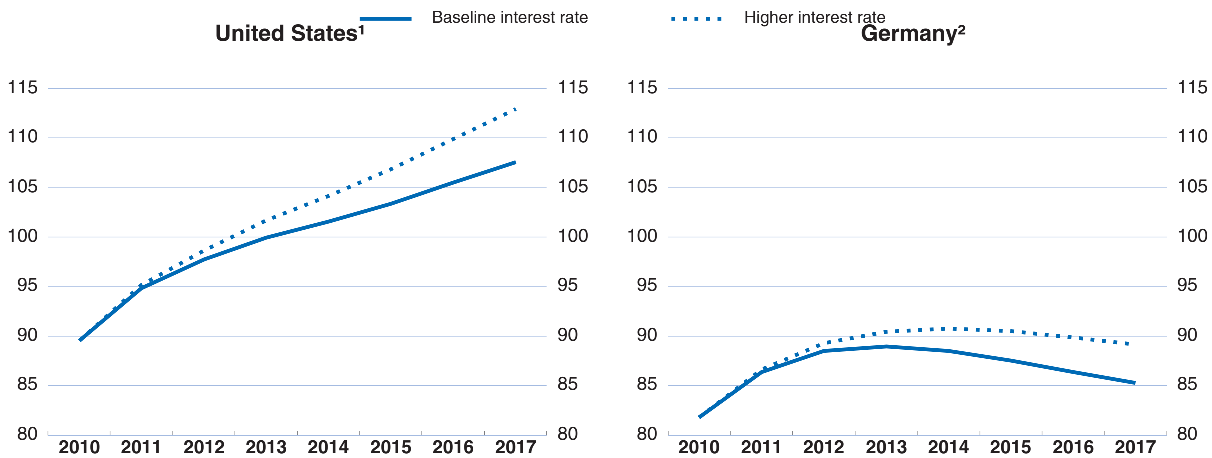
All in all, the three-year government loans and guarantees, together with the significant steps taken by the ECB, should solve current liquidity problems in the markets. They cover the likely funding needs of the most-exposed governments and should enable the financial institutions most exposed to the sovereign liabilities of those countries (and therefore most exposed to the possible risk of default) to obtain the near-term funding they require on adequate terms.

including the conditions under which countries will qualify for aid, the decision-making process required for that aid to be granted swiftly and in adequate amount, and what will happen if a request for aid is denied. Unless based on a clear and transparent process, the provision of support may be seen by financial markets as subject to significant political risk. The existence of additional support facilities for euro area countries also poses moral hazard problems which, if left unchecked, would weaken incentives to maintain sound fiscal positions. Enhanced surveillance and co-ordination of fiscal policies under the European Stability and Growth Pact could help to reduce this risk, though a much increased impact at the national level will be required for such a process to be effective. Options range from improved surveillance of national plans at one extreme of the spectrum to arrangements implying a fiscal union at the other extreme, with national budget autonomy combined with centrally-agreed rules, external audit of accounting and reporting rules and penalties in-between. More stringent and timely sanction mechanisms for cases of non-compliance with EU fiscal rules will be required, including higher penalties for excessive budget deficits. Spelling out more clearly the conditions under which support facilities will be available may also enhance the disciplining effect of financial markets.

Current fiscal plans might not suffice to stabilise debt-to-GDP ratios

Most OECD countries have announced medium-term consolidation targets. However, even if countries adhere to these plans, in contrast to frequent slippages in the past, current programmes in many OECD countries may not suffice to halt adverse debt dynamics, particularly if growth remains more subdued than assumed. For example, if GDP growth and interest rates evolve as assumed in the long-term scenario presented in this *OECD Economic Outlook*, the President's medium-term budget proposal would not suffice to stabilise the US debt-to-GDP ratio without further amendment (Figure 1.16). Under similar assumptions, the deficit target in Germany implies that the debt ratio continues to rise for the next three years. However, it is scheduled to fall thereafter due to the recently introduced constitutional requirements. Nonetheless, a concrete consolidation strategy for meeting the target is not yet available and will need to be developed.

Figure 1.16. **Gross debt ratios under announced government consolidation plans**



Note: Baseline interest rates follow a long-term baseline scenario that is presented in *OECD Economic Outlook 87*. In the higher interest rate case, interest payments arising from financing needs from 2011 onward are based on interest rates that are set 100 basis points higher than the long-term equilibrium rates in the long-term scenario. In estimating the financing need arising from roll-over of maturing portions of the debt, the redemption schedule based on maturity distributions of marketable debt issued by the central government is applied to total general government debt. Up to 2011, growth and interest rate assumptions are taken from the projections in *Economic Outlook No. 87*. Thereafter, growth rates and gross asset ratios are based on the long-term scenario, with the exception of the United States, where the cyclical impact on fiscal balances under the government consolidation plan is based on national assumptions.

1. The consolidation path is based on changes in dollar values of fiscal balances (net of interest expenses) published in the President's Budget proposal as of 1 February 2010, as assessed by the Congressional Budget Office (CBO). Fiscal impacts of final health care legislation are also taken into consideration based on the CBO's assessment as of 20 March 2010.
2. The consolidation plan up to 2013 is based on the annual changes of cyclically-adjusted primary balances as per cent of GDP incorporated in the "German Stability Programme January 2010 Update". Beyond 2014, cyclically-adjusted primary balances are assumed to improve at equal steps, so that net lending reaches balance in 2020.

Source: OECD Economic Outlook 87 database; and OECD calculations.

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Consolidation needs are large to stabilise public debt ratios

A long-term scenario to 2025 has been used to assess the extent of consolidation needed to stabilise public debt ratios (see Chapter 4). The scenario assumes that from 2012 onwards there is a gradual and sustained improvement in the underlying primary balance by ½ per cent of GDP per year until the debt-to-GDP ratio stabilises. For several countries this assumption implies a degree of fiscal consolidation which is less ambitious than incorporated in current government plans and it would in general seem to be insufficient, but it serves as a baseline to discuss more ambitious policies and it provides an illustration of what is needed just to stabilise debt at often very high levels. Indeed, the stabilisation of the debt-to-GDP ratio would call for a tightening of underlying primary balances of between 5 and 10% of GDP in the countries with the largest primary deficits (Ireland, Japan, Spain, Poland, Iceland, the United Kingdom and the United States) (Table 1.7). Even then, debt in the OECD area is projected to increase by a further 18 percentage points of GDP from 2012 onwards before it stabilises, exceeding 100% of GDP for about a third of the OECD countries. In particular, the increase in the debt ratio amounts to 25% of GDP or more for the United States, the Czech Republic, Finland, United Kingdom, Ireland and Poland.

Table 1.7. **Consolidation requirement to stabilise the debt-to-GDP ratio over the long-term horizon**

As per cent of potential GDP

	Underlying primary balance in 2010	Underlying primary balance required to stablise debt[1]	Required change in underlying primary balance	Projected Change in underlying primary balance in 2011	Requirement beyond 2011
	(A)	(B)	(C) = (B) - (A)	(D)	(C) - (D)
Australia	-1.8	0.1	1.9	1.0	0.9
Austria	-1.1	0.8	1.9	0.2	1.7
Belgium	1.9	0.9	-1.0	0.7	-1.6
Canada	-1.4	0.1	1.5	0.6	0.9
Czech Republic	-3.0	-0.4	2.6	0.0	2.6
Denmark	-0.5	0.2	0.7	0.3	0.4
Finland	-0.4	-0.4	0.0	-0.4	0.4
France	-3.2	1.7	4.9	0.7	4.2
Germany	-1.2	1.2	2.4	0.7	1.7
Greece	1.0	4.1	3.1	2.1	1.0
Hungary	2.1	2.5	0.4	0.0	0.4
Iceland	-2.6	2.4	5.0	3.0	2.0
Ireland	-4.7	1.6	6.3	0.1	6.2
Italy	1.8	3.2	1.4	0.0	1.4
Japan	-5.0	3.6	8.6	-0.2	8.8
Korea	0.4	-1.7	-2.1	-0.3	-1.8
Luxembourg	-2.2	0.1	2.3	-1.1	3.4
Netherlands	-2.0	0.8	2.9	0.7	2.1
New Zealand	-3.1	0.1	3.1	0.1	3.0
Norway	-4.0	0.6	4.7	0.4	4.3
Poland	-4.8	2.0	6.8	0.4	6.4
Portugal	-2.8	1.8	4.6	2.2	2.3
Slovak Republic	-3.3	1.4	4.7	1.2	3.5
Spain	-5.2	0.6	5.8	1.9	3.9
Sweden	1.7	-0.3	-2.0	1.2	-3.2
Switzerland	0.3	0.0	-0.4	0.1	-0.5
United Kingdom	-5.7	3.1	8.8	0.9	7.9
United States	-7.1	2.6	9.7	1.3	8.3

1. Underlying primary balance required in 2025, based on gradual but steady consolidation paths, to stabilise debt-to-GDP ratios over the long-term horizon, embodied in the long-term baseline scenario presented in *OECD Economic Outlook 87*. Debt stabilisation may take place at undesirably high levels.

Source: OECD calculations.

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Consolidation should largely rely on spending restraint

Against this background, plans should be made – and published – for stabilisation and eventual reversal of debt levels so as to boost credibility. For medium-term plans to be credible, they need to be based on cautious assumptions, provide details about how and when consolidation is to be achieved and include information on how contingencies will be addressed. Credible programmes can also trigger private sector responses that offset to some extent the contractionary impact of consolidation on GDP (Box 1.7). Past experience shows that consolidation based on expenditure cuts is more likely to succeed than consolidations relying on higher taxes (Guichard *et al.*, 2007). To some extent this may be because restraints on

Box 1.7. **Will fiscal consolidation affect short-term growth?**

Traditionally, fiscal consolidation is considered to have a negative impact on economic activity, as reducing government spending or raising taxes, and associated multiplier effects, weigh on aggregate demand. However, the private sector's response to government action might be such that it offsets, at least partially, the contractionary impact. To what extent such offsets materialise depends on a range of factors, notably the size of government debt, the credibility of the consolidation programme, the type of instruments used to achieve the consolidation goals and financial market conditions. This box highlights a number of aspects that are relevant at present.

Consolidation may lead to lower interest rates as it reduces the burden of government securities on capital markets, and might stabilise or reduce inflationary expectations. Lower interest rates, by raising the relative returns of investment projects and durable consumption goods, can stimulate private investment and consumption. In a flexible exchange rate regime they might also cause a depreciation of the exchange rate, stimulating exports although this effect might be less relevant in the current situation, with simultaneous consolidation needs in most OECD countries. A positive wealth or liquidity effect on consumption might also arise, as lower long term interest rates tend to raise the price of assets (bonds, stocks and real estate).

Expectations play an important role in the transmission of fiscal policy measures to the private sector. In particular, consumers are likely to base their consumption decisions to some extent on expected future income streams (permanent income) rather than on current disposable incomes. In this context, if private agents anticipate that a tax increase or public spending cuts will take place in the future, they may already have adjusted their spending behaviour before the implementation of the tax increases and spending cuts, as their permanent income has been cut. In such cases, the implementation of the fiscal measures would have no effect on aggregate demand. While this proposition (a corollary to the "Ricardian Equivalence" proposition) in its pure form would apply only under rather strict assumptions that are hardly met in reality, it is found to be of some relevance for actual behaviour.

Recent OECD estimates assessing Ricardian equivalence, suggest that the public/private saving offset is on average across OECD countries around 40% (Röhn, 2010) and that this offset already materialises in the short term.[1] However, large variations across countries exist. Additionally, the evidence suggests that the offset becomes larger with increasing debt levels.[2] This is consistent with the notion that the level and growth rate of public debt may trigger discrete changes in private expectations giving rise to non-linear effects between fiscal policy and private responses.[3] For example, given high levels of debt, consolidation can signal a permanent regime shift of future fiscal retrenchment leading to expectations of permanently lower taxes and thus higher disposable income in the future. Also, with fiscal positions considered unsustainable at high debt levels, a large and credible consolidation programme can reduce the expected probability of default, reducing risk premia on government securities. This in turn, can imply falling interest rates more generally, with positive effects on economic activity. Given the current large and unsustainable debt levels in many OECD countries, the evidence therefore suggests that consolidation may trigger a positive private response leading to less adverse effects on short-term growth or even expansionary effects[4]. However, the credibility of the consolidation programme is a crucial prerequisite for private agents to anchor their expectations. The credibility can be enhanced by the size of the consolidation and/or the introduction of fiscal rules.

Box 1.7. **Will fiscal consolidation affect short-term growth?** *(cont.)*

Getting the financial sector in order is an important prerequisite for successful fiscal consolidations (Barrios *et al.*, 2010). The Ricardian offset of public saving is stronger the less credit-constrained private agents are (Röhn, 2010). Also, the extent of potential crowding-in of private investment and consumption depends on the need for private agents to repair their balance sheets. Against this background, the recent improvement in financial conditions in the OECD can be seen as a supportive factor for consolidation efforts.

1. These estimates are in line with other recent studies that estimate the short term offset to be between 0.1 and 0.5. However, most of these studies find a significantly higher offset in the long term (*e.g.* de Mello *et al.*, 2004). A possible caveat of the saving offset estimates is that they are derived under the assumption that private-public savings offsets are equal in fiscal expansions and contractions.
2. See also Nickel and Vansteenkiste (2008), Berben and Brosens (2007), and Nicoletti (1988, 1992).
3. See *e.g.* Giavazzi *et al.*, 2000; Blanchard, 1990; Sutherland, 1997; Perotti, 1999.
4. Indeed, several consolidation episodes in the past have been identified as expansionary such as Denmark 1983-1986 and Ireland 1987-1989 (*e.g.* European Commission, 2003).

spending demonstrate commitment, thereby bolstering the credibility of the consolidation strategy. To the extent that revenue increases are needed in the consolidation process, the scope to cut tax expenditures should be exploited, and taxes with the least distortionary impact on economic activity, such as recurrent taxes on immovable property and consumption taxes should be employed (Johansson *et al.*, 2008). Taxation of carbon emissions and the auctioning of emission permits could also raise revenues while addressing environmental concerns. Curbing public sector wages might also go some way to improve fiscal positions in the short term, although there is a risk that they might rebound at a later stage or that public sector pay might lose competitiveness relative to the private sector.

Scope to raise public sector efficiency should be exploited

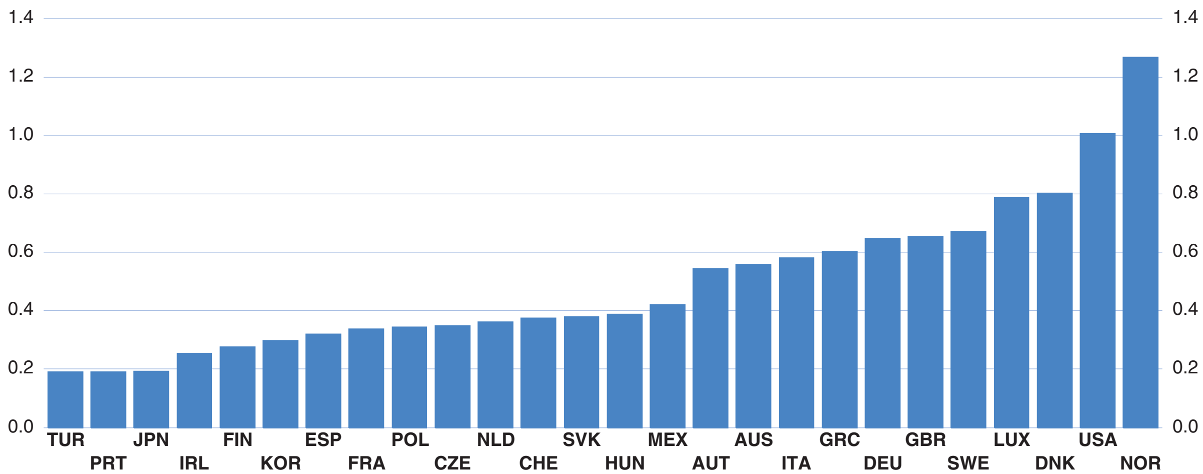
Public spending reductions should also be designed to favour long-term growth. Hence, outcomes in growth-enhancing activities in areas like infrastructure, health care and education should be preserved to the extent possible given that these are also large spending items. Achieving this will be helped by exploiting the wide scope for greater efficiency within these spending categories. As recent OECD studies document, the budgetary impact of moving to international best practice in key public services can be sizeable. For the health care sector it has been estimated that on average across OECD countries potential efficiency gains from moving to best practice while leaving health outcomes unchanged could amount to 2% of GDP (Joumard *et al.*, 2008). In primary and secondary education moving to OECD best performance could on average generate efficiency gains between one quarter and more than 1% of GDP (Figure 1.17) (Sutherland *et al.*, 2007).

Fiscal rules and independent monitoring can help

Sustaining significant consolidation efforts over many years can be difficult, but there is some evidence that fiscal rules, in particular those that have expenditures as a focus in combination with deficit rules, can have a favourable impact on both the size of fiscal consolidation and the duration of the consolidation effort (Guichard *et al.*, 2007). In a similar vein, involving independent institutions in the monitoring of consolidation policies would

Figure 1.17. **Potential efficiency gains in primary and secondary education are large**

Per cent of GDP



Note: The numbers show potential resource savings at the national level from reducing teacher-student ratios while holding outputs constant. Implied input cuts were applied to compensation of all staff in primary, secondary and post-secondary non-tertiary education for the year 2002.

Source: Sutherland *et al.*, 2007.

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be an option to strengthen the credibility of consolidation strategies by raising the political costs of deviating from plans.

Rebalancing debt maturities can help contain to debt servicing costs

It may also be possible to economise on debt-servicing costs, but there is often a trade-off with risk. Some countries, notably Germany and France, have recently shortened significantly maturities at issuance of government securities (Box 1.8). Although this reduces debt servicing

Box 1.8. **The maturity structure of government securities and refinancing (roll-over) risk**

Financing needs for governments arise from several different sources. In each period, governments must finance primary deficits and gross interest payable on the continuing stock of gross debt. In addition, governments need to cover financing needs associated with the turnover of the maturing portion of the debt.

Information for selected OECD countries provided by national authorities suggests that average remaining maturities of central government marketable debt lie between 6 and 7½ years for most countries, but are longer, about 13 years, for the United Kingdom (due to issuance of very long-dated gilts) and somewhat shorter, about 4½ years, for the United States (due to relatively large reliance on medium-term Treasury bills) (see first table below). Debt managers have responded differently to the crisis, as witnessed by the proportion of short-term and long-term instruments issued in 2009 compared to the mix of maturities issued pre-crisis during 2007 (see second table below). While France, Germany, Switzerland and, to a lesser extent, Japan significantly increased the portion of debt issuance with very short maturities (one year or less) at the expense of long term securities (10 years and more), the United States, Italy, United Kingdom, Canada and Sweden have reduced the share of short-term debt, with Italy and Sweden increasing the share of emissions with long-term securities (10 years and more). All in all, present maturity distributions imply that, for most countries, a substantial portion of the debt will mature in the near future, by the end of 2011, adding to financing pressures on governments and increasing sensitivity to changes in interest rates.

Box 1.8. **The maturity structure of government securities and refinancing (roll-over) risk** *(cont.)*

Distribution of remaining maturities of marketable central government securities

	United States	Japan	Germany	France	Italy	United Kingdom	Canada	Belgium	Netherlands	Sweden	Switzerland
	January 2010	March 2009	February 2010	December 2009	January 2010	January 2010	January 2010	January 2010	January 2010	February 2010	March 2010
Average remaining maturity (years)	4.7	6.3	6.5	6.9	6.9	13.0	6.2	5.7	5.5	7.5	7.0
Portion of the debt maturing within one year (%)	33	17	20	26	23	9	39	22	28	14	16
Portion of the debt maturing within two years (%)	45	28	35	36	35	14	49	32	38	20	25
Portion of the debt maturing within three years (%)	56	37	43	44	45	20	56	42	49	31	34
Portion of the debt maturing beyond ten years (%)	9	18	15	19	19	42	19	14	13	25	20

Source: OECD calculation based on national data.

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Distribution of maturities at issuance of marketable central government securities

		Percent of the debt maturing in:			
		1 year or less	2 year or less	3 year or less	10 years or more
United States	2007	80.7	80.7	83.6	15.1
	2009	73.8	80.0	85.5	5.0
Japan	2007	21.9	40.5	40.5	37.6
	2009	25.8	47.0	47.0	32.5
Germany	2007	33.5	59.5	59.5	23.7
	2009	52.7	71.9	71.9	17.4
France	2007	63.9	66.1	70.3	18.3
	2009	75.4	77.7	81.4	9.9
Italy	2007	56.0	62.6	70.2	15.7
	2009	51.9	60.1	67.7	19.6
United Kingdom	2007	55.2	55.2	55.2	37.0
	2009	38.0	39.1	45.1	37.9
Canada	2007	90.2	91.7	93.7	4.9
	2009	80.3	86.7	89.1	5.5
Belgium	2007	70.2	70.2	70.3	13.9
	2009	70.2	72.7	79.1	8.2
Netherlands	2007	76.3	79.9	79.9	18.0
	2009	81.2	83.0	87.7	5.7
Sweden	2007	86.0	87.0	87.0	9.1
	2009	72.9	73.8	75.3	20.4
Switzerland	2007	85.9	85.9	85.9	14.1
	2009	91.9	91.9	91.9	2.9

Note: Data refer to all debt instruments issued during the year shown. The amount of debt issued is aggregated by length of maturity at issuance, with the proportions shown being calculated as a percentage of total issuance during the given year.
Source: OECD calculations based on national data.

StatLink http://dx.doi.org/10.1787/888932306007

costs in the short term, given low short-term interest rates, it makes government budgets more sensitive to a normalisation of the yield curve and can put upward pressure on short-term rates. Moreover, as long-term rates are likely to increase once the economic upswing is firming, it is worth considering whether to rebalance debt maturities towards longer maturities so as to lock in currently low interest rates for longer-term securities. An increase in interest rates on government securities across the maturity spectrum by one percentage point from 2011 onwards, relative to the long-term rate assumed in the OECD's long-term scenario, would be associated with significantly higher debt levels in the medium term, increasing debt servicing costs in 2017 by about 3% of GDP for Japan and about 1% for the other countries.

All in all, consolidation poses major challenges

All in all, fiscal consolidation will need to be carried out in a way that ensures that a lack of credibility of consolidation plans does not raise risk premia while, at the same time, preserving long-term growth. Higher risk premia and weak growth could frustrate consolidation efforts, possibly triggering a downward spiral leading to increasingly adverse debt dynamics. To preserve growth, the composition of spending cuts and revenue increases should be carefully selected while structural reforms to boost potential output should be implemented, as discussed later.

Monetary policy

Exit is gradually taking place...

Exit from the massive monetary policy stimulus injected during the crisis is taking place gradually outside the euro area. In the euro area, the process has been reversed by the steps taken to counter the sovereign debt scare. A number of special liquidity provision measures have been scaled down or withdrawn, or announcements to that effect have been made. Asset purchase programmes have been completed, or are scheduled to close in the near future in the the United States and have been paused in the United Kingdom since February. And in a few countries, the normalisation of policy interest rates has already commenced (Australia, Brazil, India, Israel, and Norway) or is expected to begin earlier than previously anticipated (Canada and Sweden). Monetary policy normalisation is also underway in China, which together with Brazil and India has increased bank reserve requirements among other measures.

Exit from extraordinary liquidity provision

... especially for bank liquidity provision...

As improvements in funding markets and greater confidence in counterparties have made it less costly for banks to use market sources of finance, some central bank liquidity facilities have already contracted. An exception to this pattern is the re-introduction of short-term liquidity facilities by the ECB on 10 May (see Box 1.6) The scaling down of the liquidity facilities should depend predominantly on the robustness of financial markets. An option is to retain the remaining measures on the books as long as financial markets are still fragile, while discouraging their use outside situations of stress by increasing access costs progressively.[8] This may help to avoid the need to have to re-introduce support facilities in event of renewed stress, as was the case with the recent changes made by the ECB, with potential negative effects on confidence. A collateral framework for refinancing operations based on graded haircuts that reflect asset quality, as the ECB will start operating in 2011, may provide support for low-quality assets in periods of stress, while also protecting central banks' balance sheets. At the same time, however, changing the gradings could be a difficult process unless it is seen to be based on objective criteria. Abrupt termination of short-term liquidity facilities should be avoided because a sudden contraction of liquidity can give rise to volatility in bank overnight interest rates. In deciding on the scaling back of liquidity provision, account should also be taken of possible implications for longer-term asset markets, given that banks in some countries have used abundant low-cost liquidity to purchase higher-yielding longer-term assets, such as government bonds.

Exit from central banks' extraordinary asset holdings

... while programmes to purchase long-dated assets are terminated in many countries...

The large accumulation of long-dated assets by the monetary authorities in the United States, Japan and the United Kingdom, aimed at supporting particular segments of financial markets and/or increasing the money supply, has slowed down since the end of 2009 and is poised to finish in the course of the first half of 2010, as asset purchase programmes are terminated.[9] On the other hand, the ECB announced on 10 May that, in addition to its programme to purchase covered bonds, it would conduct additional interventions in the euro area public and private debt securities markets to ensure depth and liquidity in those components which are dysfunctional, sterilising the impact of such interventions on the money supply.

...depending on macroeconomic and financial conditions

The sale of private and public assets needs to be decided on the basis of the distortions such holdings entail, macroeconomic conditions and the functioning of the underlying asset markets. From a long-term perspective, there is a strong case to sell such assets to avoid misallocation of resources and reduced potential output.[10] However, in

8. In the United States and the euro area, access conditions to extraordinary and mid-term liquidity, respectively, have been tightened.
9. The purchase of agency debt and agency mortgage-backed securities ended at the end of March in the United States, together with part of the Term Asset-Backed Securities Loan Facility (TALF). Support for commercial mortgage-backed securities (CMBS) will continue until the end of June 2010. The Bank of England has already completed the implementation of the £200 billion asset purchase programme and the covered bond programme by the ECB should be fully accomplished by the end of the second quarter of 2010.
10. This is because long-term asset purchase programmes have artificially reduced the cost of government debt accumulation and the cost of home ownership, with a longer-term risk of over-investment in residential property if holdings are maintained for a long time. Indeed, central banks' purchases of government bonds in the United States and the United Kingdom may have reduced long-term interest rates by 50 basis points or more, and the purchase of asset-backed (mostly mortgage-backed) bonds in the United States could have cut mortgage rates by an additional 50 basis points. See Sack (2009) and Gagnon (2009).

the short run, higher yields on government and private bonds as a result of government divestiture of accumulated assets would discourage spending by households and businesses, and could translate into pressures on domestic currencies.[11] Moreover, sales could lead to the realisation of losses for central banks which might raise questions about their credibility and independence.[12]

The sale of long dated assets should be gradual

Given the macroeconomic outlook and the still fragile state of some of the relevant asset markets, these considerations suggest that asset sales should be limited in the near term and conducted at a slow pace when they begin. Such a strategy would only be viable and compatible with eventual increases in policy interest rates if central banks offset the impact of such asset holdings on liquidity. Central banks can drain liquidity by means of liability management tools, including reverse repurchase agreements, term deposits and issuance of central bank bills, the latter two being more practical as they are not necessarily tied to particular assets. As well, the remuneration of banks' deposits at the central bank allows the control of overnight rates in a situation of large excess reserves. However, whilst this latter option lowers banks' cost of holding reserves, and can therefore be expected to reduce the effect of liquidity on broad money growth, it does not fully remove the possibility that they may fuel an expansion in broad money, in contrast with liquidity-absorbing operations. Since retaining long-term assets for too long can have adverse implications for inflation, not least through effects on expectations, the authorities should also provide a clear road map on the offsetting and the eventual unwinding of long-term asset holdings so as to anchor long-term inflation expectations, which in some cases have drifted up recently.[13]

11. An additional factor having a bearing on the selling of assets is that it could destabilise the relevant markets, in particular securitised markets in the United States.
12. Retaining long-term assets to maturity would avoid abrupt large losses that would have to be realised if such assets were sold in an environment of higher long-term rates, while they were purchased at relatively high prices. As large-scale upfront losses could raise more acute questions about the independence of monetary authorities than losses smoothed over time, because of recapitalisation needs, retention could be preferable from the point of view of protecting central bank credibility as much as possible. This does not seem to be an issue for the Bank of England because the UK Treasury has agreed to compensate the Bank for any loss associated with the implementation of the Asset Purchase Programme.
13. Unconventional measures could destabilise inflation expectations if the huge accumulation of reserve balances results in a rapid increase in the aggregate money stock, aggregate demand and inflationary pressures. Alternatively, inflation expectations may drift upwards if economic agents perceive a greater risk that central banks' actions are constrained by their expanded balance sheets, which would prevent them from adjusting interest rates in a timely manner. See Cournède and Minegishi (2010).

Exit from very low policy rates

The exit from low policy rates should focus on expected inflation and macroeconomic conditions…

The start and pace of the normalisation of policy interest rates from the current close-to-zero rates in major OECD economies should depend on the outlook for inflation expectations, and therefore macroeconomic conditions in general. Hence, it should be differentiated across countries depending on their current slack, current inflation levels, and the expected strength of their recovery (which will be influenced by their fiscal policy settings): the bigger the current level of slack, the longer the delay in starting the exit and the slower the normalisation; the faster the expected recovery, the sooner and faster the increase in interest rates. Given the headwinds from continued balance-sheet adjustment and prospective fiscal consolidation, the exit should be gradual and focus on the emergence of underlying inflationary pressures. Low inflation means that policy interest rates should reach neutral levels only by the time output gaps are closed. Signs that inflation expectations begin to drift up, *e.g.* due to lack of credible medium-term fiscal consolidation plans, would be a reason to bring forward the exit. The normalisation will in a number of cases need to begin while some unconventional policy measures are still in place, using liquidity management tools to absorb reserves or to ensure that market rates can be increased despite high levels of excess reserves.

… and should commence in the current year…

Against this background, and given expectations concerning the short and medium-term strength of the recovery, the exit from extremely accommodative policy interest rates should proceed at different speeds for key central banks:

… in the United States…

- In the United States, where some long-term measures of inflation expectations have increased and the labour market has stabilised earlier than expected, the start of normalisation should not be delayed beyond the last quarter of 2010. Policy interest rates should be well above half-way to neutral by end-2011, but the path of convergence to full normalisation would have to accelerate if long-term inflation expectations were to drift up further.[14]

… Canada…

- In Canada, where domestic demand is projected to be strong and core inflation has remained surprisingly resistant to further declines emanating from economic slack, monetary authorities should start the normalisation process by mid-2010 and be only some 100 basis points below neutral by the end of 2011.

14. As a first step, creating room for overnight interest rates to increase, the US Federal Reserve has already increased the interest rate at which it provides liquidity under the discount window lending programme, to encourage depository institutions to rely on private funding markets for short-term credit. The authorities have increased the discount rate from 0.5% to 0.75% (effective from 19 February 2010), shortened the maximum maturity for primary credit loans from 28 days to overnight (effective from 18 March 2010), and raised the minimum bid rate for the Term Auction Facility (TAF) by 0.25%.

... the United Kingdom...

- In the United Kingdom, the authorities face the challenge of preserving credibility, with headline inflation and some measures of inflation expectations exceeding the targeted rate in the context of extremely expansionary monetary and fiscal policies. The reversal of the December 2008 VAT cut and higher fuel prices have contributed to the recent jump in inflation. Notwithstanding the temporary nature of these price developments, the gradual drift up of some measures of inflation expectations implies a need to increase interest rates earlier than previously thought and no later than the last quarter of 2010. The projected increase of core inflation to the Bank of England target warrants an increase of the policy rate to 3½ per cent by end-2011.

... and the euro area...

- In the euro area, and in the near term, the ECB should continue to prevent overnight rates from converging too soon to the higher key policy interest rate by ensuring sufficient amounts of liquidity. In the light of the weak economic recovery and consumer price inflation which is expected to remain subdued over the forecast horizon, convergence between policy and overnight rates should occur only towards the end of 2010, at the time when the main policy interest rate should be raised. The projected state of the economy, and also expectations beyond the projection period, do not warrant more than a 100 basis point increase by end-2011.

... but much later in Japan

- In Japan, in spite of a pick-up in economic activity towards end-2009, ongoing deflation calls for keeping policy interest rates close to zero until inflation is positive. This is not expected to be the case until 2012 at the earliest. In view of entrenched deflationary tendencies, the authorities need to explore alternative means to boost the economy, including by purchasing long-term government assets on a far larger scale than in the past.

In China and India the process of monetary normalisation should continue

- In China, the monetary authorities should tighten monetary policy further to rein in credit and money growth as a way to contain inflationary pressures. This may have the added advantage of moderating undue appreciation of property prices and associated credit developments.[15] Over the near term, a tightening of monetary conditions through exchange rate appreciation could assist monetary policy. Over the longer term, initiatives to permit the currency to float more freely would allow monetary policy to focus better on domestic objectives. In India, the process of interest rate normalisation should

15. Measures already taken include the strengthening of lending standards and capital requirements for commercial banks, tightening the conditions applicable to mortgages for the acquisition of second homes, banning loans for third home purchases in areas with excessive property price gains, and limiting outright the number of homes that can be purchased over a certain time period. Moreover, the monetary authorities have also increased the reserve requirements ratio twice since the beginning of the year, imposing higher requirements on individual banks with the fastest loan growth.

continue, to counter inflation risks associated with a solid recovery and surging food prices spilling over into more widespread inflation. In Brazil, the policy interest rate needs to rise further in the coming months to address growing inflation pressures.

Exit from ultra-low policy rates should take into account the pace of fiscal withdrawal

Though monetary policy should be independent of political interference, exit from the extremely accommodative monetary policy stance should take into account the pace of removal of fiscal stimuli insofar as the latter affects the prospect for activity and inflation. However, such an articulation between fiscal and monetary policies will only be feasible in the context of clear and fully credible consolidation programmes. The announcement of credible medium-term consolidation plans can also help to keep inflation expectations anchored in the face of large fiscal imbalances in the near term, providing the monetary authorities with the room to slow down the normalisation of interest rates.[16] In the absence of credible fiscal consolidation plans, monetary policy may need to be tightened so as to prevent a rise in inflation expectations.

Credit and asset price bubbles: a role for macro-prudential policy

Macro-prudential regulation and targeted instruments can help to tackle asset overvaluations

The recent stabilisation or recovery of many asset prices, in combination with the experience of credit-fuelled asset price booms in the run-up to the crisis, has increased the focus on how best to respond to such developments. Interest rate hikes aimed at leaning against excessive asset price and credit growth may need to be large to have a material impact. Macro-prudential regulation, and other targeted instruments that focus on lenders, discussed in more detail in Chapter 6, can in principle be more effective in tackling asset overvaluations in particular markets by acting as a brake on feedback loops between asset prices and credit supply. However, before a strong macro-prudential framework is in place, and even if the risk of credit-fuelled house price bubbles is still low in the OECD area, the authorities should stand ready to respond by accelerating the pace at which interest rates are raised if house price inflation and mortgage credit expansion were judged to become excessive, given the economic costs that arise eventually when such bubbles burst.[17] Once a proper macro-prudential framework is in place, changes in interest rates to address perceived asset and credit bubbles can best be seen as a last line of defence.

Financial policy

Exit is also underway for financial policy support…

Improvements in the functioning of financial markets have allowed authorities across the OECD to withdraw gradually some special support

16. Abnormally high long-term interest rates will put upward pressure on government debt service costs and headline deficits, potentially leading to a vicious cycle.
17. That real estate bubbles tend to have much higher economic costs than equity price bubbles is illustrated by the fact that the average output loss (with respect to trend) following a real estate burst is a cumulated 5% of GDP after five years, while it is nil in the case of equity price booms. This has been the outcome for a sample of 17 developed nations plus China since 1970, see Posen (2009).

measures for banks and other institutions. Government programmes to guarantee bank debt have expired as scheduled at the end of 2009 in the United Kingdom and the euro area, in March 2010 in Australia, where the termination date had been left unspecified by the authorities, and in April 2010 in Sweden. In the United States, the more restrictive emergency facility implemented since October 2009 also expired at the end of April 2010. However, special deposit guarantees introduced during the crisis in many countries remain in force.

… while some countries have taken action to tax banks and restrict their activities…

At the same time that financial support is being scaled back, recent initiatives at the national level to strengthen framework conditions in the financial sector have been directed to taxing banks and restricting their activities. A temporary tax on banks' bonuses has already been implemented in France and the United Kingdom to recoup part of the fiscal cost of rescuing the banking sector and to encourage banks to develop sustainable long-term remuneration policies and build up loss-absorbing capital.[18] The effectiveness of this measure has been reduced by the fact that banks have found ways of avoiding the tax penalty through offering loans to employees against deferred awards and by increasing basic salaries altogether. Some countries in the OECD area, including France, Germany and the United Kingdom, are evaluating the implementation of a bank tax, though the modalities still remain to be defined. Legislation for a temporary tax (a "responsibility fee") levied on the non-deposit liabilities of large banks has been proposed in the United States as a way to recover taxpayer losses from the bailout of the financial sector during the crisis and to encourage a healthier funding structure.[19] The authorities could, in principle, increase the size of the fee and make it permanent and progressive, which would reduce the benefits of becoming too big to fail. To keep banks that benefit from deposit insurance from taking undue investment risks, the US authorities have also proposed measures for banks, or financial institutions that contain a bank, to limit their ability to do proprietary trading.

… and a comprehensive regulatory reform is being discussed at the global level…

Together with actions by individual countries, a comprehensive regulatory reform is being discussed under the auspices of the G20 in recognition of the need for internationally co-ordinated rules to strengthen financial stability, in particular by reducing opportunities for

18. In France and the United Kingdom, banks that pay discretionary bonuses above a certain threshold (£25 000 in the United Kingdom and euro 27 500 in France) will pay an additional one-off bank payroll tax of 50% on these excess bonuses.
19. The 2008 law creating TARP required the Administration to put forward a proposal to recover any potential losses, currently estimated at $117 billion. The intention is to impose a 0.15% fee on total assets excluding core capital and FDIC-assessed deposits and insurance policy reserves. The fee would be applied on financial firms with more than $50 billion in consolidated assets and is expected to raise $117 billion over about 12 years, and $90 billion over the next 10 years. The authorities estimate that the 10 largest financial institutions will pay over 60% of the total receipts from the tax.

Table 1.8. **Assessing progress towards the implementation of financial regulatory reform**

	Progress to date and timeline for implementation
Strengthening global capital and liquidity	A consultative document on proposals to strengthen the capital and liquidity frameworks was released in December 2009 by the BIS, for comments by mid April 2010. These measures are intended to be introduced by end-2012, after conducting a thorough impact assessment and allowing for a sufficiently long period to ensure a smooth transition to the new standards.
Expanding oversight of the financial system	The FSB, the IMF and the BIS have developed at end-2009 guidance for national authorities to assess the systemic importance of financial institutions, markets and instruments. A set of high level principles that would be sufficiently flexible to be applied to a broad range of countries and circumstances, is still to be defined. Moreover, the FSB and the IMF have reached a consensus over information gaps that need to be filled, including data to better capture the build-up of risk in the financial sector, the degree of international financial network connections, and to monitor the vulnerability of domestic economies to shocks. The FSB and the IMF will issue a report by mid 2010 on the actions taken together with a plan and timetable for implementing recommendations.
Reducing moral hazard posed by systemically important institutions	The FSB, the BIS and the International Organisation of Securities Commission (IOSCO) are already working on a set of final proposals expected to be delivered in October 2010. Moreover, the Cross-border Bank Resolution Group of the Basel Committee released a report at end-2009 on specific actions to achieve an effective, rapid and orderly wind-down of large cross-border financial firms.
Implementing sound compensation practices	The FSB has issued Principles for Sound Compensation Practices and Implementation Standards in April and September 2009, respectively. The FSB is currently monitoring the steps being taken or planned by member jurisdictions.
Strengthening accounting standards	The IASB is seeking comments until mid-2010 on accounting standards for expected loss provisions. The IASB has already issued in November 2009 standards on the classification and measurement of financial assets, while the FASB is expected to seek comments on a proposed model for accounting for financial instruments in the first half of 2010. Discussions are being held between the IASB and the FASB in order to harmonise these standards by mid 2011.

Source: OECD.

regulatory arbitrage.[20] While many details are still to be determined, overall consensus has been reached on a broad set of principles (see Table 1.8 for progress and timelines):

... to strengthen global capital and liquidity regulations...

- Strengthening global capital and liquidity regulations, so that banks have larger buffers to cushion downturns.[21] An appealing option in this respect is to use contingent capital, *i.e.* a security that converts to

20. For evidence on the role of regulatory arbitrage in the excessive risk taking behaviour that contributed to the recent crisis, see for instance Valukas (2010).
21. This includes: *i*) raising the quality, consistency and transparency of the capital base; *ii*) improving the capital framework by strengthening the capital requirements for counterparty credit risk exposures arising from complex products; *iii*) introducing a leverage ratio to help contain the build-up of excessive leverage in the banking system; *iv*) introducing measures to promote the build-up of capital buffers in good times to be used in periods of stress, including more forward-looking provisioning rules; and *v*) improving global liquidity standards for internationally active banks.

common equity in troubled times and that instantaneously replenishes the core capital of the bank.[22]

... to expand oversight of the financial system...

- Expanding oversight of the financial system to include all systemically important activity which should be subject to appropriate supervisory oversight, and co-ordinated for internationally active firms, should help to contain the build up of systemic risk in the financial system.

... to reduce moral hazard posed by systemically important institutions...

- Reducing moral hazard posed by systemically important institutions and associated economic damage. Options for addressing the "too-big-to-fail" problem being discussed include: targeted capital, leverage, and liquidity requirements; improved supervisory approaches; simplification of firm structures; strengthened national and cross-border resolution frameworks, including the development of "living wills" for major cross-border firms; and changes to financial infrastructure that reduce contagion risks.

... to implement sound compensation practices...

- Implementing sound compensation practices at large financial institutions to ensure that financial firms structure their compensation schemes in a way that does not encourage excessive risk taking.

... and to strengthen accounting standards

- Strengthening accounting standards. The International and US Financial Accounting Standards Boards (IASB and FASB) have been considering approaches to improve and simplify accounting for financial instruments, provisioning and impairment recognition, and are converging in approaches to netting rules and the treatment of repos. While discussions are being held between the IASB and the FASB in order to harmonise these standards, progress has so far been sluggish and needs to be accelerated also in view of the mid-2011 deadline for convergence.

Taxing banks can help pay for a future financial crisis

In addition, the International Monetary Fund has proposed to tax banks across and outside the OECD in order to pay for the cost of future financial crises.[23] Bank taxes, the proposal goes, should be harmonised across countries to prevent regulatory arbitrage and should focus mainly on bank liabilities.[24] The tax could be flat for all institutions initially, but

22. Such an option has three advantages. First, both shareholders and subordinated debt holders would have a strong incentive to monitor and restrain risky bank behaviour. Second, there is no need to develop difficult surcharges for systemically important institutions, as riskier banks will be penalised through the market pricing of these securities. And, third, it would minimise the use of taxpayers' money to rescue financial institutions, as a systemic risk fund would be created within the financial system itself.
23. There seems to be room to tax banking sectors more heavily across the OECD, given that it is difficult to implement value added taxes on banks, and because the tax deductibility of households' interest payments constitutes an implicit subsidy for the banks given that their lending rates include a component reflecting earnings of bank employees and shareholders.
24. The objective would be for countries to raise taxes equivalent to between 2 to 4% of gross domestic product over the long term.

could later be adjusted to reflect systemic risk. Taxing abnormal bank profits should also assist authorities in providing extra resources to pay for future financial bailouts.

Momentum to implement reforms should be maintained

A succinct evaluation of many of the measures discussed or already implemented is contained in Table 1.9. Given the multitude of incentive problems and market failures affecting financial markets and

Table 1.9. **Assessing proposals to reform the financial sector**

	Excessive risk taking	Too big to fail	Systemic Risk	Other impacts
US Responsibility Fee	Deters excessive reliance on wholesale borrowing in favour of retail deposits, a more stable form of funding.	Contains banks' size (and moral hazard), because the fee is implemented on big institutions only. A progressive fee could greatly enhance this benefit.	As far as banks are leveraged from a wide number of institutions, reducing leverage will reduce contagion risk.	Provides tax revenues. The financial sector may be smaller than without the tax.
Separation of proprietary trading from essential bank services	Reduces excessive risk taking, by eliminating an implicit taxpayer guarantee for certain risky activities.	As some activities will be separated, some banks will become smaller, helping containing moral hazard.	Safer individual institutions should boost the safeness of the entire financial system. Though the system may become instable if funds move from one market segment to the other depending on macroeconomic conditions.	It increases the cost of funding for the activities that are separated, because they lose an implicit guarantee.
Size Limits	Banks that feel that they may be allowed to fail will be more cautious when engaging in risk taking activities.	It helps contain the too big to fail issue automatically by ensuring institutions do not exceed a given absolute size.	In principle, smaller institutions are less likely to put the entire system in danger. Though systemic risk may not be contained if a large number of small institutions take similar risky exposures at the same time.	
Contingent convertibles (CoCos)	Shareholders have an incentive to contain risk taking, because excessive risk taking can potentially dilute their stakes.	For contingent convertibles to help to prevent too-big-to-fail, they have to be implemented in a progressive way (for example, as an increasing share of long term debt based on size).	Provided that CoCos are compulsory, the system itself is better prepared to deal with common negative shocks.	It increases the cost of debt for financial institutions.
Progressive Capital Requirements		As the cost of capital increases for bigger institutions, it helps containing banks' size and moral hazard.	It contributes to reduce systemic risk as institutions internalise the externalities they create through higher capital requirements.	
Counter cyclical capital requirements	More stringent capital requirements (and higher risk weights) in the expansion phase would reduce risk taking in boom times.		The system becomes sounder because all institutions have more capital in advance of a downturn triggered by a common negative shock.	The bank capital channel of monetary policy transmission would be weaker.

Source: OECD.

Table 1.9. **Assessing proposals to reform the financial sector** *(cont.)*

	Excessive risk taking	Too big to fail	Systemic Risk	Other impacts
Dynamic loss provisioning	As resources are set aside, higher loss provisioning in the expansion phase would reduce risk taking in boom times.		As with counter cyclical capital requirements forward-looking provisioning should help increase buffers to deal with negative common shocks.	The bank capital channel of monetary policy transmission would be weaker.
Liquidity Ratios	It helps to contain excessive systemic risk taking as liquidity requirements increase with risk exposure.	Contains too big to fail if ratios are progressive with respect to size. This is another way to make systemically important institutions to internalise the risks they pose to the system.	Contains systemic risk because the system is better equipped to cope with liquidity shocks.	Liquidity requirements may artificially reduce the price of government securities and reduce bond market discipline.
Leverage Ratios	Can reduce the risk of excessive leverage building up in individual entities, and as such, excessive risk taking.	It does not resolve the too big to fail issue, as nothing prevents the institutions to grow bigger with more capital, unless it is made progressive with size.	As it can reduce the risk of excessive leverage building up in individual entities, it can also contain risk in the financial system as a whole.	
Living Wills		Pre-planned regimes can reduce moral hazard by unravelling banks' structural complexity, forcing them to simplify legal structures, and helping allowing an orderly wind-down of global financial institutions.	Contains systemic risk, by ensuring that in the event of failure contracts with counterparties are resolved in an orderly fashion.	
Compensation practices	By de-linking compensation from banks' short-term outcomes, sound compensation policies can help contain excessive risk-taking.		As it can reduce excessive risk-taking in individual entities, it can also contain risk in the financial system as a whole.	
Taxes on banks' bonuses and profits	The impact of taxing bankers' compensation and bank profits is not clear-cut. It can even boost risk-taking to compensate for the nominal loos in bankers' income induced by the tax.		The impact on systemic risk will depend upon the impact on individual institutions.	It may help to boost capital levels if compensation and dividend payments are more taxed than retained earnings.
Resolution authority	Incentives to take excessive risks are reduced, as far as in case of failure the owners are not made whole and top managers are ousted.	Reduces moral hazard for big institutions, by ensuring the owners and managers of big institutions will not be bailed out in case of failure.	It reduces systemic risk by ensuring an orderly unwinding of failed institutions.	

Source: OECD.

institutions, as well as the risk that individual measures may be circumvented, the eventual policy response will have to include a substantial number of the measures discussed. It is important that the momentum to enact reforms at the global level be maintained even as economies recover, before a fading memory of the crisis complicates the political economy of the process. Implementation of regulatory changes should proceed at varying speeds for different reforms so as not to cut bank credit when it is most needed for the economic recovery.[25] In the near term, the authorities need to maintain pressure on banks to deal with bad assets notwithstanding favourable developments in financial markets, and to use current high margins – which owe much to policy support – to rebuild their capital buffers. To the extent that this does not take place, appropriate restrictions on dividends, share buy-backs and compensation may be useful, until bank capital has recovered sufficiently.

Competition policy should feature prominently in financial regulatory reform

The financial crisis has resulted in domestic financial markets becoming more concentrated and facing less competition from foreign players (Figure 1.18). The expectation of taxpayer backing for systemically important institutions has further impaired competition, because it has acted as a subsidy to big institutions.[26] Measures to address these issues would level the playing field with respect to smaller institutions and should act to compress mark-ups and reduce rents. Apart from those directed to deal with the too-big-to-fail issue (see above), measures that can help to boost competition in the banking sector include: the removal of segmentation across regions; the reduction of barriers to entry when regulation and supervision are sufficiently effective to permit it; more stringent exit and disciplining rules; and stronger and more independent supervisory or competition-enforcing bodies, including the granting of powers and a mandate to prevent mergers that are expected to result in increased systemic risk or distorted competition.[27]

Structural policies

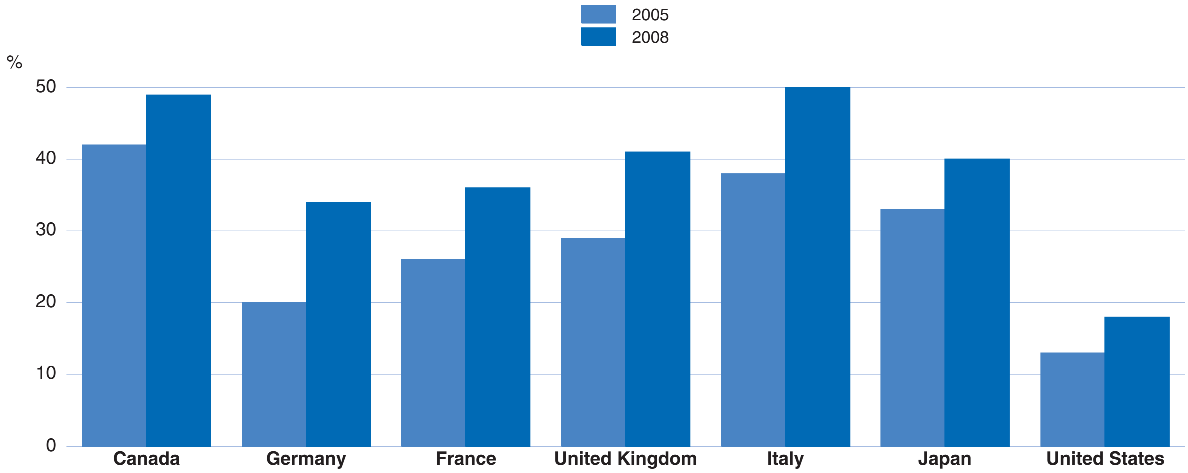
Potential output should be raised via…

Labour and product market reforms would help to raise potential output, offsetting some of the crisis-related cuts in sustainable output and help to strengthen governments' structural budget positions. Indeed, governments have often implemented ambitious reforms during past crises, with awareness of severe economic problems reducing resistance to changes in existing arrangements. However, the empirical evidence also suggests that the need for fiscal consolidation may act as an obstacle to reform, possibly because governments need to spend political capital

25. For example, while sound compensation practices should be implemented right away, more stringent capital requirements should be phased in smoothly, once the recovery is firmly rooted.
26. Concentration impairs bank competition according to a study based on data for 23 European and non-European countries in the period 1988-98, see Bikker and Haaf (2002).
27. See Saunders and Schumacher (2000) on removing segmentations, and Angelini and Cetorelli (2003) on reducing barriers to entry in the banking industry. The role of exit and disciplining rules and supervisory and competition-enforcing bodies in enhancing competition in the banking sector was analysed by Ahrend *et al.* (2009).

Figure 1.18. **Concentration in the financial system has risen**

Largest three institutions, share over total assets



Note: Includes clearing institutions and custody, commercial banks, cooperative banks, finance companies, governmental credit institutions (excluding Federal Reserve Banks), group finance banks, investment and trust corporations, investment banks, micro-financing institutions, other non-banking credit institutions, private banking and asset management companies, real estate and mortgage banks, savings banks and securities firms.

Source: OECD calculations based on Bankscope.

StatLink http://dx.doi.org/10.1787/888932304088

on fiscal retrenchment or because reforms may involve up-front costs to pay-off the beneficiaries of the *status quo* (Høj *et al.*, 2006; Tompson and Dang, 2010). In this crisis, governments have so far not introduced major reforms in labour and product markets, concentrating their efforts on crisis accommodation in labour markets (see Chapter 5), as well as macroeconomic policy and reforms to financial regulation. However, with the risk of lower potential output post-crisis and the need to strengthen public finances, fundamental product and labour market reforms are needed now more than ever before. Indeed, their implementation would facilitate fiscal consolidation.

… labour market reforms and…

Notwithstanding labour market reforms over the past two decades in many OECD countries, there remains much to do, especially in continental European countries. As discussed in Chapter 5, there are a number of obstacles to labour demand in many of these countries, often alongside weak work incentives. Swift action in this area would help to strengthen job creation and make the recovery more job-rich. It would also raise long-term potential and thereby provide a much-needed boost to government finances, raising tax revenues while, at the same time reducing public spending on social benefits.

… product market reforms

Product market reforms would increase potential output by raising productivity and strengthening employment performance. Even if product market reforms have been extensive in some OECD countries since the late 1990s, statutory entry barriers and other competition-restraining regulations continue to hold back efficiency in many countries. OECD empirical analysis suggests that aligning national regulatory stances on the least constraining one in the OECD area could increase productivity by well over 10% in low-income member countries with sizable gains also possible in the large continental European countries (see Arnold *et al*, 2009). Product market reforms, coupled with other innovation-enhancing measures set out in the OECD Innovation Strategy would also help to activate new sources of growth. Given that regulatory constraints on competition tend to be stronger in Brazil, China, India, Indonesia and South Africa than in the OECD area (OECD, 2010b), product market reforms in these countries may be particularly effective in raising their GDP per capita.

Trade barriers have not increased markedly…

Governments have generally kept their WTO commitments to open markets since the start of the recession, with the overall extent of new trade restrictions gradually declining. New import-restricting measures introduced by G20 governments from September 2009 until mid-February 2010 cover only some 0.4% of global imports (OECD-UNCTAD-WTO, 2010). Globally, there was also a decline in the recourse to potentially-legal trade remedy actions (anti-dumping, safeguards and countervailing duties) through 2009, although in the year as a whole there was considerably more usage of such measures than in 2008 (Bown, 2010). This reflected increased usage by developing economies; the number of new import-restricting trade remedy policies introduced by the United States, the European Union and Canada in 2009 was lower than in 2008, although still above the level of 2007. However, in the United States and Canada, the number of ongoing investigations rose from 2008. Going forward, it will be important to ensure that the scope of protectionist measures is not widened further during the early stages of the recovery, at a time when continued high unemployment and pressures from ongoing restructuring could influence policy decisions. Governments also need to ensure that existing trade-distorting measures are unwound promptly.

… but cross-border investment may be affected by greater state involvement in private companies

Regarding cross-border investment, potential constraints on investment flows in the G20 continue to be in place as a result of the stronger financial relationships that now exist between some governments and companies they have rescued (OECD-UNCTAD-WTO, 2010). Foreign direct investment flows remain subdued relative to their pre-crisis levels, though this is in part endogenous to the strength of the global economy and financial markets, and cross-border bank lending has continued to contract sharply (Figure 1.19).

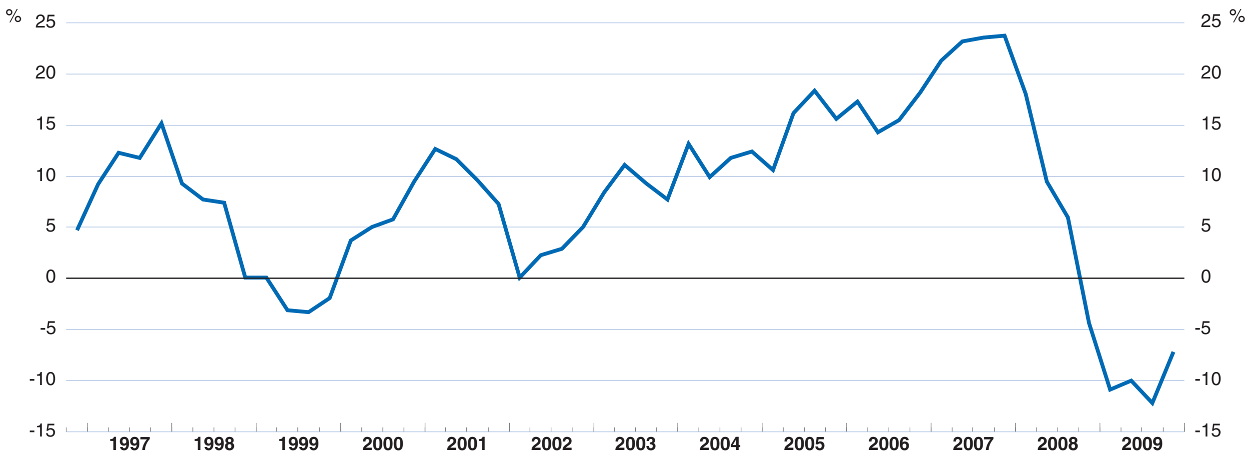
Policies for a strong, sustainable and balanced global economy

Ambitious medium-term fiscal consolidation is necessary for a strong and sustainable global economy

Currently announced policies will fail to create a strong, sustainable and balanced global economy. Medium-term fiscal programmes in some countries are currently not available (*e.g.* Japan), or not sufficient to stabilise debt-to-GDP ratios (*e.g.* the United States) or would stabilise the ratios at a level that would result in high long-term interest rates, thereby undermining long-term growth. Outside the OECD area, China does not

Figure 1.19. **Cross-border bank lending remains subdued**

Year-on-year change in foreign loans from BIS-reporting banks, adjusted for currency movements



Note: Data concerning 2009 q4 is provisional.

Source: BIS.

StatLink http://dx.doi.org/10.1787/888932304107

seem to be in need of consolidation, whereas India needs to address the large public deficit that will otherwise crowd-out productive investment. Stronger medium-term consolidation efforts are therefore necessary in many countries, with the stabilisation of public debt relative to GDP being a minimum requirement. Bringing debt ratios back to their pre-crisis levels by 2025 would strengthen the global economy in the longer term via lower interest rates and via the enhanced freedom it gives to deal with contingencies. However, it might involve weaker growth in the short term, especially since monetary policy will be able to provide only limited additional support over this period in many economies. On the other hand, provided that governments' medium-term consolidation plans are deemed fully credible, long-term interest rates might fall, providing support to the economy during the consolidation phase. Structural reforms would provide a boost to longer-term growth, thereby supporting fiscal consolidation.

Better balance in the global economy can be attained by adjustments to exchange rates …

Establishing sound public finances and a strong domestic economy are only steps towards a better balanced global economy. Beyond the short term, global imbalances are affected by fiscal consolidation around the world, but less so if it occurs simultaneously in many countries, as illustrated by the scenarios in Chapter 4. A different constellation of exchange rates could help to narrow current account imbalances durably, although only to a limited extent.

… but will have to rely mainly on structural reforms

Against this background, an important mechanism to achieve a better balanced global economy would be to narrow gaps between private saving and investment at the national level through implementing structural reforms that are already desirable on efficiency and/or welfare and equity grounds. In countries with a surplus on their current account, including Japan and Germany, removing obstacles to investment in the sheltered part of the economy, such as regulations that reduce profitability and hence capital spending in service sectors, would help to reduce global imbalances. In deficit countries, including the United States, policy distortions that encourage current spending, such as tax deduction of interest payments, should be removed. In addition, reductions in private saving rates in China and other Asian countries as social-security and public health-care systems are further developed, thus reducing the precautionary motive for saving, will contribute to the reduction of global imbalances. China has embarked on reforms to increase spending on social and health-care programmes (OECD, 2010c), and strengthening reform efforts could contribute strongly to a better balanced global economy.

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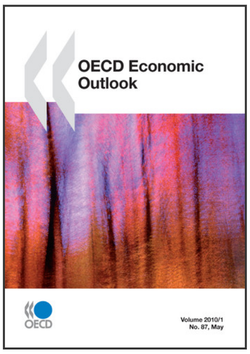

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