

Chapter 1

GENERAL ASSESSMENT OF THE CURRENT ECONOMIC SITUATION

Summary

- Global activity and trade are projected to strengthen gradually in 2014 and 2015, but the recovery is likely to remain modest.
- This modest acceleration is due to the feed-through of past improvements in financial conditions, continued support from accommodative monetary policies and reduced drag from fiscal consolidation. However, unemployment is set to remain stubbornly high in several OECD countries.
- Growth in the large emerging market economies (EMEs) is expected to remain subdued by past standards, held back by supply-side constraints, recent policy actions and the recent tightening of financial conditions triggered by expectations about US monetary policy.
- The slowdown in EMEs is likely to exert some modest drag on activity in advanced economies, with the United States relatively sheltered from such feedbacks.
- The strengthening recovery in the United States should gradually reduce unemployment and erode economic slack, with inflation rising close to target, while the muted pick-up in the euro area will make little dent in high levels of joblessness and ample slack will keep inflation very low; in Japan, core inflation is set to turn positive but, abstracting from indirect tax effects, still remain well below its target.
- Monetary policy needs to remain very accommodative, especially in the euro area, where deflation risks have risen, and Japan, where asset purchases should be continued as planned. In the United States, should unemployment continue to fall and inflation strengthen as projected, asset purchases should be wound down in 2014 and policy interest rates start to be raised in 2015.
- The planned slowing in the pace of fiscal consolidation in the United States and the euro area is appropriate given the state of public finances and the economic outlook; a strong fiscal tightening in Japan is necessary to slow public debt accumulation and eventually reduce debt.
- Structural reforms are critical for exiting the crisis, notably in Japan, the euro area and many EMEs, to strengthen growth prospects, debt dynamics, and facilitate global and euro area rebalancing.
- Sizeable long-standing downside risks still remain and new concerns have emerged.
- In the short term, if the debt ceiling in the United States became binding early in 2014, it could have large adverse effects on the stability and growth of the world economy; to prevent the possibility of such disruptive effects from weighing on confidence and investment, the legislated nominal debt ceiling should be abolished.
- The turmoil following the tapering discussions in mid-year has revealed how sensitive some EMEs are to US monetary policy. This may involve turbulence when actual tapering takes place as needed, with negative feed-back effects on advanced economies.
- In the euro area, still weak bank balance sheets, fragile public finances and the uncertain political situation in some vulnerable countries could unsettle financial markets. To guard against this, the establishment of a fully-fledged banking union needs to be expedited and weakness in bank balance sheets must be credibly identified in the coming stress tests and asset quality review of euro area banks and swiftly corrected.

Introduction

The recovery is gaining momentum only slowly and there are large downside risks

The global recovery remains modest and uneven, with continued divergence in activity developments both between and within advanced and emerging economies. Outcomes this year and near-term prospects appear a little weaker than had been expected in May, at the time of the previous *Economic Outlook*, with global GDP growth revised down by just under ½ percentage point both this year and in 2014 to 2.7% and 3.6% respectively. Almost all of this reflects a further growth slowdown in the large emerging market economies (EMEs), which is tempering the pace of the recovery in the OECD economies. At the same time, downside risks have also risen once more. Long-standing sources of risk, such as fragilities in the euro area banking sector and the Japanese fiscal situation, have been augmented by new concerns, most notably the possibility of significant financial instability in advanced and, especially, EMEs during the exit from unconventional monetary policies in the United States, and potentially extreme adverse outcomes if political stalemate were to make the debt ceiling in the United States binding early next year. Provided these large adverse risks do not materialise, and uncertainty about macroeconomic policy settings subsides, continued support from accommodative monetary policies, the feed-through of past improvements in financial market conditions and a reduced drag from fiscal consolidation should allow global activity and world trade to strengthen gradually over 2014-15 (Table 1.1). However, the pace of the recovery seems likely to remain modest, with the currently high OECD-wide unemployment rate declining by only ½ percentage point over the two years to 7.4% by end-2015, and inflation projected to remain weak in many OECD economies and moderate only gradually in most EMEs.

Policy challenges are substantial, with monetary policy requirements varying across economies

Economic policies need to provide support to demand, take account of the sizeable downside risks and correct past imbalances. Monetary policy will need to remain accommodative in most OECD economies over the next two years. However, in some economies, decisions will be required about the timing and speed at which monetary policy stimulus is reduced, balancing the need to support the recovery against the risks of unsettling inflation expectations and stoking asset price bubbles. For the United States and the United Kingdom, well anchored inflation expectations, ample spare capacity, and the predominance of global downside risks all imply that the current very accommodative policy rates are likely to remain appropriate for some time. Nevertheless, conditional on downside risks not materialising and receding gradually, and on the recoveries in these countries proceeding as projected here, it would be appropriate for the United States to consider increasing gradually policy

Table 1.1. **The global recovery will gain momentum only slowly**
OECD area, unless noted otherwise

	Average 2001-2010	2011	2012	2013	2014	2015	2013 Q4 / Q4	2014 Q4 / Q4	2015
Per cent									
Real GDP growth¹									
World ²	3.4	3.7	3.1	2.7	3.6	3.9	3.1	3.8	3.9
OECD ²	1.7	1.9	1.6	1.2	2.3	2.7	1.9	2.4	2.8
United States	1.6	1.8	2.8	1.7	2.9	3.4	2.1	3.2	3.5
Euro area	1.1	1.6	-0.6	-0.4	1.0	1.6	0.4	1.3	1.8
Japan	0.8	-0.6	1.9	1.8	1.5	1.0	3.2	0.6	0.7
Non-OECD ²	6.8	6.3	5.1	4.8	5.3	5.4	4.7	5.4	5.4
China	10.5	9.3	7.7	7.7	8.2	7.5	8.0	7.8	7.4
Output gap³	0.3	-1.9	-2.0	-2.6	-2.3	-1.8			
Unemployment rate⁴	6.8	8.0	8.0	8.0	7.8	7.5	8.0	7.7	7.4
Inflation⁵	2.2	2.5	2.1	1.5	1.9	2.0	1.5	2.0	2.1
Fiscal balance⁶	-3.9	-6.6	-5.9	-4.8	-4.0	-3.2			
<i>Memorandum Items</i>									
World real trade growth	4.9	6.3	3.0	3.0	4.8	5.9	3.7	5.5	6.0

1. Year-on-year increase; last three columns show the increase over a year earlier.

2. Moving nominal GDP weights, using purchasing power parities.

3. Per cent of potential GDP.

4. Per cent of labour force.

5. Private consumption deflator. Year-on-year increase; last 3 columns show the increase over a year earlier.

6. Per cent of GDP.

Source: OECD Economic Outlook 94 database.

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rates in early 2015 and for the United Kingdom to do so later in the year, not least to contain possible pressures on asset prices. More substantive increases in policy rates may be required in both countries beyond the projection period to prevent anchored inflation expectations being put to the test. In contrast, in the euro area in the coming two years, the monetary policy stance should remain unchanged, provided disinflationary pressures do not intensify further, and strong quantitative and qualitative monetary easing should be implemented as planned in Japan. As already shown this year, the anticipation and actual start of the monetary stimulus withdrawal in the United States could have adverse global spillover effects, especially if it results in financial market instability. Emerging market economies are particularly vulnerable to shifts in investor sentiment and some will possibly come under pressure to raise interest rates at a time when the economy is weak. Possible turmoil in EMEs and its feedback to advanced economies would magnify the challenges of managing the exit.

Other policy requirements also vary across economies...

... including changes in budgetary procedures in the United States...

Other important policy requirements in the main OECD areas include:

- In the United States, political leaders need to ensure that the normal functioning of government is not disrupted once more early next year. Changes are also needed in budgetary procedures to prevent such disruptions from reoccurring, preferably including the abolition of the

nominal debt ceiling, so that the borrowing implied by budgets and resolutions passed by Congress is authorised automatically. In addition, an agreement to put public finances on a sound footing in the long term needs to be concluded.

... more ambitious structural reforms in Japan...

- In Japan, more ambitious structural policy reforms are needed to lift potential growth rates and, in view of the extraordinarily high public debt ratio, a more detailed and credible medium-term consolidation plan is required to maintain confidence in government finances.

... and greater progress towards a full euro area banking union

- In the euro area, the automatic fiscal stabilisers should be allowed to operate on both sides of the current structural consolidation path and structural reforms are needed in both external surplus and deficit countries to raise growth and facilitate rebalancing. Notwithstanding recent progress, more needs to be done to establish a fully-fledged banking union, notably a sufficient common fiscal backstop, and to ensure adequate capital cover in the banking system. It is also vital that the forthcoming comprehensive assessment of euro area banks be conducted in a manner that is fully credible, with a clear plan for how any identified capital shortfalls will be addressed.

This chapter is organised as follows. After discussing the factors behind the growth slowdown in the EMEs and the implications for OECD economies, the other main economic and financial forces presently acting on the OECD economies are outlined. The projection is then set out, along with the implications for inflation, labour markets and external balances, and the other key risks around the projection are reviewed. This is followed by a discussion of the main macroeconomic policy requirements. Indicators of potential financial vulnerabilities are reported in an annex.

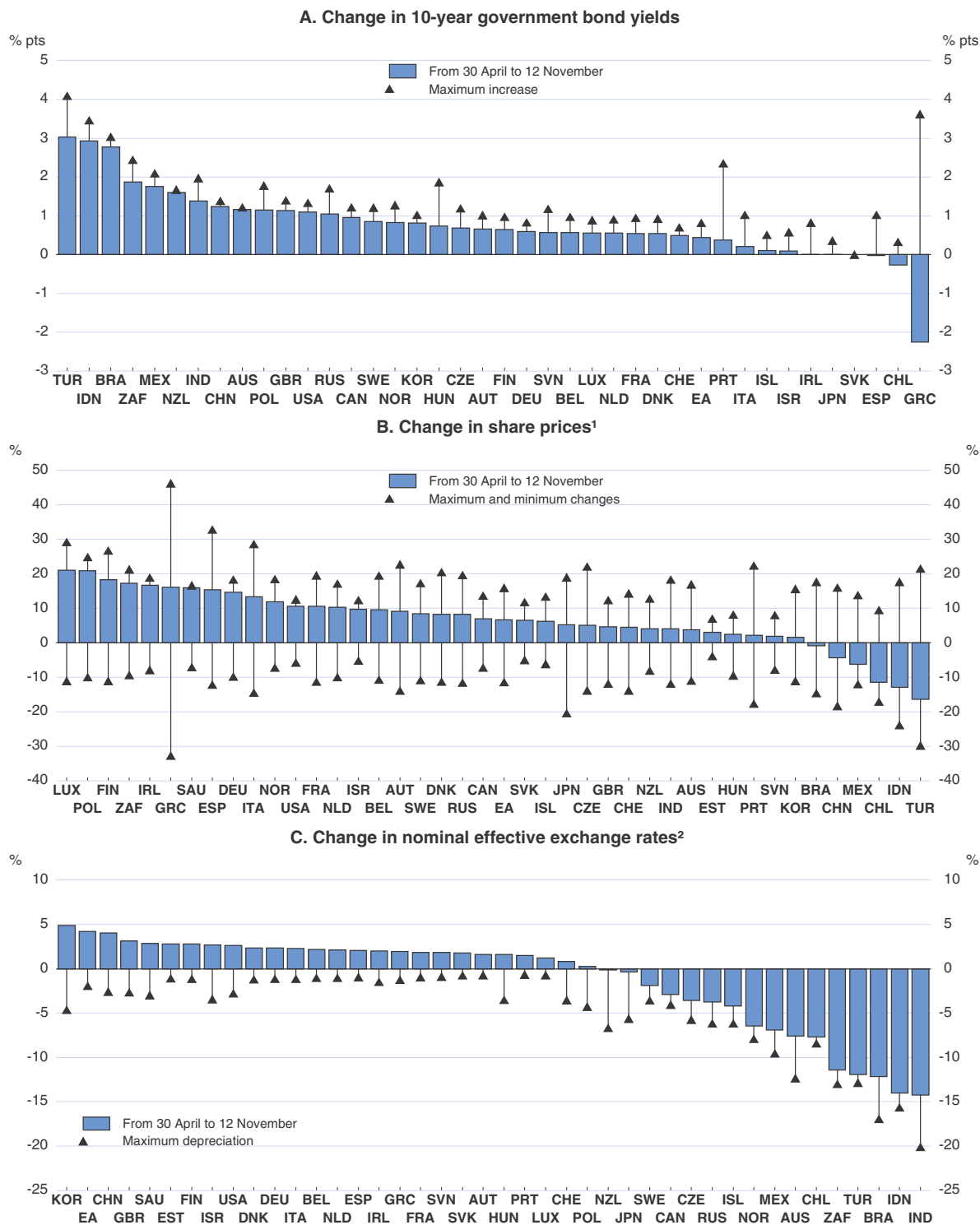
Recent activity and financial developments

The growth slowdown in EMEs, spillovers and feedback effects

Financial conditions have tightened significantly in some EMEs...

An important development since the May *Economic Outlook* is the marked deterioration in financial conditions in the major EMEs outside China. This occurred in May to August as US long-term interest rates rose following signals that the tapering of Federal Reserve asset purchases might begin earlier than expected (see below), prompting capital outflows and exposing vulnerabilities that had built up in some EMEs. Reinforced by concerns about growth slowdowns and the sustainability of high external deficits and political tensions in some economies, large portfolio investment outflows contributed to tighter liquidity conditions, sharp declines in bond and stock prices and sizeable currency depreciations. This was especially marked in Brazil, India, Indonesia, South Africa and Turkey, all countries with large external financing needs (Figures 1.1 and 1.2). China has been an exception, appearing to be less sensitive to the impact of possible tapering; long-term bond rates have edged up since April, but equity prices have remained largely unchanged, the effective exchange rate has appreciated and a domestically-driven liquidity squeeze in June was quickly reversed.

Figure 1.1. **Government bond yields have increased, while equity prices and exchange rates have gyrated**



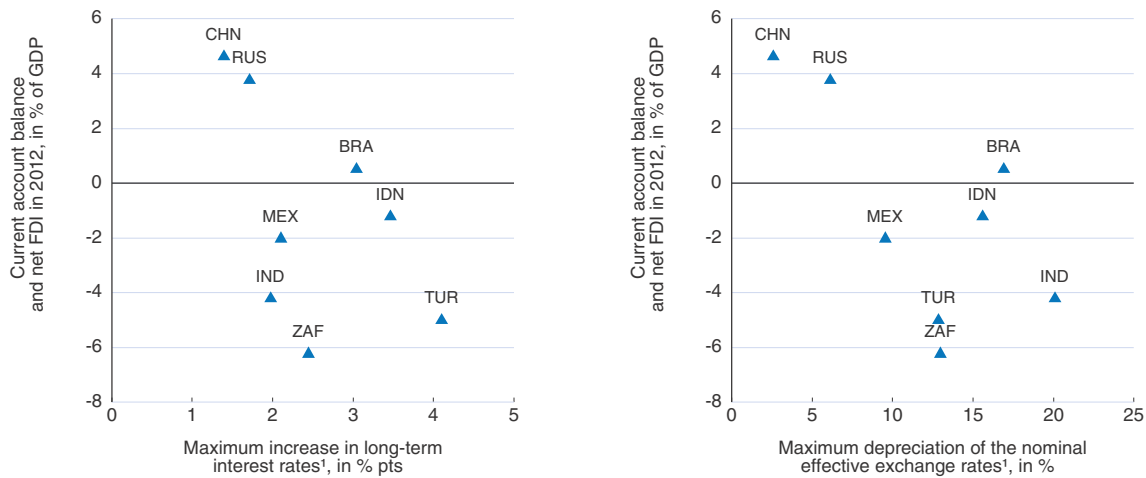
Note: Based on daily information. EA represents the OECD euro area members.

1. In domestic currency.

2. An increase in the nominal exchange rate implies its appreciation.


Source: OECD Economic Outlook 94 database; and Datastream.

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Figure 1.2. **Financial conditions fell especially sharply in external deficit EMEs**

1. Based on daily information from 30 April to 12 November 2013.

Source: OECD Economic Outlook 94 database; Datastream; and IMF Balance of Payments database.

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... which will damp growth prospects, especially in EMEs with domestic financial vulnerabilities

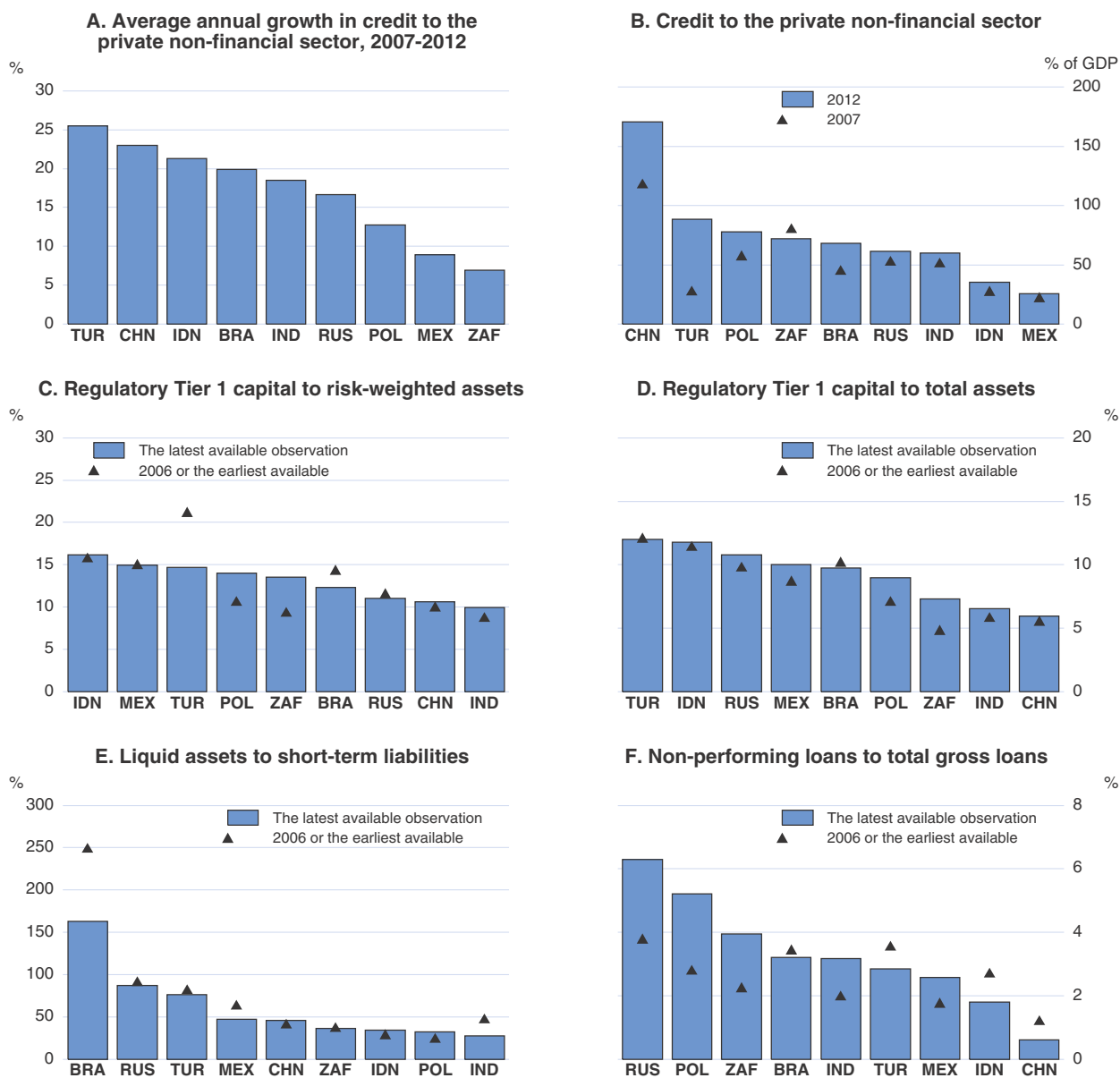
The subsequent unexpected delay in tapering of asset purchases in the United States and prompt domestic monetary policy actions have stabilised financial conditions in the EMEs more recently, with portfolio investment inflows resuming. Even so, the changes that have occurred since May this year will exert a drag on growth and have raised the risk that future steps towards tighter monetary policy in the United States may interact with domestic financial vulnerabilities in some EMEs and give rise to further financial turbulence, with adverse spillover effects on the global economy. The domestic financial vulnerabilities relate to banking system and external financing problems in some countries:

Warning signs of banking sector vulnerabilities have appeared in some EMEs...


- Signs of possible banking sector vulnerabilities have surfaced in some EMEs. In particular, private sector credit has increased rapidly since 2007. In nominal terms, it grew on average by around 20% per year in many large EMEs, although, in relation to nominal GDP, it increased sizeably only in Turkey, China and Brazil (Figure 1.3). Such a rapid credit build-up increases the risks of financial turbulence, as it exposes banks to losses in the event of a negative macroeconomic shock, especially if it has been associated with lax lending standards.¹ Other signs of vulnerability in some EME banking systems include the increased incidence of non-performing loans and lower liquidity coverage ratios. Nevertheless, capital positions of the banking sectors appear to be sound, at least at the aggregate level, with leverage ratios generally above 5% (Figure 1.3).²

1. Rapid credit growth is one of the key predictors of financial crises – see for instance Gourinchas and Obstfeld (2012) and Schularick and Taylor (2012).

2. Due to data limitations, the leverage ratio is defined as a ratio of regulatory Tier 1 capital, rather than core Tier 1, to total (un-weighted) assets. Thus, it differs from the ratio used below for the euro area countries.

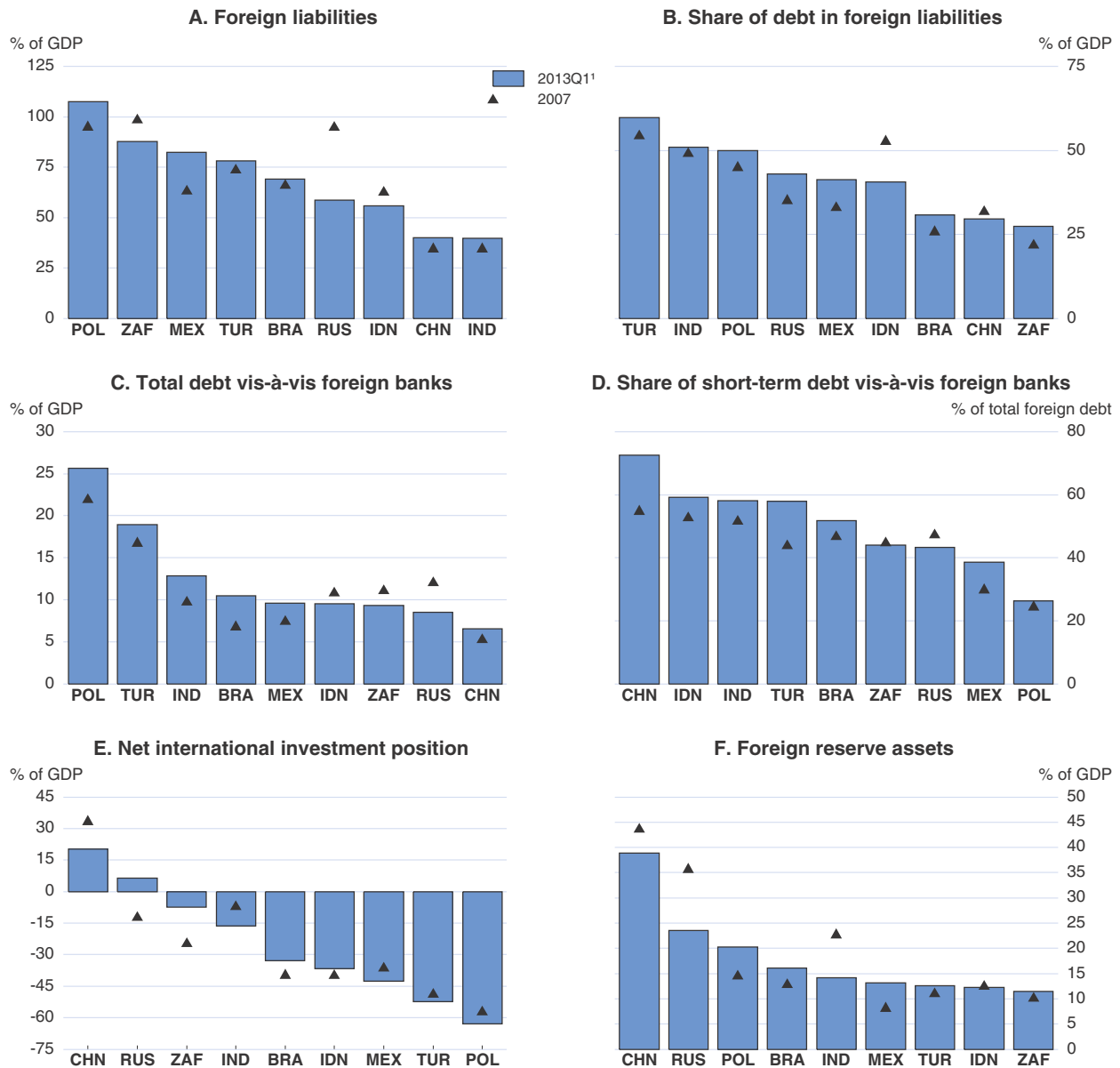
Figure 1.3. **Banking sector vulnerabilities have surfaced in some EMEs**

Source: BIS; Central Bank of the Republic of Turkey; and IMF Financial Soundness Indicators.

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... and external vulnerabilities have increased in some countries

- External financing patterns also point to vulnerabilities in some EMEs (see Annex 1.1). The increased dependence of some external deficit economies, notably India and Indonesia, on portfolio inflows has made them vulnerable to sudden stops of such financing (Figure 1.4). Financial vulnerabilities have also risen in a number of EMEs due to the increased share of debt in total foreign liabilities (notably in India, Turkey and Poland) and the increased dependence on short-term loans

Figure 1.4. **External vulnerability indicators in selected EMEs**

1. Or latest available figures.

Source: BIS; and IMF Balance of Payments statistics.

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from foreign banks. Some of these risks might, however, be mitigated by foreign reserve assets that have been high or rising in recent years in some EMEs (Figure 1.4).

Economic growth has already slowed, reflecting...

Even before the recent tightening in financial conditions, economic growth in the major EMEs had softened steadily over the past eighteen months or so, with aggregate non-OECD GDP growth projected to be around 4¾ per cent this year, around 2 percentage points weaker than the

annual average observed over the previous decade. This reflects different factors:

... subdued external demand...

- One common development in the major EMEs has been the adverse impact of soft external demand. This initially reflected the weak level of import demand in the OECD economies, especially in the euro area, but the impact of this on GDP growth in the EMEs has been lower this year than in 2012. More recently, the growing trade linkages between the EMEs have meant that the demand slowdown in the large emerging market economies has had broader negative spillover effects on other EMEs.³ Direct trade linkages between China and many other Asian economies are particularly strong, even though, given the composition of global supply chain linkages, the key demand driver is more likely to be from the major advanced economies than from China. On the other hand, weaker demand from China has placed downward pressures on international commodity prices, especially for metals and minerals, with adverse terms-of-trade effects on other EMEs that are commodity producers.

... and a slowdown in potential growth rates

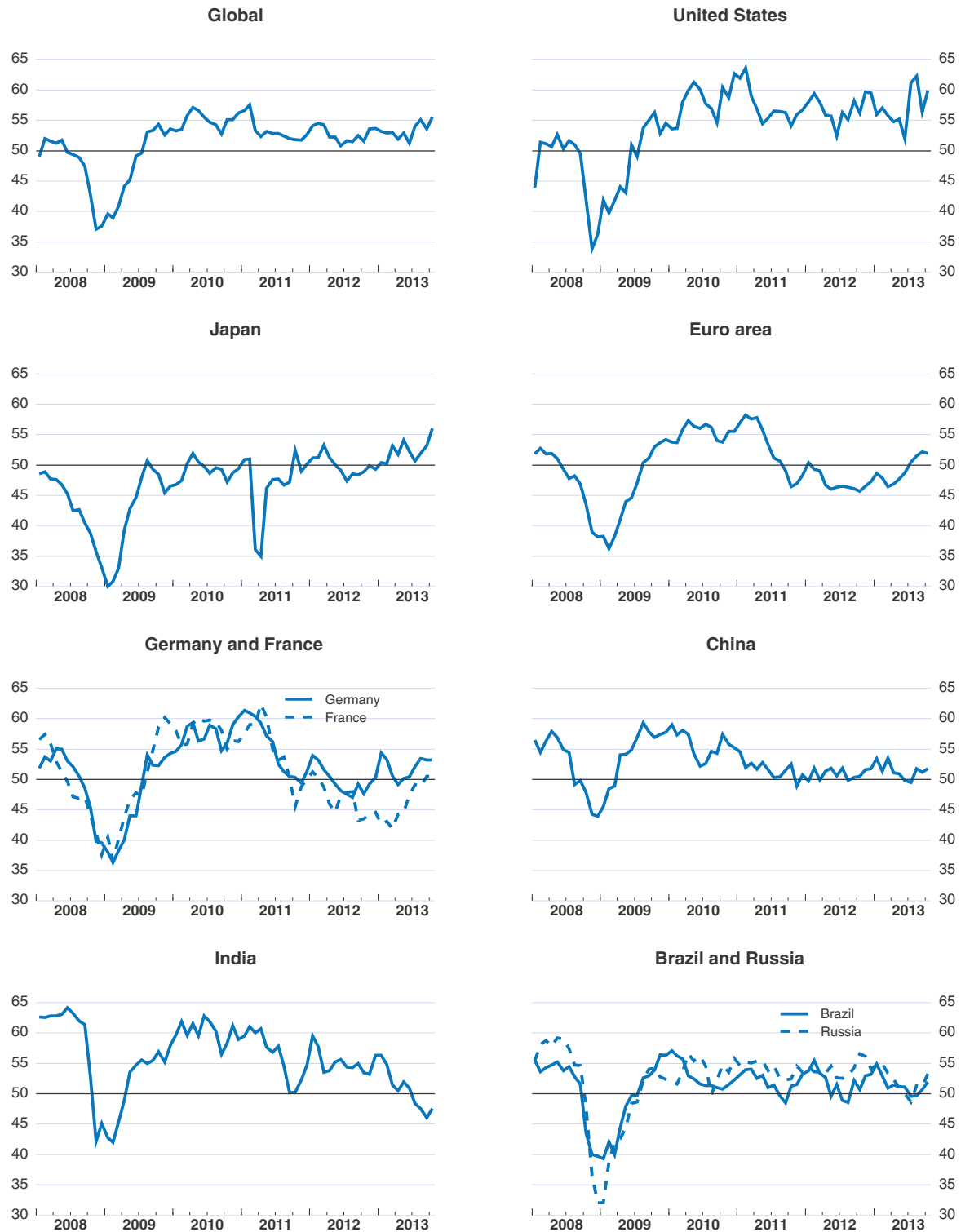
- There has also been a gradual slowdown in trend GDP growth rates in many emerging economies. For example, current OECD estimates suggest that the trend GDP growth rate for the BRIICS as a whole declined by 1¼ percentage points between 2007 and 2013. Contributory factors include: demographic developments, with working-age population growth now slowing in most of the BRIICS, and negative in Russia; signs that the effects of past structural reforms may be fading, with trend productivity growth slowing, especially in China and India; and subdued investment growth due to structural bottlenecks and rigidities, especially in Brazil and India. Further declines in trend growth in some of the BRIICS are incorporated in the current projections for 2014 and 2015. This partly reflects limited recent progress in structural reforms needed to raise comparatively low labour productivity levels, including: reductions in still-high regulatory barriers to competition; improvements in infrastructure investments; greater openness to FDI and trade; and the need to strengthen education access and teaching quality (OECD, 2013a).

Recent activity indicators point to diverging activity prospects...

Notwithstanding slowing potential growth, forward-looking business surveys point to a gradual pick-up in near-term prospects for China and, more tentatively, Brazil and Russia (Figure 1.5). This is already reflected in cross-country differences in the strength of domestic demand, with growth improving in China, but being more sluggish in some other large EMEs.

3. On a gross value basis, South-South trade accounted for approximately 17% of global trade in 2012, up from 6½ per cent in 2002 (Garcia-Herrero et al., 2013).

Figure 1.5. **Recent business sentiment outcomes are mixed**
Aggregate business PMI



Note: Weighted average of manufacturing output PMI and services business activity PMI.
Source: Markit.

... with solid demand growth in China...

- In China, retail sales growth remains solid and the housing market is buoyant, despite efforts to damp speculation this year, with strong price increases in the major cities. Investment in housing and infrastructure supply has also picked up, helped by increasing government outlays on railway investment and the strength of housing demand. This has raised the risks of eventual over-supply and a sharp correction in investment spending. The recent slowdown in credit growth and moves to rebalance the economy will also likely weigh on investment in the coming years.

... but weaker outcomes in some other EMEs

- Investment growth has lost momentum in some other large EMEs, especially India. Despite some recent structural initiatives, such as the partial deregulation of FDI and official efforts to fast-track large investment projects in India, and steps to encourage greater private sector participation in infrastructure projects in Brazil, more needs to be done to strengthen competition and lower obstacles to investment. Private consumption growth has also been muted in many EMEs, held back by high inflation and soft income growth.

These developments have potentially sizeable spillover effects on the global economy...

The growth slowdown in the EMEs, and the possibility that domestic vulnerabilities could lead to capital outflows intensifying again during the tapering of asset purchases and subsequent policy rate increases in the United States, have consequences for the major advanced economies, via spillovers that come through trade and financial channels. Some of the areas in which spillovers can occur if growth in the large EMEs were to slow further, either because of weaker trend growth or as a result of capital outflows and deteriorating financial conditions, are discussed in Box 1.1 and include:

... via trade effects...

- A sharp slowdown in domestic demand in the EMEs would have noticeable negative trade spillover effects. For instance, macro-model simulations suggest that a one year decline of 2 percentage points in domestic demand growth in all non-OECD countries apart from China, would, all else equal, lower OECD GDP growth by around 0.4 percentage point that year.⁴ The US economy appears to be relatively sheltered in such circumstances, with the direct adverse activity effects being much stronger in Japan and also in China, reflecting their greater trade integration with the other non-OECD economies.

4. The first year impact of this shock would lower non-OECD GDP growth by a little over 1½ percentage points. The first-year effects from the shock are thus broadly equivalent to those that might result from a 200 basis point rise in the US term premium (which, all else equal, could lower non-OECD GDP growth by around ½ percentage point) together with a 1 percentage point slowing in non-OECD GDP growth. A very large increase in the US long-term interest rate would be required to generate the full 1½ percentage point hit to non-OECD GDP in the absence of the demand shock, one that would likely imply a significant deterioration in global financial conditions and widespread recession.

Box 1.1. **Global spillovers from the growth slowdown in emerging market economies**

The growth slowdown in the emerging market economies (EMEs) gives rise to broader negative spillover effects on activity in the world economy as a whole. Moreover, with the six BRIICS now accounting for 30% of world GDP (at PPP rates) and 15% of global equity markets, and other non-OECD countries comprising a further 12% of world GDP, a growth slowdown has larger effects on the global economy and OECD countries than in the past. This box considers spillovers that arise from trade and financial cross-border linkages. Other possible transmission channels, such as spillovers on business sentiment, may also be quite important, particularly in a more serious slowdown.

OECD countries' trade exposures (in gross or value-added terms) are largely to other OECD countries; but direct trade exposures to non-OECD countries have risen substantially over the past two decades. In 2012, gross merchandise exports from OECD economies to non-OECD countries amounted to around 6% of OECD GDP. However, trade linkages vary considerably across countries, with commodity producers and countries strongly linked in global value chains tending to have a higher share of exports to EMEs (see first figure below). Korea had the highest direct export exposure of the OECD countries, with goods exports in 2012 amounting to one-third of GDP. Estonia, Slovenia and Hungary also have relatively high exposures. Some of the BRIICS, as well as OECD economies such as Chile and Turkey, also have a sizeable exposure to the non-OECD economies, equivalent to 10% of GDP or more, by this measure. A sharp slowing in external demand could prove particularly problematic for countries such as Turkey and South Africa, with gross merchandise exports to non-OECD economies that are around 12% of GDP and current account deficits of around 6% of GDP.

Gross export data are likely to overstate the economic importance of direct trade exposures, as the former typically have a high import content. OECD/WTO trade-in-value-added data allow for this, although the data are currently available only up to 2009. Using the value-added data for combined exports of goods and services, OECD exports to the non-OECD countries accounted for around 30% of total OECD value-added exports and 5% of OECD GDP in 2009. Cross-country differences in the extent of exposure are, however, not that different to those found using gross export data (see first figure below), with Korea and commodity-producing economies such as Chile and Australia having relatively high exposures in value-added terms. Amongst the large OECD economies, Japan and Germany have the highest direct exposures to the non-OECD economies, likely reflecting their relative specialisation in exports of capital goods, often to the foreign subsidiaries of domestic companies.

Any slowdown in emerging economies is also likely to lower commodity prices, with adverse effects on the terms of trade of commodity exporters. This is particularly true of weaker growth in China, which accounts for around three-fifths of world iron ore imports, close to one-third of copper imports and 12% of crude oil imports. Incomes in Australia and Chile may be most exposed; the terms-of-trade in these economies have risen by almost 70 per cent over the past decade, reflecting both the rise in commodity prices and concurrent falls in prices of manufactured goods. Other emerging market economies that have benefited from past commodity price strength – such as Brazil, Russia and South Africa – would also suffer, potentially prolonging their growth slowdowns.¹ Oil exporters would also be affected, with further spillovers.

An idea of the magnitude of the trade-related spillovers and the additional second-round effects that might result from a demand slowdown in the non-OECD economies can be obtained from simulations using NiGEM, the global macroeconomic model of the National Institute of Economic and Social Research. In the illustrative scenario shown here, there is a one-year decline of 2 percentage points in domestic demand growth in all the non-OECD economies apart from China. This scenario can be seen as an approximation of the hit to domestic demand in the non-OECD economies brought about by a higher term premium on long bond rates in the United States (as occurred this year) combined with an underlying slowing of growth due to domestic bottlenecks and rigidities in many non-OECD economies (though not China).

Box 1.1. Global spillovers from the growth slowdown in emerging market economies (cont.)

Such a slowing would have negative feedback effects on the OECD economies, with OECD GDP growth likely to decline by some 0.4 percentage points in the first year, though the feedback on the United States is weak and smaller than spillovers to other OECD economies (see second figure below). In the simulations used here, policy interest rates and exchange rates are assumed to remain at their baseline settings. In practice, exchange rate adjustments could cushion the shock somewhat in the non-OECD economies, as well as in commodity producers such as Australia and Chile, but add to the shock in the major OECD economies.

Financial linkages would be likely to raise the impact of a growth slowdown in the EMEs still further. Globalisation of financial markets has helped to more than double the share of OECD international portfolio and direct investment assets held in the BRIICS from a decade earlier (for countries with available data), although the share remains relatively small, at around 5%. An orderly but generalised slowdown in the non-OECD economies would be likely to have adverse effects on asset values and also lower earnings from equity and foreign direct investments. Data for the United States show that the effect on corporate profits might be non-negligible, with over one-third of the profits of the majority-owned foreign affiliates of US parent companies coming from affiliates in non-OECD economies (including around 10% from affiliates located in the BRIICS).² Overall, Korea has the highest concentration of its foreign investments in the BRIICS, while the financial centres have larger direct exposures relative to GDP.

Banking links may also transmit EME developments to OECD economies. Bank for International Settlements (BIS) data on foreign claims on a consolidated, ultimate risk basis show that exposures to the EMEs are higher than before the financial crisis in banks from a range of countries, including the United States, the United Kingdom, Japan and some euro area economies.³ Amongst those countries for which these data are available, the exposures to EMEs of banks in Spain, the United Kingdom, the Netherlands and Switzerland appear to be larger relative to GDP than those of banks in other OECD countries, but are in all cases small relative to bank assets (see third figure below).⁴

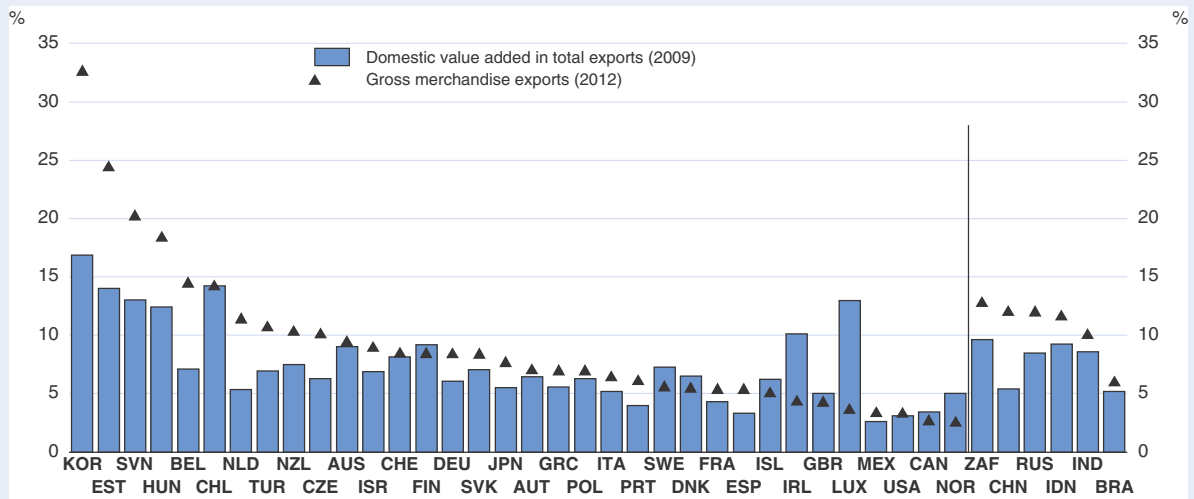
A generalised growth slowdown in the EMEs might result in weaker returns and potentially even an increase in credit impairment, especially if financial sector vulnerabilities in the EMEs were to deepen the impact of the initial slowdown. This could add to problems facing the banking sector of lending countries in which banks are under-capitalised. If some of the more weakly capitalised banking sectors are exposed to large losses, banks could even cut back on new lending, thereby propagating the crisis.

Overall, if risks materialise for EMEs individually, spillovers to most high-income economies are likely to be limited: even large emerging economies such as China and India account only for a relatively limited share of developed economies' exports. Moreover, on a bilateral basis, only a relatively modest share of high-income economies' external assets is held in the EMEs. However, in the event of a broader slowdown in the EMEs, brought about, for instance, by further capital outflows as the tapering of asset purchases begins in the United States, potentially sizeable spillover effects can occur in the OECD economies as well as in other EMEs. A systemic event arising from financial vulnerabilities in the EMEs would have much larger effects.

1. The terms of trade for commodity exporters have already fallen with the declines in commodity prices from their peaks, due to both lower global demand and rising supply following large investments to expand production.
2. Based on the profits of the majority-owned foreign affiliates of US companies in 2010, with profits approximated by total nominal value added less compensation of employees. Profits from outside the United States represent around one-third of total pre-tax US corporate profits.
3. The consolidated foreign claims data used here better capture the potential exposure of banks to lower earnings than the channels for contagion because the capital of affiliates operating in foreign countries will provide some protection against these shocks. However, linkages through offshore centres, which are not included in the data here, would add to OECD exposures.
4. These data capture loans, but do not capture off balance sheet exposures, which may exacerbate or mitigate losses.

Box 1.1. Global spillovers from the growth slowdown in emerging market economies (cont.)

Direct trade exposures to non-OECD economies are large in some countries

Exports, in per cent of GDP¹

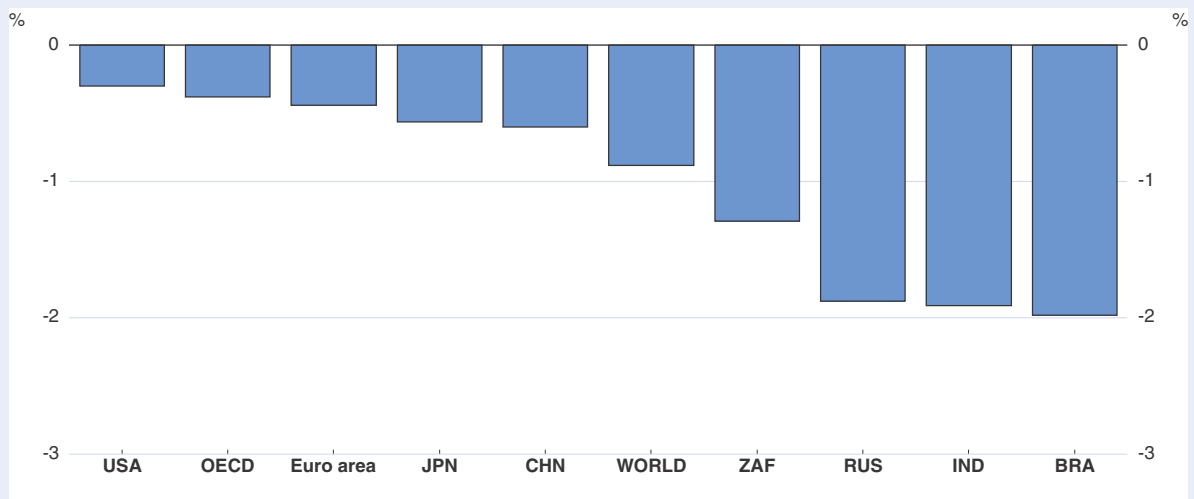
1. Within the two groups of OECD countries and BRIICS, countries are ordered by the non-OECD share of gross merchandise exports in 2012.

Source: OECD Economic Outlook 94 database; IMF Direction of Trade Statistics; OECD-WTO Trade in Value Added database; and OECD calculations.

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A domestic demand slowdown in the non-OECD could have sizeable adverse activity effects

First-year change in GDP from baseline

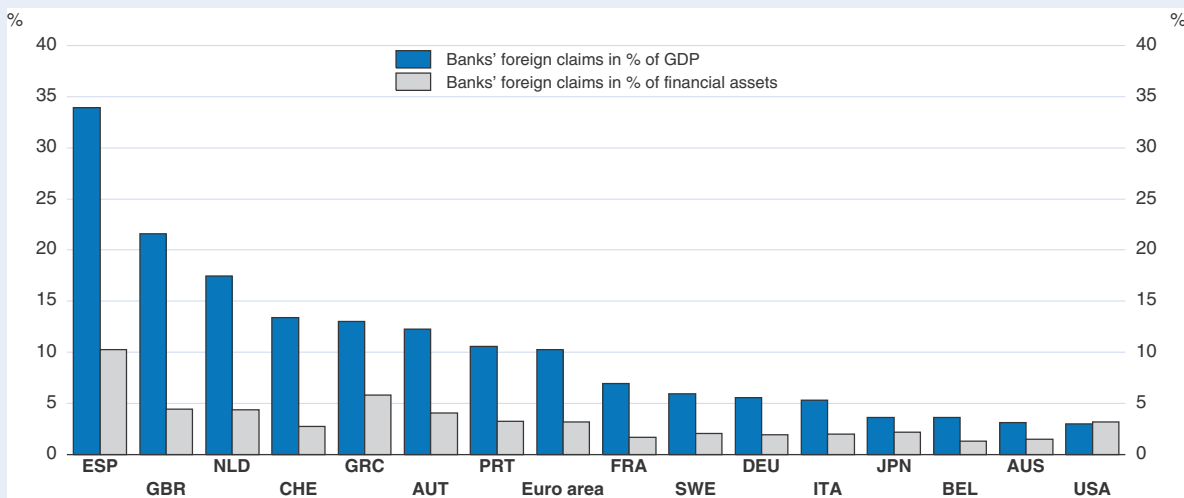


Note: Based on a one-year decline of 2 percentage points in domestic demand growth in all non-OECD countries apart from China.

Source: OECD Economic Outlook 94 database; and OECD calculations.

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Box 1.1. Global spillovers from the growth slowdown in emerging market economies (cont.)

Banks' foreign claims on emerging market economies¹Consolidated claims on an ultimate risk basis²

1. The emerging market economies are the BRIICS plus Chile, Hungary, Poland, Mexico and Turkey.

2. Data are for 2013Q2. Exposures for Austria and France are understated due to missing data. The euro area is calculated based on the countries shown.

Source: OECD Economic Outlook 94 database; BIS; National sources; and OECD calculations.

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... and financial linkages

- Financial linkages would be likely to raise the impact of a growth slowdown in the EMEs still further, given the sizeable proportion of OECD external assets held in the non-OECD economies. An orderly but generalised slowdown in the non-OECD economies would have adverse effects on asset values, lower earnings from equity and foreign direct investments, and result in weaker returns from banking sector investments. Banks in the United States appear to have a modest direct exposure to developments in the major EMEs relative to that of some other OECD economies (Box 1.1).

A systemic event could have much larger effects

- The direct spillovers on the advanced economies would be much greater if financial vulnerabilities in the EMEs were to result in the occurrence of an adverse event with systemic implications. Financial institutions in the EMEs have higher capital buffers than before earlier event shocks, such as those in Asia and Russia in 1997-98, but are also much more heavily integrated into the global economy than at that time. This raises the risks of a systemic event, with marked adverse effects on OECD financial conditions and growth prospects.⁵

5. Trade data and financial exposures based on official external asset and liabilities could also understate high-income countries' vulnerability to EMEs, reflecting, for example, the likely role of financial centres in channelling some investments to EMEs and the number of countries for which information on current bilateral banking exposures are not available.

Financial conditions in OECD countries

Financial conditions have tightened...

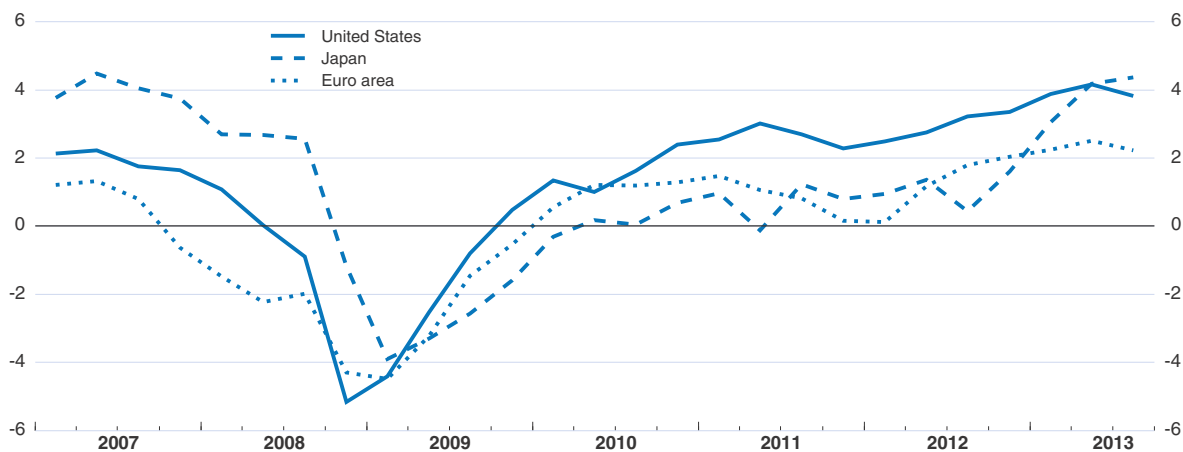
OECD financial conditions tightened in the second half of 2013. Against the backdrop of improving activity prospects in the United States and other advanced economies, the bond sell-off in the United States at the end of May, triggered by the Federal Reserve's communication about the future tapering of asset purchases, also affected many OECD countries, with prices of their equities, government bonds and currencies being driven down (Figure 1.1).⁶ Following the Federal Reserve's clarification of its policy intentions, and, more recently, its decision to maintain unchanged asset purchases, equity prices rebounded to or above their mid-May levels and government bond yields eased. Overall, in the third quarter, financial conditions measured by the OECD Financial Conditions Indices tightened slightly in the United States and the euro area, but eased in Japan (Figure 1.6). This is likely to weaken financial tailwinds for economic growth in the United States and the euro area but not derail the recovery.

Key developments in the main economies include:

... in the United States...


- In the United States, 10-year government bond yields are around 100 basis points higher than in early May and the dollar has strengthened slightly in real terms. These developments reflect market expectations

Figure 1.6. **Aggregate financial conditions have tightened slightly in the euro area and the United States**



Note: A unit increase (decline) in the index implies an easing (tightening) in financial conditions sufficient to produce an average increase (reduction) in the level of GDP of ½ to 1% after four to six quarters. See details in Guichard et al. (2009). Based on available information up to 12 November 2013.

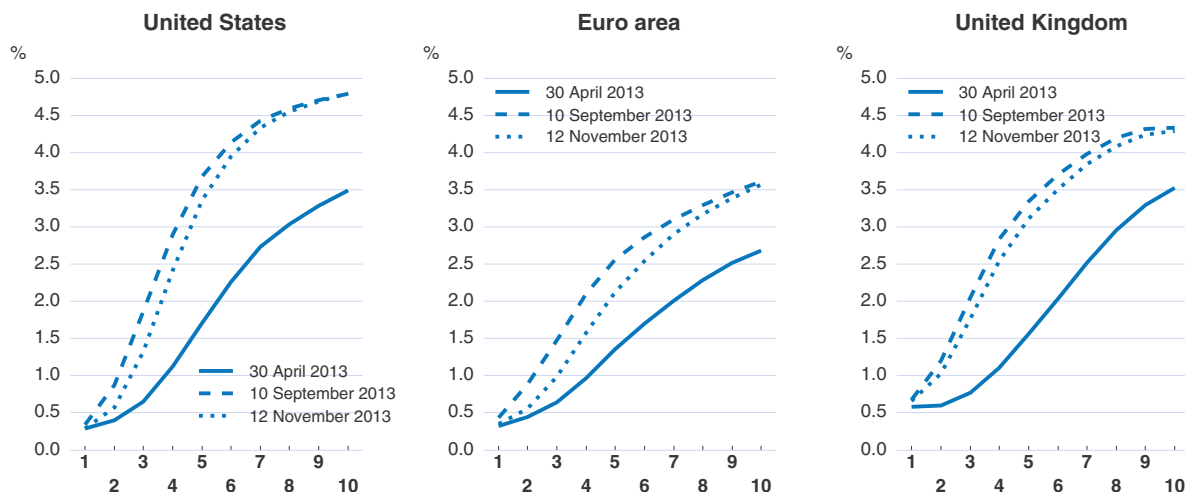
Source: Datastream; OECD Economic Outlook 94 database; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888932947922>

6. The deterioration in financial conditions was compounded by country-specific shocks, including policy-induced bond market volatility in Japan and political tensions in some of the euro area countries.

Figure 1.7. **Market participants now expect earlier and faster monetary policy tightening**

Future interest rates derived from zero yield curves



Note: Horizontal axes refer to the number of years into the future.

Source: OECD calculations based on Datastream data.

StatLink  <http://dx.doi.org/10.1787/888932947941>

of both earlier exit from continued quantitative easing and earlier and faster policy rate increases (Figure 1.7). Financing conditions for the non-financial private sector have also tightened, with corporate bond yields (except for high-yield bonds), mortgage interest rates and MBS yields higher than six months ago. However, equity prices have risen, despite some volatility (Figure 1.1), reflecting market expectations about improving growth prospects and rebalancing of investment portfolios into equities from bonds. Banks, on balance, have continued to ease their lending standards, but the year-on-year growth of credit is now somewhat weaker than in early 2013.

... and the euro area...

- In the euro area as a whole, financial conditions have tightened, with higher real interest rates and the euro appreciation outweighing the beneficial effects of higher equity prices. Spillovers from the United States drove up government bond yields in the core euro area countries while the euro strengthened. In addition, they seem to have brought forward expectations about future policy interest rate increases (Figure 1.7).⁷ Financial conditions continued to normalise in many vulnerable countries, but at a slower pace than previously. Despite political tensions in some of them, 10-year government bond yields have been little changed and spreads against German bunds have declined since early May. The better performance of bond markets in the euro area periphery reflects improved risk perceptions, with credit default swap spreads also declining. In addition, Target 2 imbalances

7. Some of the increase in swap-based future curves may, however, reflect changing duration risk.

continued to narrow, cross-country loan interest rate differentials stabilised and, in some vulnerable countries, the cost of credit declined.

...but not in Japan

- In Japan, financial markets have been very volatile but, on balance, financial conditions have eased slightly since the second quarter. Government bond yields have gone down since May, with yields hardly affected by the global bond repricing. In contrast, equity prices initially reacted strongly to the global financial market turbulence (Figure 1.1) but subsequently rebounded and have recently been close to their levels in early May. The yen nominal and real effective exchange rates have fluctuated over the past six months, but remain 20% weaker than a year ago.

Demand and activity developments in OECD economies

Key demand and activity developments include:

Business surveys point to differentiated activity prospects

- Forward-looking business surveys and composite leading indicators signal growth in the advanced economies rising towards, or above, trend rates. Signs of activity improvements are particularly apparent in the United Kingdom, Japan and the United States, with a more modest, but broad-based improvement also increasingly visible in the euro area economies (Figure 1.5).

Trade growth is recovering gradually

- Global trade growth has picked up this year relative to the latter half of 2012, helped by stronger final demand in the major OECD economies. However, key indicators do not currently point to a further acceleration in the near term. New export orders have changed only marginally in recent months; shipping costs remain at comparatively low levels; and trade-intensive global tech activity indicators remain mixed. Subdued growth in the BRIICS is also holding down export growth from OECD economies, especially major commodity producers and trading partners linked via global supply chains. Provided trade restrictions do not intensify,⁸ trade growth is expected to strengthen gradually relative to GDP growth over the projection period, rising by just over one-and-a-half times GDP growth in 2015, just under the pre-crisis norm. A stronger recovery in capital investment (a trade-intensive category of expenditure) could help to bring about a more marked pick-up in trade growth.

Household demand remains weaker in the euro area than in other major economies

- Consumption growth has been resilient this year in the United States and Japan, with on-going improvements to household balance sheets resulting from strong asset price growth, improving labour market outcomes and substantive deleveraging (helped in the United States, by institutions conducive to debt write-downs). These forces should

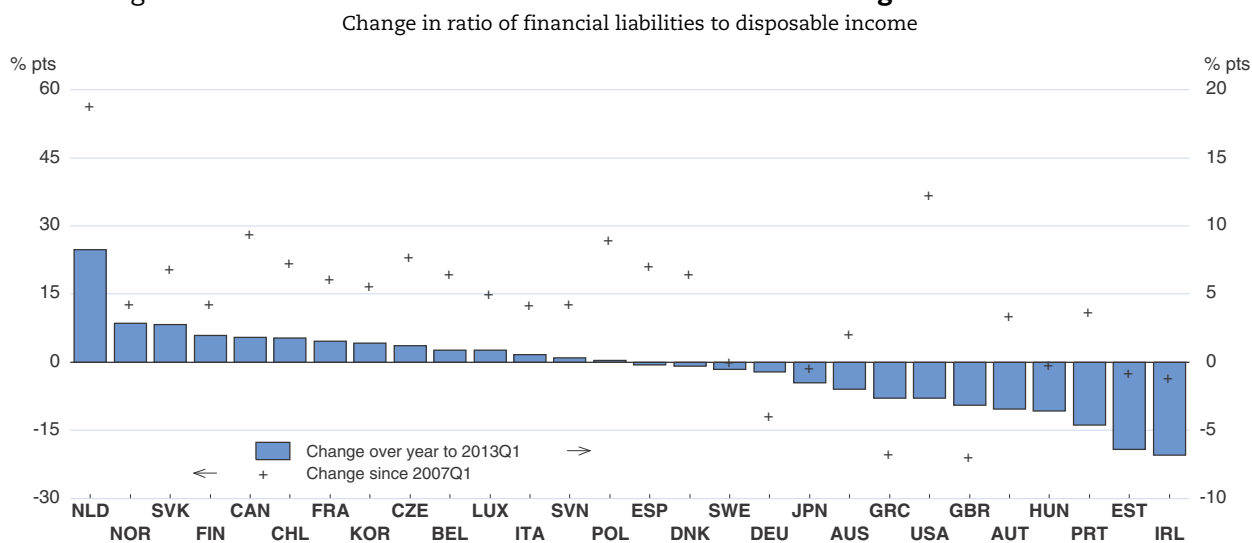
8. The most recent G20 report on trade and investment measures highlighted a growing stock of trade restrictions in many countries and industries (OECD/UNCTAD/WTO, 2013).

continue to support private consumption growth, with additional balance sheet adjustment taking place whilst saving ratios remain close to their current levels. In Japan, spending growth and the saving rate are likely to fluctuate during 2014 and 2015, due to the planned increases in the consumption tax rate. In the euro area, outside of Germany, household demand is expected to remain much softer, reflecting a mix of weak income growth, high unemployment, declines in property values and debt deleveraging, which has yet to begin in some economies (Figure 1.8). However, area-wide car sales and retail sales have both now started to increase and private consumption is expected to pick up slowly through 2014-15. That said, there is a risk that household saving ratios may turn out to be somewhat higher than assumed in the projections in some countries, such as the Netherlands, Spain and Italy, to counteract on-going balance sheet deterioration via declines in property values.

Investment growth could start to pick up in the next two years

- OECD-wide business capital spending has been subdued in recent years, even allowing for soft demand growth, with investment growth only recently becoming positive in countries such as Japan, Germany and the United Kingdom. The reasons for this remain unclear, though survey and anecdotal evidence from business have pointed to factors such as the higher cost (or even unavailability) of capital post-crisis and policy uncertainty. However, the pre-conditions for stronger investment growth now appear more favourable, especially outside the euro area. Greater risk appetite, as reflected in stronger equity prices, has raised the availability of external finance, and the aggregate balance sheet position of the non-financial corporate sector

Figure 1.8. **Household financial liabilities are now declining in more economies**



Note: Gross disposable income is the sum of the latest two quarters annualised; OECD estimates are used where data are unavailable. Netherlands estimates are based on partial data.

Source: OECD Economic Outlook 94 database; and OECD, National Accounts database.

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has improved in some countries. Against this, the cost of borrowing has risen this year, reflecting the increases in long-term interest rates since May, with additional increases assumed to occur over the next two years (see Box 1.2). Reflecting the return of risk appetite, improved financial conditions and an acceleration-type mechanism as final demand strengthens, in particular in the United States, Japan and the United Kingdom, OECD-wide business investment growth is projected to pick up over the next two years. However, the share of business investment in GDP would still remain below longer-term norms, reflecting the long period of weak investment since the crisis began. Even so, there is a downside risk, especially if interest rates were to increase more sharply or demand growth were to be slower than projected. Prospects remain weaker in the euro area, outside Germany, than elsewhere, reflecting subdued final demand, less favourable balance sheet developments that may show up in debt repayment rather than capital spending, still high barriers to competition and continued financial fragmentation. Structural policy priorities in particular economies to tackle barriers to credit supply, and implement product market reforms that raise general competitive pressures, are discussed further below.

Housing markets are now improving on average in the OECD

- Housing markets are now improving in the OECD as a whole, but conditions vary considerably across economies (Table 1.2). In the United States, the on-going significant rebound in real prices has been accompanied by further improvements in builders' confidence and an upturn in sales and real housing investment, although the recent rise in the long-term mortgage rate has tempered developments somewhat. Even so, the upturn in activity is expected to persist, with housing investment rising at double-digit rates through the projection period. Strong growth in household disposable income and favourable financing conditions are also boosting real house price growth in Germany and Switzerland, despite tightening macro-prudential measures in the latter. In these economies, prices are now better aligned with household rents and incomes. Real prices are also still rising in Belgium, Canada, New Zealand, Norway and Sweden, even though prices are high relative to rents, pointing to a risk of future correction, especially with borrowing costs now rising.⁹ By contrast, real house prices continue to decline in Japan, France, and most other euro area economies, with the pace of the decline being particularly sharp in the Netherlands, Greece, Spain, Italy and Portugal, putting pressure on household balance sheets and potentially adding to non-performing loans in the banking sector.

9. House price inflation is also high in a number of countries with a comparatively short span of historical data, including Austria, Estonia, Israel and Turkey.

Table 1.2. **Housing market developments continue to diverge**

	Per cent annual rate of change				Level relative to long-term average ¹		
	2004-2011	2012	2013 ²	Latest quarter ³	Price-to-rent ratio	Price-to-income ratio	Latest available quarter
Australia	2.4	-2.9	3.1	5.7	142	123	Q3 2013
Austria	2.0	9.5	1.2	2.7	..	..	Q2 2013
Belgium	4.2	0.1	0.8	1.0	162	150	Q2 2013
Canada	5.2	3.4	1.2	1.4	168	132	Q3 2013
Czech Republic		-4.0	-1.6	-2.0	..	..	Q2 2013
Denmark	1.3	-5.6	1.3	1.7	113	109	Q2 2013
Estonia		3.5	2.5	4.1	..	..	Q2 2013
Finland	2.3	-1.3	-0.4	-2.2	136	99	Q3 2013
France	3.6	-2.3	-1.9	-2.4	132	129	Q2 2013
Germany	-0.2	3.8	3.9	4.3	89	83	Q2 2013
Greece	-0.9	-12.5	-7.8	-10.8	82	103	Q2 2013
Hungary		-9.3	-6.2	-7.2	..	..	Q2 2013
Iceland		1.3	1.1	1.9	..	..	Q2 2013
Ireland	-3.7	-13.2	-1.4	1.4	92	92	Q3 2013
Israel	4.0	1.0	5.4	6.7	110	..	Q2 2013
Italy	0.3	-5.4	-5.5	-7.2	95	112	Q2 2013
Japan	-2.1	-2.1	-0.9	-1.3	62	64	Q1 2013
Korea	1.2	0.7	-1.5	-1.7	104	61	Q3 2013
Luxembourg		2.5	2.0	3.4	..	..	Q2 2013
Netherlands	-0.4	-8.3	-8.6	-7.0	105	118	Q3 2013
New Zealand	1.8	3.9	6.1	8.8	166	126	Q2 2013
Norway	5.2	5.8	2.2	0.0	168	127	Q3 2013
Portugal	-0.2	-3.6	-3.5	-3.8	86	94	Q3 2013
Slovak Republic		-4.4	-1.0	-0.9	..	..	Q2 2013
Slovenia		-8.4	-3.8	-5.6	..	..	Q2 2013
Spain	-0.9	-11.1	-6.8	-9.5	106	107	Q2 2013
Sweden	4.6	-2.6	1.9	2.5	132	120	Q3 2013
Switzerland	2.2	4.8	4.8	5.5	101	97	Q3 2013
Turkey		3.2	3.3	6.0	..	..	Q2 2013
United Kingdom	-0.2	-0.9	0.3	0.8	132	122	Q3 2013
United States	-2.8	1.5	4.8	6.1	102	88	Q2 2013
Euro area ⁴	0.8	-2.7	-1.8	-2.6	107	107	Q2 2013
Total OECD ⁴	-0.6	-0.3	1.4	1.9	105	95	Q2 2013

Note: House prices deflated by the private consumption deflator.

1. Average from 1980 (or earliest available date) to latest available quarter = 100.

2. Average of available quarters where full year is not yet complete.

3. Increase over a year earlier to the latest available quarter.

4. Using 2010 GDP weights, calculated using latest country data available.

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

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The near-term projections

Economic prospects are for a continued but mild recovery in...

The near-term economic outlook is for a continued moderate recovery in activity in the major economies provided none of the marked downside risks materialise. In the OECD as a whole, on-going support from accommodative monetary policies (Box 1.2), the feed-through of past

Box 1.2. Policy and other assumptions underlying the projections

Fiscal policy settings for 2013, 2014 and 2015 are based as closely as possible on legislated tax and spending provisions. Where government plans 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. Where there is insufficient information to determine the allocation of budget cuts, the presumption is that they apply equally to the spending and revenue sides, and are spread proportionally across components.

In the United States, the general government underlying primary balance is assumed to improve by close to 1% of GDP in both 2014 and 2015, roughly as implied by current legislation including continuation of the sequester though the fiscal drag from the sequester tapers off over the projection period.

In Japan, the projections incorporate the consumption tax increases from 5% to 8% in 2014 and to 10% in 2015. They also incorporate the fiscal stimulus package (about 1% of GDP) and the additional 1 trillion yen tax cut that will accompany the consumption tax increases. Overall, the underlying primary balance is assumed to improve by 1½ per cent of GDP in 2014 and a further 2% of GDP in 2015.

In euro area countries, fiscal consolidation in 2014 and 2015 is assumed to proceed so as to attain the amount of structural consolidation (measured as the change in the structural primary balance) that is implied by draft budget laws or, if these are not available, the stated targets in consolidation plans under the Excessive Deficit Procedure and Stability Programmes. The automatic stabilisers are assumed to operate freely around structural adjustment paths. For countries receiving financial assistance from the EU and the IMF, it is assumed that financing will be forthcoming to allow the automatic stabilisers to operate freely.

In the large euro area countries, structural budget components are assumed to evolve as follows. For Germany, the government's medium-term fiscal plans, as contained in the Stability Programme, have been built into the projections. In France, the projections incorporate a cumulative reduction in the structural deficit of 1.5% of GDP in 2014 and 2015, with consolidation shifting toward greater efforts on the spending side, as presented in the draft budget law. For Italy, the projections incorporate the government's medium-term fiscal plans, as presented in the September 2013 update of the Economic and Financial Document.

For the United Kingdom, the projections are based on tax measures and spending paths set out in the March 2013 budget.

The concept of general government financial liabilities applied in the *Economic Outlook* is based on national accounting conventions. These require that liabilities be recorded at market prices as opposed to constant nominal prices (as is the case, in particular, for the Maastricht definition of general government debt). During and following the financial and economic crisis, euro area programme countries (Greece, Ireland and Portugal) experienced large changes in the price of their government bonds. For the purpose of making the analysis in the *Economic Outlook* independent from strong fluctuations in government debt levels on account of valuation effects, the change in government debt in 2010, 2011 and 2012 in these countries has been approximated by the change in government liabilities recorded for the Maastricht definition.

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 upper bound of the target Federal Funds rate is assumed to be raised gradually between March and end-2015 from the current level of ¼ per cent to 1½ per cent.
- In the euro area, the refinancing rate is assumed to be kept at 0.25% throughout the projection period.
- In Japan, the short-term policy interest rate is assumed to be kept at 0.1% for the entire projection period.

Box 1.2. Policy and other assumptions underlying the projections (cont.)

Although their impact is difficult to assess, the following quantitative easing measures are assumed to be taken over the projection period, implicitly affecting the speed of convergence of long-term interest rates to their reference rates. In the United States, asset purchases are assumed to cease around mid-2014 and the stocks maintained until the end of the projection period. In Japan, asset purchases are assumed to increase in line with the stated plans of the monetary authorities. In the euro area, no additional purchases are built into the projections, and no new Long-Term Refinancing Operations are assumed.

In the United States, Japan, Germany and countries outside the euro area, 10-year government bond yields are assumed to converge slowly toward a reference rate (reached only well after the end of the projection period), determined by future projected short-term interest rates, a term premium and an additional fiscal premium. The latter premium is assumed to be 2 basis points per each percentage point of the gross government debt-to-GDP ratio in excess of 75% and an additional 2 basis points (4 basis points in total) per each percentage point of the debt ratio in excess of 125%. In Japan, the premium is assumed to be 1 basis point per each percentage point of the gross government debt-to-GDP ratio in excess of 75%. The long-term sovereign debt spreads in the euro area vis-à-vis Germany are assumed to decline by one-third from their recent levels by end-2015.

The projections assume unchanged exchange rates from those prevailing on 25 October 2013: one US dollar equals 97.02 JPY, EUR 0.72 (or equivalently one euro equals 1.38 dollars) and 6.08 renminbi.

The price of a barrel of Brent crude oil is assumed to increase at a rate of \$5 per year from the first quarter of 2014 onwards, from an assumed price of \$110 in the last quarter of 2013. Non-oil commodity prices are assumed to be constant over the projection period at their average levels of September 2013.

The cut-off date for information used in the projections is 14 November 2013. Details of assumptions for individual countries are provided in Chapters 2 and 3.

improvements in financial market conditions and a gradual easing in the pace of fiscal consolidation should help the momentum of the recovery strengthen gradually. In the BRIICS, growth is expected to remain subdued by past standards, especially in economies in which inflation remains high and activity is held back by supply-side constraints, recent policy actions and the recent tightening of financial conditions. In some of the EMEs within the OECD, including Turkey and Mexico, growth is set to remain relatively resilient, despite the additional headwinds from more subdued external demand and tighter financial conditions.

The key features of the economic outlook for the major OECD economies are as follows:

- ... the United States...**
- In the United States, final demand growth remains at a moderate rate, held back by the poorly-targeted budgetary sequestration, higher long-term interest rates and, more recently, the adverse impact on confidence of the political impasse over the debt ceiling. Provided that the latter does not reoccur, the economy should gradually gain momentum through the course of 2014 and 2015, with private final demand buoyed by still-supportive financial conditions, strengthened private sector balance sheets and accommodative monetary policy. On-going fiscal consolidation and net exports will however remain a drag on the recovery. Solid employment growth is projected to continue,

with the unemployment rate declining to just above 6% by end-2015 and the negative output gap narrowing steadily.

... the euro area...

- In the euro area, growth has resumed and confidence is now improving in almost all member states, with some of the vulnerable economies exiting from recession or close to doing so. However, the recovery remains hesitant, reflecting remaining fiscal pressures, high unemployment and the lingering effects of the euro area crisis on balance sheets and credit conditions. Growth is thus likely to gain momentum only slowly, helped by further monetary accommodation, the fading pace of fiscal consolidation and stronger external demand. Although growth is projected to move above trend rates from mid-2014 onwards, the large negative output gap is set to close only slowly, with the area-wide unemployment rate remaining above 12% until mid-2015. GDP growth in Germany, and also a handful of smaller economies, including Ireland, is projected to be a ½ percentage point or more above that for the area as a whole.

... and Japan

- A strong cyclical upturn has occurred in Japan this year, helped by the large monetary stimulus, favourable financial conditions and improved private sector confidence. Looking ahead, these factors, along with gradual labour market recovery, should remain supportive of growth through 2014 and 2015. Solid export growth, helped by improving external demand and the lagged effects from the yen effective rate depreciation in the last year, and improving corporate profitability should also help the recent rebound in business investment to strengthen further. However, fiscal consolidation, including reductions in public investment and the rise in the consumption tax rates in 2014 and 2015, will exert a substantial drag on activity in the next two years and gradually moderate the pace of the upturn.

The outlook varies in the large non-OECD economies...

Despite tighter financial conditions and slowing potential growth, output growth in the non-OECD economies is expected to strengthen modestly to between 5¼-5½ per cent in 2014 and 2015 (Table 1.1). However, there are marked differences in developments across the major economies:

... with above-par growth set to persist for a while in China...

- Growth in China has now turned up once more, helped by the impact of modest fiscal stimulus and rapid growth in credit up to June this year. As the impact of these effects fades, domestic demand growth should ease, with GDP growth slowing from a little over 8% in 2014 to around 7½ per cent in 2015, close to estimated potential rates.

... but growth strengthening more slowly in India...

- In India, annual GDP growth is expected to increase gradually, with the recent exchange rate depreciation helping to boost export growth and new infrastructure projects getting underway. However, the recovery is likely to be subdued by past standards, with strong supply rigidities and tighter

domestic financial conditions limiting the pace of the upturn, with GDP rising by 4¾ per cent in 2014 and just under 5¾ per cent in 2015.

- ... **Brazil...**
- In Brazil, growth is expected to continue at close to its present moderate pace, with GDP projected to rise by around 2¼ per cent in 2014 and 2½ per cent in 2015, with the recent currency depreciation helping to reduce significantly the drag exerted by strong net import growth. Continued monetary tightening is likely to check domestic demand, but private investment should strengthen, helped by on-going infrastructure and tax reforms.

- ... **and Russia**
- In Russia, output growth is projected to improve slowly from its current modest pace to around 2¼ per cent in 2014 and just below 3% in 2015, with moderating headwinds from high price inflation and a pick-up in infrastructure investment helping to boost domestic demand.

Inflationary pressures in OECD economies are weak...

Consumer price inflation rates remain low in most OECD economies:

... **edging up in the United States but not in the euro area...**

- Core inflation rates have remained very low for several months in the United States and the euro area, stabilising at between 1-1¼ per cent in the United States, but declining unexpectedly sharply to around ¾ per cent in the euro area despite increases in indirect taxes and administered prices. Nonetheless, swap-based measures of inflation expectations have generally remained well-anchored. Looking ahead, the divergence in activity outcomes is likely to be reflected in diverging inflation prospects. In the United States, core inflation could drift up slowly towards 2% during 2014-15 as economic slack is reduced and the labour market firms. In contrast, in the euro area, with economic slack projected to narrow only slowly and remain sizeable at the end of 2015, core inflation is expected to stay very low, at just over 1% through next year and edge up only marginally in 2015. This would be well below the ECB definition of price stability, with intensifying risks of entering deflation if growth does not strengthen as projected or if the euro effective exchange rate were to appreciate significantly further.

... **and rising modestly in Japan**

- In Japan, domestic deflation is slowing gradually. Quarterly movements in prices have been volatile, but the year-on-year headline inflation rate has recently become clearly positive, with the large effective exchange rate depreciation pushing up import prices and having additional indirect effects via stronger output growth. The year-on-year rate of core inflation is now close to zero, longer-term inflationary expectations have risen and the OECD estimate of the output gap has turned positive. Prices are projected to rise in the remainder of this year, with the annualised quarterly rate of core inflation reaching a little over 1% in the latter half of 2015. The impacts of the planned increases in the consumption tax rate in 2014 and 2015 should raise the price level

further, by around 2 percentage points and 1.4 percentage points respectively.

Inflation pressures remain high in many EMEs...

Inflationary pressures remain high in many large EMEs despite subdued growth, with the recent exchange rate depreciations likely to push up import prices markedly.

... including India...

- In India, consumer price inflation remains above 9½ per cent, in part reflecting administered price increases on fuel products and food price inflation. With a likely moderation in domestic food price pressures, the recent tightening of monetary policy and rising spare capacity could eventually ensure that inflation begins to moderate, provided the exchange rate does not depreciate much further.

... and Brazil...

- In Brazil, consumer price inflation has now edged below the upper limit of the target band, but remains high despite subdued output growth, pointing to limited spare capacity in the economy. However, recent and assumed future monetary policy lightening should allow inflation to be brought down to target, with future growth expected to be moderate.

... but not China

- In China, headline inflation continues to be boosted by food price pressures, but these should fade when weather conditions return to normal. Non-food consumer price inflation has remained low in recent months, at between 1½ and 2 per cent. Looking forward, activity growth is not projected to be at a pace that would raise core inflation much further, with the output gap now estimated to be small and projected to remain so.

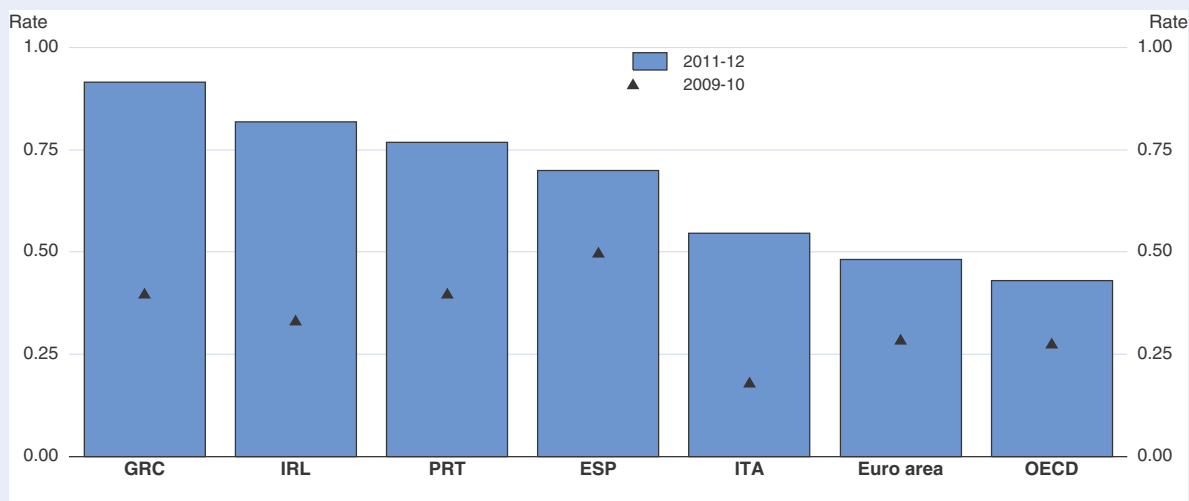
Labour market conditions have diverged...

The OECD-wide unemployment rate has stabilised at a high level, with diverging developments in the major OECD economies. As noted in the May 2013 *Economic Outlook*, employment outcomes over the past two years in the United States, the United Kingdom and Germany have been persistently better than might have been expected on the basis of past relationships with output growth. In the United States, soft productivity growth, likely reflecting an adjustment of employment to more normal levels following heavy job losses in 2008-09, has supported job growth, with on-going declines in labour force participation helping these gains to be reflected in a declining unemployment rate. In Germany and the United Kingdom, the resilience in job growth likely reflects wide-ranging, albeit very different, labour market reforms put in place to enhance the scope for businesses to use employees more flexibly and to strengthen job matching through greater help with job search and stronger work availability requirements. In many other euro area economies, job losses in recent years have been extremely large even allowing for the severity of the fall in demand, although this may change as the impact of recent structural reforms begins to be felt later on during the projection period (Box 1.3).

Box 1.3. Progress on structural reform in the vulnerable euro area countries


The financial crisis and ensuing euro area crisis were accompanied by extraordinary financial market pressures on Greece, Ireland, Italy, Portugal and Spain to rebalance their economies. The OECD has emphasised the role for structural reforms, particularly in labour and product markets, to improve these countries' international competitiveness and public debt dynamics through stronger growth. Indeed, for the EU-IMF programme countries, financial assistance has been made conditional on wide-ranging structural reforms. As a result of financial market pressures and programme conditionality, the pace of reform in the vulnerable countries has accelerated in recent years and outpaced that of other economies (see first figure).

Responsiveness to Going for Growth recommendations



Note: Responsiveness rates are calculated as the share of priority areas in Going for Growth in which 'significant' action has been taken. The euro area and OECD rates are calculated as an unweighted average.

Source: OECD, Going for Growth (2013).

StatLink  <http://dx.doi.org/10.1787/888932947770>

Since the downturn, the vulnerable countries have undertaken a range of labour market reforms. One sign of progress is the declines that have occurred in the OECD indicator of employment protection legislation in many of these countries (see second figure), but reforms have also been made in other areas influencing labour utilisation.

- Measures to reduce the *cost of labour* of regular workers include successive reforms in Portugal to shorten notice periods required for dismissal and reduce severance pay, as well as reducing the difficulty of dismissal and procedural inconvenience. Greece has also initiated similar reforms. Reforms in Italy and Spain have concentrated on easing the difficulty of dismissal and procedural inconvenience. Even so, employment protection legislation remains as, or more, restrictive in the vulnerable countries than the OECD average, with the exception of Ireland.
- Several countries have undertaken reforms to improve the *responsiveness of wages* to labour market conditions. Greece has overhauled its wage bargaining institutions fundamentally, abolishing the administrative extension of collective contracts to third parties and decentralising collective bargaining. Ireland has also enacted reforms to improve the responsiveness of wages set in collective agreements to economic conditions and limit the extension of collective agreements. In Portugal and Spain, some changes have been made to the collective wage bargaining system, but these systems remain important areas for reform.
- Unemployment benefit schemes have also been adjusted to strengthen incentives and make them more inclusive. In Ireland, Portugal and Spain, benefit rates have been lowered and in Portugal, the duration has been reduced. At the same time, in Portugal and Italy the coverage of schemes has been broadened.

Box 1.3. Progress on structural reform in the vulnerable euro area countries (cont.)

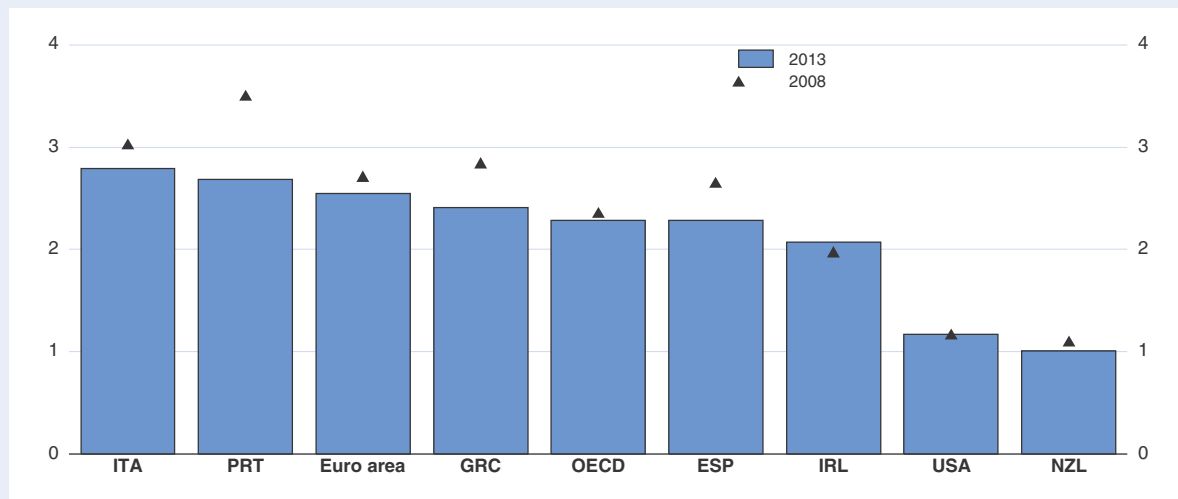
Considerable product market liberalisation has occurred in Greece and Portugal, whereas product market reforms have been minimal overall in Ireland, Italy and Spain. In all five countries, the effective implementation of planned reforms is crucial to improving competitiveness.

- In Greece and Portugal, there have been reductions in state control of the economy and various barriers to entrepreneurship, including in the services sector. In Greece, three-quarters of professions have been opened to competition. Greece has also reduced barriers to trade, such as differential treatment of foreign suppliers.
- In Ireland and Spain, legislative programmes to reform the utilities sector, reduce administrative burdens, and strengthen competition are underway although there have been some delays. In Italy, there has been some liberalisation of professional services, for example, but government involvement in business operations remains relatively high.

Despite the progress that has been made, there is much scope for further improvement in these countries.

There has been progress in reforming labour markets¹

Strictness of employment protection²



1. The two countries with the least strict regulation are shown for comparison. The OECD and the euro area points are the average of the available countries.

2. Protection of regular workers against individual and collective dismissals.

Source: OECD, Database on Employment Protection.

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Some important reforms have been initiated in other areas, such as taxation and pensions. Greece and Portugal have implemented reforms to improve the efficiency of the taxation system: Greece has broadened its tax base and simplified the tax system; and Portugal has implemented major reforms shifting taxation towards consumption and property taxes. Greece and Spain have made substantial progress in the area of pension reform.

The benefits of reforms undertaken to date could be large. For example, previous OECD work has shown that:¹

- The marginal impact of reforms that would lower the value of the employment protection index by the same amount as achieved on average by OECD countries that undertook reforms between 2000 and 2008 would be to raise average annual labour productivity growth by 1.6 percentage points over 10 years.
- Reforms that would reduce the OECD's product market regulation indices by the same amount as achieved on average by OECD countries that undertook reforms between 2000 and 2007 would increase average annual total factor productivity and GDP growth by about 0.7 percentage points over 10 years.

Box 1.3. Progress on structural reform in the vulnerable euro area countries (cont.)

- A 3-percentage-point reduction (the median over the past three decades) in the share of tax revenue accounted for by taxes on income, profits and capital gains (rather than property or consumption) raises productivity by about 1% in the long run.
- Benefits of these reforms may take longer to increase growth outcomes; other reforms that have also been undertaken, such as increasing wage responsiveness to economic conditions, could add to job creation in the near term.

Looking ahead, for the vulnerable countries, it is crucial to maintain reform momentum as activity improves, given the need to strengthen growth prospects, further enhance externally-oriented sectors and reduce the risk of high unemployment becoming structural. Key priorities going forward include:

- Further reductions in regulatory barriers to firm entry and competition, including through privatisation, to boost competitiveness and job creation. In particular, greater liberalisation of retail trade and services sectors could yield large returns.
- Further labour market reforms to reduce the cost of labour and improve competitiveness, including lowering the tax wedge and reforming the system of collective wage bargaining to enable wages to be more responsive to labour market conditions.
- Facilitating training and job-search assistance for unemployed workers to mitigate the risks of rising structural unemployment.

1. See OECD and World Bank (2013). Note that the estimates were based on the indicators of employment protection and product market regulation in 2008.

... with this pattern likely to persist...

Looking ahead, these cross-country labour market trends seem likely to continue (Table 1.3 and Figure 1.9):

Table 1.3. **OECD labour market conditions are likely to improve slowly**

	2010	2011	2012	2013	2014	2015
	Percentage change from previous period					
Employment						
United States	-0.6	0.6	1.8	1.1	1.4	1.6
Euro area	-0.3	0.3	-0.7	-0.9	0.0	0.5
Japan	-0.3	-0.1	-0.3	0.5	0.0	0.0
OECD	0.3	1.0	1.0	0.6	0.9	1.1
Labour force						
United States	-0.2	-0.2	0.9	0.4	0.8	1.0
Euro area	0.3	0.4	0.6	0.0	0.1	0.2
Japan	-0.3	-0.6	-0.6	0.2	-0.1	-0.1
OECD	0.5	0.6	1.0	0.7	0.8	0.8
Unemployment rate						
	Per cent of labour force					
United States	9.6	8.9	8.1	7.5	6.9	6.3
Euro area	10.0	10.1	11.3	12.0	12.1	11.8
Japan	5.0	4.6	4.3	4.0	3.9	3.8
OECD	8.3	8.0	8.0	8.0	7.8	7.5

Source: OECD Economic Outlook 94 database.


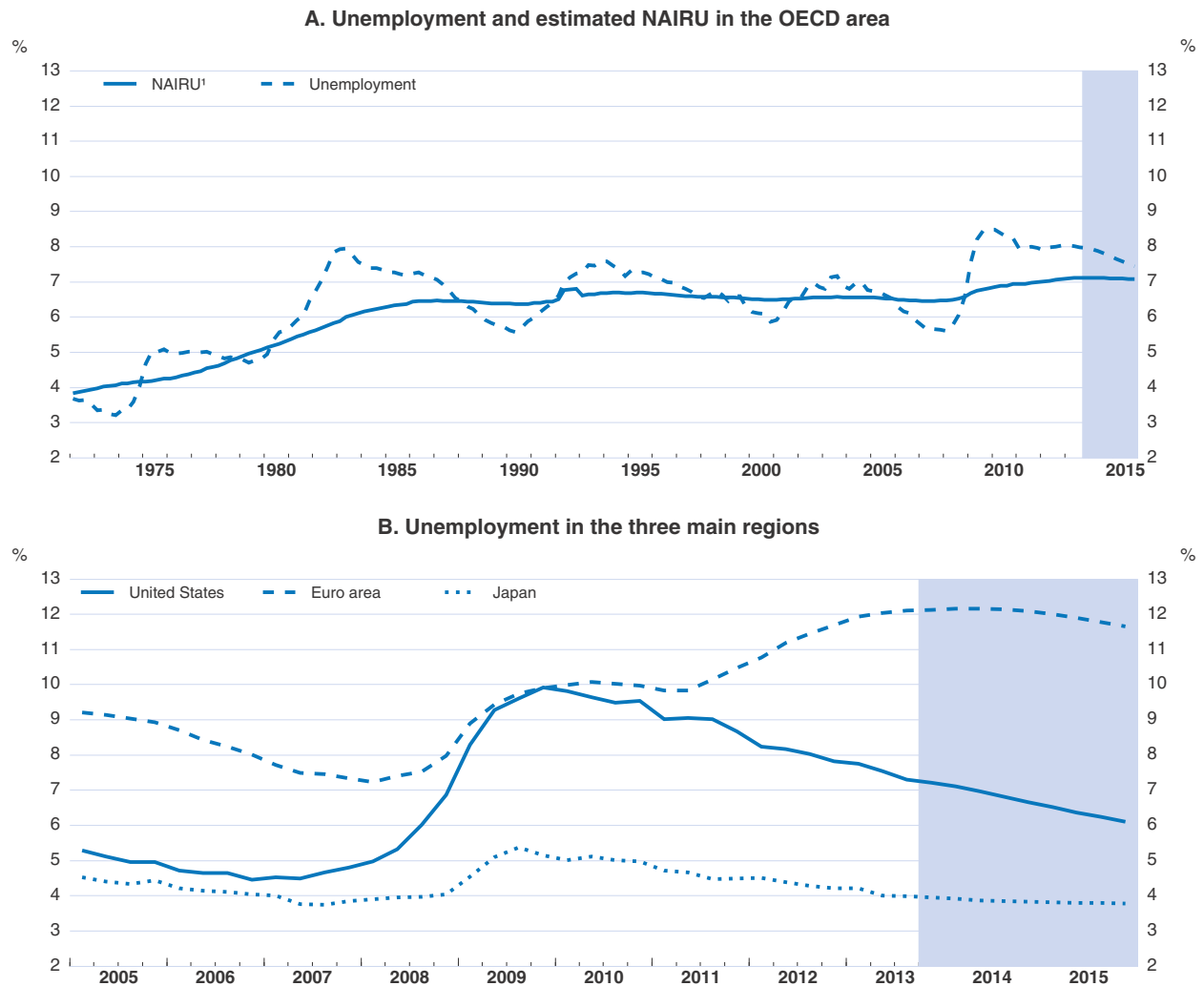

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Figure 1.9. **Labour market slack is diverging and large overall**
Percentage of labour force



1. The NAIRU is based on OECD estimates.

Source: OECD Economic Outlook 94 database; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888932947979>

... with only small improvements in the euro area...

- In the euro area, survey measures of hiring intentions remain soft and with output growth projected to pick up only slowly, net job growth seems likely to resume only from mid-2014, with the unemployment rate remaining above 12% until mid-2015 and falling only slowly thereafter.

... stronger outturns in Japan...

- In contrast, stronger output growth in Japan could allow the unemployment rate to remain below the long-term sustainable rate, helping wage growth to become positive during the projection period.

... and continued declines in unemployment in the United States

- In the United States, uncertainties about future labour market developments include the future behaviour of labour force participation and the likely strength of productivity growth. The present cyclical shortfall in the participation rate (estimated to be around 1 percentage point for those aged 15 and over) is expected to be largely eliminated by end-2015, with the actual participation rate stabilising close to its present level. With labour productivity growth assumed to pick up to around 1¼ per cent by 2015 from the unusually subdued rates seen recently, employment is projected to grow by around 1½ per cent per annum over the next two years. Against this background, the unemployment rate is likely to drift down gradually, falling below 6½ per cent early in 2015 and close to the current, albeit uncertain, OECD point estimate of the sustainable unemployment rate by the end of that year.

Reforms are essential to foster job growth

Against the background of only slowly strengthening demand, labour market reforms remain essential to foster employment growth and reduce the risk that persistent cyclical unemployment increasingly becomes structural. Reform efforts to improve labour utilisation by changing labour market regulations and welfare systems have recently intensified in a number of OECD economies (OECD, 2013a and Box 1.3), particularly in many euro area countries in which sizeable fiscal consolidation is being undertaken. Additional reforms are still needed to strengthen and redesign active labour market and social policies so as to cushion the near-term effects of high unemployment and improve the matching of workers and jobs, including in the United States and many EU economies, with specific priorities differing across countries. Product market reforms to relax regulatory restrictions in service sectors in which there is a strong potential for new job growth could also help improve labour market outcomes, including in Japan, Canada, Germany and France.

Global imbalances have eased since 2008 but momentum has recently stalled in...

Global imbalances declined from around 5% of global GDP in early 2008 to around 2½ per cent of GDP by end-2012,¹⁰ but momentum has subsequently stalled, and they are expected to remain broadly unchanged over the projection period, rising in the United States and Japan but narrowing elsewhere (Table 1.4). A substantial proportion of the post-crisis narrowing – possibly up to one-half – can be accounted for by cyclical factors, such as more negative output gaps and soft housing investment in external deficit economies, and the impact of low interest rates on the investment income balances of both external credit and debtor economies (Ollivaud and Schweltnus, 2013). As such factors fade, it will be important to implement structural reforms that, in addition to their positive effects on medium-term growth prospects, help to lower saving-investment imbalances. Together with an additional adjustment

10. Global imbalances are measured as the sum of absolute current account balances in the major surplus and deficit economies.

Table 1.4. **World trade will strengthen only gradually**
Goods and services trade


	2011	2012	2013	2014	2015
	Percentage change from previous period				
World trade¹	6.3	3.0	3.0	4.8	5.9
OECD exports	5.9	2.7	1.8	4.4	5.3
OECD imports	5.1	1.3	1.1	4.1	5.2
Trade prices²					
OECD exports	9.1	-3.7	0.7	2.9	1.3
OECD imports	10.7	-2.8	-0.2	3.0	1.4
Non-OECD exports	14.5	0.0	-0.7	2.6	3.1
Non-OECD imports	11.0	-0.5	-0.8	2.3	3.1
Current account balances	Per cent of GDP				
United States	-2.9	-2.7	-2.5	-2.9	-3.1
Japan	2.0	1.1	0.9	1.2	1.5
Euro area	0.7	1.9	2.6	2.6	2.8
OECD	-0.6	-0.5	-0.2	-0.2	-0.2
China	1.9	2.4	2.3	1.5	1.5
	\$ billion				
OECD	-295	-228	-80	-111	-121
United States	-458	-440	-422	-501	-578
Japan	118	66	43	60	78
Euro area	88	228	330	351	384
Non-OECD	871	820	787	755	769
China	136	193	208	152	169
Major oil producers	830	846	835	862	901
Rest of the world	-95	-220	-256	-259	-301
World	575	592	707	644	648

Note: Regional aggregates include intra-regional trade.

1. Growth rates of the arithmetic average of import volumes and export volumes.

2. Average unit values in dollars.

Source: OECD Economic Outlook 94 database.

StatLink  <http://dx.doi.org/10.1787/888932949119>

of real exchange rates and the continued fiscal consolidation needed in external deficit economies, these can help to bring about further durable reductions in global imbalances. Amongst the major economies, key developments and policy requirements to aid rebalancing include:

... the United States...

- In the United States, the current account deficit has been broadly stable over the past year, at around 2½ per cent of GDP, with rising net exports of petroleum products, on the back of favourable domestic supply developments, offset by an increasing non-oil deficit, reflecting the relative strength of domestic demand. Whilst monetary conditions remain accommodative, strong domestic demand growth over 2014-15 is projected to push the external deficit up to a little over 3% of GDP in 2015. Reforms to reduce the generosity of the tax treatment of interest expenses and fiscal consolidation could help to increase saving, improve resource allocation and reduce both the fiscal and external deficits.

... China... ● In China, the overall current account surplus is projected to have remained broadly unchanged this year at between 2¼-2½ per cent of GDP. On the domestic side, only limited adjustment towards consumption-driven growth has taken place, with domestic investment growth having picked up once more. The relative strength of domestic demand is projected to reduce the external surplus to around 1½ per cent of GDP by 2015, despite continued gains in export market share. Further ahead, the necessary adjustment of the economy away from the high rate of investment towards a more sustainable pattern of demand will have to be accompanied by measures to reduce domestic saving in order to avoid a rebound in the external surplus. Structural reforms that improve the prospects for both internal and external rebalancing include the development of social safety nets, the removal of obstacles to the development of the services sector and additional financial liberalisation.

... and Japan ● In Japan, there are now signs of stabilisation in the current account surplus, following a declining trend brought about by rising energy imports since the earthquake in 2011. The depreciation of the yen has worsened the terms of trade, but the impact on the current account is now set to be offset by strong net export volume growth and a stabilisation of the already-strong net investment income balance. With fiscal consolidation likely to damp domestic demand through 2014 and 2015, the current account surplus is projected to pick up from around 1% of GDP this year to 1½ per cent of GDP in 2015. Yet-to-be tackled reforms to raise competition in product markets and to liberalise border measures on agricultural goods would boost medium-term growth and at the same time aid rebalancing by strengthening the incentives for private sector capital investment.

External deficits are set to fall in India and other large EMEs

● In India, South Africa and, to a lesser extent, Brazil and Indonesia, recent sizeable currency depreciations are expected to help gradually moderate external deficits as net trade volumes benefit from improved cost competitiveness. In addition to fiscal consolidation where budget deficits are high (as in India), key policy requirements are to enact structural reforms to strengthen domestic growth prospects and improve the incentives for long-term capital inflows. These include the removal of restrictions on inward FDI, and reforms to tackle bottlenecks and rigidities that constrain the growth of industrial sectors.

Intra-euro area rebalancing remains asymmetric

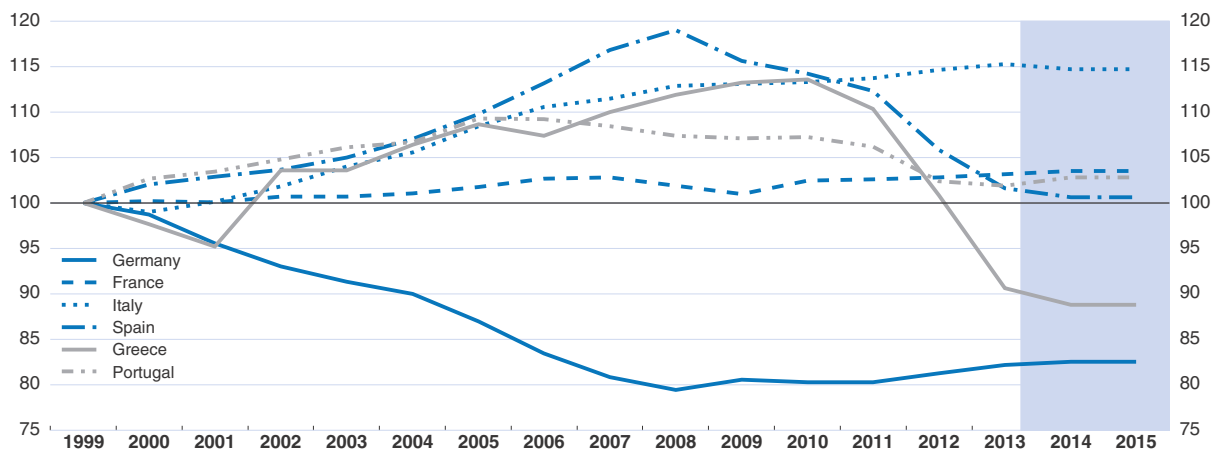
The euro area external surplus this year is projected to be around ¾ percentage point of GDP higher than in the latter half of 2012, at around 2½ per cent of GDP. An additional increase of around ¼ per cent is projected over the next two years. This reflects the continuing asymmetric nature of intra-euro area rebalancing and associated comparatively subdued growth of domestic demand.

Improvements are occurring in vulnerable economies but more reforms are needed

- Ireland, Spain, Italy, and more recently, Portugal and Greece all now have current account surpluses, which are projected to rise further over the next two years. This reflects strong structural reform efforts (Box 1.3) and wage adjustments stemming from large negative output gaps which have helped relative unit labour costs become better aligned (Figure 1.10), but further adjustment may still be needed as cyclical conditions improve.¹¹ Extremely weak domestic demand has contributed to the rebalancing,¹² but there have also been strong improvements in export performance observed in Spain and Portugal since 2008-09 and projected to occur in Greece over 2014-15.¹³ For these improvements to be continued, further reforms in both labour and product markets to help strengthen productivity and improve price and non-price competitiveness will be necessary. Sticking to already-agreed ambitious medium-term fiscal targets in vulnerable economies will also help to ensure that the improvements in their external balances persist as the recovery gets underway.


Figure 1.10. **Relative unit labour costs are continuing to adjust in the euro area**

Index 1999 = 100



Note: The figures shown are for whole economy unit labour costs relative to unit labour costs in the rest of the euro area.

Source: OECD Economic Outlook 94 database; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888932947998>

11. The competitiveness adjustments in some external deficit countries may be overstated, given the extent to which adjustments in wage levels have been driven primarily by wage developments in the public sector rather than in the business sector.
12. Cyclical effects improved the combined current account balance in these countries by around 2% of GDP in 2012 (Ollivaud and Schwellnus, 2013).
13. One positive aspect for the vulnerable economies, highlighted in new OECD/WTO statistics on trade in value added, is that exports of services account for a higher proportion of the value-added component of exports than they do of gross exports. Thus the required structural shift of resources into tradeables in these economies does not necessarily imply a large shift into manufacturing sectors, but instead into tradable services (Benito, 2013).

Slower progress is occurring in external surplus economies and reforms are needed to boost growth and rebalancing

- In euro area surplus countries, there has been less policy adjustment to foster rebalancing, with the German external surpluses remaining at around 7% of GDP over the past year, and the external surpluses of the Netherlands and Austria rising by around 1½ percentage points of GDP this year. In Germany, rising relative unit labour costs (albeit from a low level) are now starting to check export performance improvements, but the recent pace of structural reforms has been slow. A key remaining priority is to further improve domestic investment prospects by undertaking product market reforms to enhance competitive pressures and entry into sheltered sectors such as professional services and network industries. This would help to rebalance growth in Germany and help limit the overall adjustment of euro area imbalances from being largely one-sided and disinflationary, and thereby acting to increase global imbalances.

Risks to the outlook

Sizeable downside risks still remain

Durable exit from the crisis onto a strong growth path is not yet assured and, despite some positive signs of improving growth momentum in the OECD economies, sizeable downside risks remain. Some are long-standing sources of risk that have yet to be tackled fully, such as the fragility of the euro area banking sector and the unsustainability of the Japanese fiscal situation. These have been augmented by new concerns, relating to the potential large costs of the present nominal debt ceiling in the United States becoming binding, and the possibility of financial turbulence during a gradual exit from unconventional monetary policies in the United States. The first three of these risks are discussed in this section, with the various uncertainties associated with the monetary policy exit in the United States set out in detail in the section above on spillovers and feedback effects from emerging markets and the section below on monetary policy requirements.

Fiscal risks in the United States

A binding debt ceiling would lead to a large reduction in federal government expenditure...

If the debt ceiling became binding, as it nearly did in October and could still early next year, it would have large adverse effects on the stability and growth of the world economy. The federal government would face the choice of defaulting or finding some means to muddle through whilst balancing its budget. A number of suggestions for muddling through have been made, including prioritising interest payments, with the associated risk of the federal government breaching other contractual obligations. In any event, the federal government would need to contract spending massively to balance the budget, with recent CBO projections pointing to a Federal deficit of around 3.3% of GDP in the current US fiscal year.

... and have negative effects on financial markets and confidence

A failure to raise the debt ceiling would likely be accompanied by a severe deterioration in financial conditions, with significant declines in equity prices worldwide, a higher term premium on US government debt

(as occurred after the Treasury missed a debt interest payment in 1979) and, possibly, a worldwide rise in risk aversion. All of these would significantly worsen the impact of the initial fiscal consolidation, and would also imply that the consolidation would have to be even larger in order to ensure the budget was balanced.

The US economy would be pushed into a deep recession immediately with large negative spillover effects

The scenarios set out in Box 1.4 use macroeconomic model simulations to illustrate the possible economic effects from the application of the debt ceiling for one year in the United States. They assume that there is no debt default, so that the Treasury is able to prioritise debt interest payments successfully, and avoid the complications that could arise from the

Box 1.4. Quantifying the possible macroeconomic effects of a binding US debt ceiling

The scenarios in this box provide some illustrative indications of the possible economic effects of the application of the debt ceiling for one year in the United States and the large fiscal contraction that would be necessary to balance the budget in such circumstances. As consolidation has negative effects on activity and hence the budget deficit, the actual consolidation required has to be greater than the projected size of the budget deficit in the baseline. For simplicity, the resulting expenditure reduction is assumed to occur via a reduction in final government consumption.

Given the likely adverse impact on financial markets of the failure to raise the debt ceiling, it is likely that it would also be accompanied by a severe deterioration in financial conditions. For simulation purposes it has been assumed that the term premium on US long-term government bond yields would rise by around 200 basis points following the failure to raise the debt ceiling.¹ In addition to this, a worldwide decline of 25% in equity prices is also imposed.²

A broad picture of the possible near-term outcomes and effects if the debt ceiling was hit can be obtained from simulations on NiGEM, the global macroeconomic model of the National Institute of Economic and Social Research. The model permits a full account to be taken of the spillovers between countries arising from changes in trade and international financial linkages via asset prices and net foreign asset accumulation. However, it does not allow for the possible additional effects that might arise were private sector confidence to plummet throughout the world. In the simulations used here, policy interest rates and exchange rates are assumed to remain fixed at their baseline settings. The implications of relaxing these assumptions are discussed below.

The scenarios are built up in two stages. The first abstracts from financial market effects to get an idea of the size of the one-year consolidation necessary to ensure that the budget deficit declines by 3.3% of GDP. Thus, spillovers to other countries primarily stem from trade linkages. The second augments the first scenario with the additional financial market effects – the higher term premium of long-term interest rates in the United States and the global equity price decline, so that spillovers arise via both trade and financial market linkages.

The first set of simulation results (first table below) show that, abstracting from financial market effects, a one-year fiscal contraction of approximately 4% of GDP, assumed for simplicity to start in the first quarter of 2014, would be the minimum needed in the United States in order to obtain a balanced budget. The multiplier effects from this contraction, and the additional indirect effects arising from worldwide weakness, would reduce US GDP by around 4¼ per cent in the first year, pushing the US economy into outright recession. The US unemployment rate would rise by some 1½ percentage points, and disinflationary pressures would intensify, with US inflation around 1 percentage point lower than otherwise. The impact of this shock alone would be felt worldwide, with a decline of over ½ percentage point in GDP growth in the euro area, Japan and China, and world trade falling by around 3%.

Box 1.4. Quantifying the possible macroeconomic effects of a binding US debt ceiling (cont.)

US fiscal consolidation only

	2014
United States	
GDP growth (%)	-4.3
Inflation (%)	-1.0
Unemployment rate (%)	1.6
Euro area	
GDP growth (%)	-0.5
Inflation (%)	-0.2
Unemployment rate (%)	0.2
Japan	
GDP growth (%)	-0.8
Inflation (%)	-0.1
Unemployment rate (%)	0.1
China	
GDP growth (%)	-0.8
Inflation (%)	-0.3
Unemployment rate (%)	0.2
OECD	
GDP growth (%)	-1.9
Inflation (%)	-0.5
World	
GDP growth (%)	-1.3
Trade growth (%)	-3.0

Note : Government consumption reduced by 4% of GDP in 2014. Short-term interest rates and nominal exchange rates held fixed. Budget solvency rule turned off in 2014 for the United States. Model run in backward-looking mode.

Source: OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888932949157>

The second set of simulation results, incorporating an adverse reaction in financial markets, points to significantly bleaker outcomes. In this scenario a one-year fiscal contraction of approximately 5% of GDP would be the minimum needed in the United States in order to obtain a balanced budget, reflecting the additional declines in activity brought about by the deterioration in financial conditions. A deep recession would result in the United States, with GDP contracting by around 6¾ per cent relative to baseline, the unemployment rate rising by almost 2½ percentage points and very strong disinflationary pressures (see second table below). The OECD as a whole would be in recession, with GDP declining by over 3 percentage points relative to baseline, and the euro area and Japan would both be close to or in recession.³ Over 4½ million additional people would become unemployed in the United States, the euro area and Japan and well over 5 million in the OECD as a whole. The non-OECD economies would also suffer a sizeable hit, with global trade volumes over 5% lower than baseline, and the value of their international asset holdings being hit by weaker equity prices. If a worldwide increase in risk aversion were to occur – implying higher risk premia in all economies rather than just the United States – the adverse near-term effects on growth would be intensified significantly further.

If exchange rates were allowed to adjust in these simulations it could change the balance of the different activity effects for different economies somewhat. In particular, the US dollar exchange rate could be expected to depreciate, which would ease the adverse activity effects by raising the external competitiveness of US exporters, and also ease disinflationary pressures by raising import prices. In contrast, the adverse activity impacts and disinflationary effects would likely be higher in other economies, given the appreciation of their currencies relative to the dollar.


Box 1.4. Quantifying the possible macroeconomic effects of a binding US debt ceiling (cont.)

US fiscal consolidation financial markets shock

	2014
United States	
GDP growth (%)	-6.8
Inflation (%)	-1.5
Unemployment rate (%)	2.4
Euro area	
GDP growth (%)	-1.0
Inflation (%)	-0.3
Unemployment rate (%)	0.4
Japan	
GDP growth (%)	-1.6
Inflation (%)	-0.1
Unemployment rate (%)	0.2
China	
GDP growth (%)	-1.8
Inflation (%)	-0.4
Unemployment rate (%)	0.5
OECD	
GDP growth (%)	-3.2
Inflation (%)	-0.8
World	
GDP growth (%)	-2.3
Trade growth (%)	-5.2

Note : Government consumption reduced by 5% of GDP in 2014 with the budget solvency rule turned off in 2014. Term premium in long term interest rates up by 200 basis points in 2014 in the United States. Equity prices drop by 25% in 2014 in all countries (endogenously for the United States). Short-term interest rates and nominal exchange rates held fixed. Model run in backward-looking mode.

Source: OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888932949176>

A scenario of this kind would also be likely to induce urgent counteracting policy action, with further non-standard monetary policy actions being undertaken in the United States and elsewhere, along with reductions in policy interest rates in other economies with sufficient room to do so. Such effects are not incorporated in the simulations presented here, and their impact is uncertain, but they would likely alleviate the overall hit to activity somewhat.

1. The small technical default in 1979 is estimated to have raised interest rates on Treasury bills by around 60 basis points, with this effect persisting for some time afterwards (Zivney and Marcus, 1989).
2. The NiGEM model suggests that a one-year rise of 200 basis points on US long rates reduces US equity prices by around 25%. This effect is assumed to be mirrored in all other equity markets. In contrast, a 40% decline in global equity prices occurred between the latter half of 2007 and the first quarter of 2009.
3. The negative activity effects in the simulation for the euro area and Japan are of a similar magnitude to the baseline GDP growth projections for 2014.

variability in the timing of tax receipts and debt interest payments. Even in the absence of adverse financial effects, a contraction of at least 4% of GDP in federal spending would be required to achieve a balanced budget, once account is taken of the associated multiplier effects on activity. The US economy would be pushed into recession immediately, with large negative spillover effects on other economies and substantive disinflationary pressures. If, as most likely, the expenditure reduction was

accompanied by deteriorating financial conditions, the consequences for the global economy would be much more severe, with a contraction of at least 5% of GDP in federal spending required for a balanced budget. The OECD as a whole would be in recession, with more than an additional 5 million people becoming unemployed. Urgent counteracting monetary policy actions in the United States and elsewhere could perhaps cushion the impact a little, but their impact would be uncertain.

An outright default would have extremely severe effects

Even the possibility of an outright default will unsettle financial markets worldwide, and damage confidence, with negative effects on activity. If a technical default could not be avoided, the consequences would be extremely uncertain and hard to quantify *ex ante*, but would be much more severe than shown in the scenarios set out here. It would be likely to create large confusion and uncertainty in financial markets given the importance of US government bond rates in pricing financial instruments worldwide and the widespread use of US government bonds as collateral in many financial operations, and trigger a systemic flight to liquidity that could prove as catastrophic and costly as that in the days following the Lehman failure in 2008. Given the risk of incurring such costs, and the increasing frequency at which this risk has resurfaced, there is a strong case for scrapping the nominal debt ceiling altogether, so that the borrowing implied by budgets and resolutions passed by Congress is authorised automatically. In addition, a credible medium-term strategy should also be put in place to ensure long-run fiscal sustainability.

Addressing remaining risks in the euro area

Developments in the euro area could still unsettle financial markets

Still weak bank balance sheets, unsustainable public finances and the uncertain political situation in some vulnerable euro area countries mean that financial markets could become unsettled again, even though they have remained calm recently in the face of adverse developments. Possible financing shortfalls in some programme countries may renew financial tensions and put the ECB's Outright Monetary Transactions (OMT) scheme to the test if redenomination risks were to be rekindled. Losses for official creditors and the need for additional loans could lead to resistance in creditor countries, while losses for domestic banks could undermine financial stability. Moreover, the planned comprehensive assessment of euro area banks in 2014 could unsettle confidence if it is not embarked upon with clear procedures on how to deal with identified capital shortfalls (see below).¹⁴ The consequences of renewed financial tensions could be serious, posing downside risks to the mild recovery currently projected in the euro area.

14. The comprehensive assessment consists of three elements – a supervisory risk assessment, an asset quality review and a stress test (ECB, 2013).

Institutions still need to be completed to deal efficiently with financial and political crises

- Institutions still need to be strengthened to deal efficiently with financial and political crises. The OMT scheme has not yet been used and the associated conditionality may prevent a government from seeking or receiving assistance, especially if the government lacks a strong mandate to push through reforms or faces signs of adjustment fatigue. The Eurogroup agreement in June on the principles of bank recapitalisation via the ESM is welcome, but no direct capital injections by the ESM will be possible until late-2014 after the Single Supervisory Mechanism starts operating, most likely in November. Even then, ESM funds available for this purpose will be limited to 60 billion euros.

Private investors are likely to bear more of the costs of bank resolution in the future

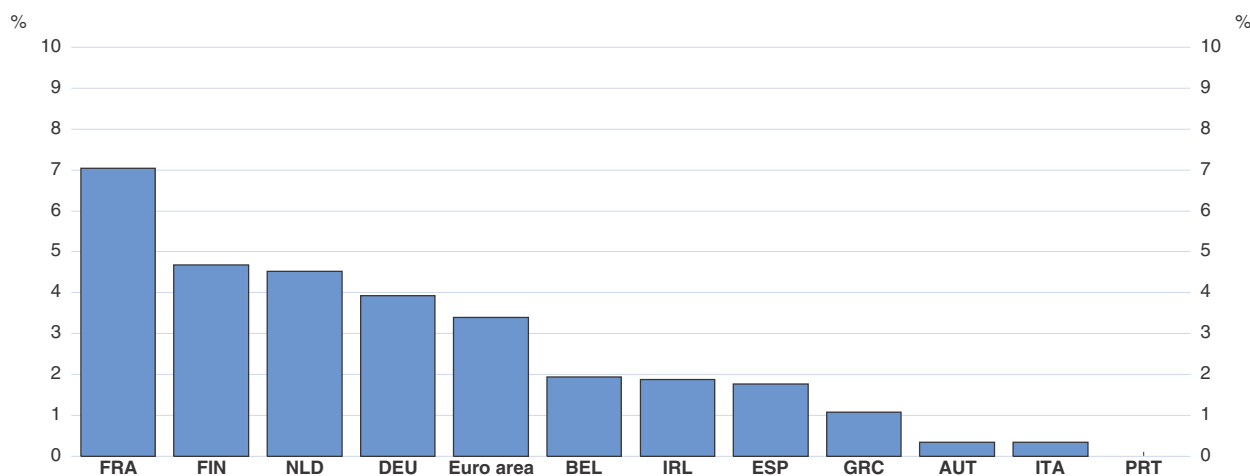
- Private investors are likely to bear more of the costs of the resolution of financial institutions in the future, following the bail-in implemented in the most recent rescue package and provisions contained in the proposed bank resolution directive agreed in June. An enhanced private sector role is welcome in principle, as it should significantly reduce moral hazard, improve *ex ante* risk awareness and weaken feedback loops between banks and public finances, with the directive foreseeing a bail-in of up to 8% of total liabilities before government funding is possible. However, in the context of weak bank capitalisation, it could trigger adverse dynamics if initial signs of problems were to spark a bank run by uninsured depositors and a bond sell-off, intensifying underlying bank funding problems. This risk is particularly high for banks with insufficient capital to absorb losses.

Many euro area banks remain insufficiently capitalised

- Many euro area banks are still insufficiently capitalised, making them a drag on growth and also a potential source of negative feedback loops between banks and government finances. Capital levels appear high on a risk-weighted basis, but this indicator is a poor predictor of banking problems. Capital levels relative to total assets (i.e. the leverage ratio) are still low in many banks, including in the core euro area countries. For instance, although the capital needs for individual national banks to reach a 5% leverage ratio over the medium term, which, as OECD studies indicate, would leave banks at a prudent distance from default, declined over past 12 months, they are still around 4% of GDP or more in four euro area countries and just under 3½ per cent of GDP for the euro area as a whole (Figure 1.11).¹⁵ High and rising non-performing loans in many euro area countries, reflecting weak growth, increasing unemployment and declining property prices, add to recapitalisation challenges. A failure to clean up bank balance sheets and strengthen

15. A minimum 5% leverage has been recommended by the OECD. It is used as a benchmark for well-capitalised banks by the US Federal Deposit Insurance Corporations (a ratio of 6% has been recently proposed as a regulatory minimum for the largest financial institutions in the United States). According to an empirical analysis, an average core Tier 1 ratio of 5% or higher significantly increases the distance to default of banks compared with a core Tier 1 ratio of less than 3% (Blundell-Wignall and Atkinson, 2012; Blundell-Wignall and Roulet, 2012). It is higher than the 3% leverage ratio in Basel III scheduled to apply in 2018. For estimates done last year, see Box 1.5 in OECD (2012).

Figure 1.11. **Capital needs in euro area banks to reach a 5% leverage ratio are still large**
In per cent of GDP



Note: Based on available information at the end of September 2013.

Source: OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888932948017>

bank capital positions could lower economic growth in the medium term.

Credible steps towards banking union and greater transparency are required

These risks require further policy measures. Progress in establishing a single supervisory mechanism and in agreeing on the design of a single bank resolution regime needs to be followed by adopting an adequate joint fiscal backstop and, possibly, a joint deposit guarantee. The building blocks of a fully-fledged banking union need to be put in place as quickly as possible and the date for an effective single bank resolution regime should be brought forward from the current 2018 target. It is also important that the asset quality review and stress tests by the ECB and the EBA, planned for 2014, are viewed as fully credible, as they are essential to help restore confidence in the banking system. However, the absence of a common fiscal backstop in the short term may complicate the exercise, and a clarification of how identified capital shortfalls will be addressed will be key in ensuring that credible stress tests do not come with a risk of renewed tensions.¹⁶ To provide reliable estimates of capital needs, the asset quality review will have to be comprehensive, as planned, and properly evaluate all assets and the adequacy of loan-loss provisions. In particular, non-performing loans, which in some core euro area countries remain surprisingly low in view of recent economic weaknesses, must be identified on a consistent basis, as planned. Details of the bank stress tests have yet to be published, but confidence in the tests would be enhanced by: making the results transparent (including publishing exposures to sovereign bonds); using common definitions of key

16. The ECB announcement of the comprehensive assessment recognised the potential need for public backstops, but stressed that capital shortfalls should be made up primarily by private investors (ECB, 2013).

indicators; consistency checks; and using demanding macroeconomic assumptions. In addition, marking to market all government securities (not only these in the trading book) would be welcome.¹⁷

Fiscal policy risks in Japan

Japanese debt dynamics could become unsustainable

Japan faces risks of turmoil related to fiscal debt sustainability given its still formidable fiscal challenges. Even if the government's fiscal target for fiscal year 2020, recently confirmed in the new medium-term fiscal plan (see below), is met, government debt will continue to rise over next years from an already high level and the risk of a change in market sentiment will persist. A rise in the real yields of sovereign bonds would aggravate debt dynamics, potentially fuelling a spiral of adverse market reactions. To reduce such a risk, it is crucial to adopt a detailed and credible consolidation strategy for the medium and long term and to pursue structural reforms to boost economic growth and improve debt dynamics – two elements in the government's economic strategy which still need to be made more concrete.

Economic policy requirements in the major economies

Monetary policy

Monetary policy in the main OECD areas continues to be eased, in contrast to some EMEs

Monetary policy has become increasingly accommodative in the large OECD economies since early May. The US Federal Reserve is continuing to purchase \$85 billion of Treasury and mortgage-backed securities per month (0.5% of annual GDP). The Bank of Japan is pursuing its new ambitious goal to double the monetary base by the end of 2014, primarily through bond purchases of increasing maturity. In November, the ECB cut the main refinancing rate to 0.25% and the marginal lending rate to 0.75%, indicated that the policy rates would remain at present or lower levels for an extended period and extended the period of full allotment of liquidity. The Bank of England issued forward guidance in August, implying that the policy rate would not be raised and the stock of purchased assets maintained at least until the unemployment rate has fallen to 7%, subject to three "knockouts" related to price and financial stability.¹⁸ By contrast, in the largest EMEs, the monetary policy stance has been tightened since early May: policy interest rates have been raised in Brazil by 200 basis points and in Indonesia by 175 basis points, and liquidity has been tightened in China. In India, the May cut in the repo rate was more than offset by increases in September and October, while the recent exceptional tightening measures to defend the rupee were unwound partially.

17. The EBA recapitalisation exercise in December 2011 assumed that all government bond holdings were marked to market, while the EU-wide bank stress test in July 2011 applied such a treatment only to bonds held in the trading book, which is consistent with international practice.

18. The Bank of England also lowered required liquidity standards for the largest financial institutions that meet the minimum 7% capital thresholds.

Monetary policy requirements diverge across...

Increasing cross-country differences in growth and inflation prospects imply the following diverging monetary policy requirements in the major economies:

... the United States...

● In the United States, very accommodative monetary policy is warranted over the projection period in view of the moderate recovery with still important downside risks, low inflation and well anchored inflation expectations. Nevertheless, with reduced slack and the steady increase in inflation towards its target, monetary stimulus will need to be scaled back gradually to prevent the risk of de-anchoring inflation expectations or triggering asset price bubbles. Conditional on projected activity developments, it would be appropriate to wind down asset purchases in the course of 2014 and then to consider gradual increases in the target federal funds rate in 2015. Notwithstanding assumed increases in the policy rate, the rate at the end of the year would be only 1½ per cent at a time when slack in the economy has been significantly reduced and inflation has risen near to its target. While this unusually low policy rate when inflation is on target and remaining slack is modest is consistent with the Federal Reserve's dual mandate of attaining both price stability and full employment, it risks excessively boosting asset prices, unless the latter is effectively mitigated by macro-prudential instruments. After 2015, it will be necessary to increase the policy rate to avoid unsettling inflation expectations. To minimise financial market volatility, the Federal Reserve should consider signalling its tightening schedule in advance. However, the timing and speed of reductions in monetary stimulus should be adjusted if growth looks set to be significantly weaker than projected. In this uncertain context, the Federal Reserve should also carefully assess the international spillovers from its policy actions and communications and take into account their possible feedbacks on the US economy, particularly if the risks associated with negative events were to materialise and have systemic repercussions in the still fragile global economic environment (see above and Box 1.1).

... Japan...

● In Japan, the current strong quantitative and qualitative monetary easing (QQME) is appropriate as inflation is still well below its target and growth is expected to moderate due to fiscal headwinds. Recent technical amendments to QQME operations seem to have been effective in boosting bond market liquidity and reducing yield volatility.¹⁹

... the euro area...

● In the euro area, the current accommodative monetary policy stance is appropriate, provided disinflationary pressures do not intensify. With underlying inflation falling to very-low levels and set to be well below the ECB's medium-term objective for inflation due to extensive slack, the ECB should keep the main refinancing policy rate unchanged at

19. The amendments included increasing the number of operations from six to about ten per month, and relaxing rules on the timing of purchases.

least until end-2015. At the same time, it should provide adequate liquidity to the market so that the overnight rate remains close to the deposit rate even if some banks repay in advance funds borrowed via the Long-Term Refinancing Operations (LTRO). Institutional changes should also be considered so that additional non-conventional measures are available if disinflationary pressures were to strengthen or turn deflationary, or if substantial uncertainties were to re-emerge, and these challenges could not be addressed by existing monetary tools. Such measures could include purchases, on a non-discriminatory basis, of government and corporate bonds, and programmes to foster bank lending to the non-financial private sector.

... the United Kingdom...

- In the United Kingdom, the current expansionary stance of monetary policy still remains appropriate in view of the ample, though declining, slack in the economy and broadly stable long-term inflation expectations. However, given the projected closing of the output and unemployment gaps and inflation outcomes slightly above target, the normalisation of policy rates should start at end-2015 and interest rates will have to increase more thereafter to prevent de-anchoring inflation expectations and asset price bubbles, unless these can be contained by macro-prudential instruments.

... China...

- In China, if the projected recovery materialises, it will be important to moderate the growth of money and credit by raising the key one-year deposit rate, so that real rates come back closer to their long-term average. At present, a partial deregulation of interest rates has resulted in undue arbitrage between different markets that could undermine financial stability. Such developments suggest that bank interest rates should be further deregulated and that stability concerns should be better addressed, including by macro-prudential measures, and co-ordinated by the recently established cross-regulatory body.

... and other EMEs

- Some other EMEs face a dilemma in the setting of monetary policy due to weak activity amidst pressures on exchange rates, capital flows and domestic prices. In India, still high inflation and a sharp depreciation of the rupee, in the context of a large current account deficit and capital outflows, call for tighter monetary policy. The pace of interest rate rises should, however, take account of the risks of undermining the recovery. In Brazil, some further tightening of the monetary policy stance would also be desirable in the near term to bring down inflation closer to the mid-point of the target range, especially if downward pressures on the exchange rate intensify. Its pace and scale would need to account for the risks of weakening already subdued growth. In Indonesia, despite recent increases in policy rates, the exchange rate remains weak and inflation high. The central bank should stand ready to lift interest rates further if signs emerge that high inflation is becoming entrenched, such as further exchange rate depreciation. In Russia, current policy rates and the liquidity provision are appropriate given the projected gradual

decline in inflation towards the upwardly revised 2014 target and only modest expected growth. However, the stance may need to be reassessed if stronger exchange rate depreciation were to affect materially the inflation outlook or if continued economic weakness were to lead to a more rapid decline in core inflation.

Macro-prudential measures could complement monetary policy tools

The on-going need for policy stimulus to the economy in the coming years raises concerns about the possible undesirable side-effects of low interest rates and abundant liquidity on specific markets. Macro-prudential policies provide a partial response to such concerns if employed pre-emptively. This option could be attractive for advanced OECD countries where such policy instruments have been little used so far but more active use of some macro-prudential instruments could also be advantageous in EMEs (see Box 1.5 in OECD, 2013b). Empirical evidence suggests that macro-prudential policies can be effective, but there are limits to their effectiveness and their implementation can be challenging.²⁰ Thus, they should not be relied on exclusively and should not substitute for eventual interest rate normalisation.

Normalisation of monetary policy will be challenging...

Highly expansionary monetary policies in the main OECD areas over the past five years have helped stabilise the economy but also increased the prices of many assets to very high levels and encouraged risk taking. Unwinding these policies is necessary in due course but the process risks triggering disorderly asset price corrections and financial instability. Developments since May are a salient reminder of such possible outcomes. Further turmoil and contagion cannot be excluded, especially when asset purchases eventually start to be wound down and interest rates increased. Their consequences are difficult to predict, reflecting the scale of current stimulus, the likely unsynchronised exit in the main OECD economies and large uncertainties about prevailing vulnerabilities in the financial sector. Such developments could prove destabilising, including through negative effects on banks, in particular in Japan (Box 1.5), and on EMEs (see above).

... requiring judicious communication

Recent developments have revealed the limits in the extent to which central banks can control market expectations, including via forward guidance. In principle, forward guidance can help to clarify the reaction function of a central bank and reduce uncertainty about the future path of monetary policy. However, if markets interpret guidance as commitment, they may react strongly when central banks have to use discretion in

20. The potential challenges involve: deciding on the right timing to introduce a given measure; calibration of various instruments so as to take into account their expected costs and benefits as well as interactions with other measures and policies; and redistribution effects across interest groups. These challenges imply that the responsibility for macro-prudential policies should preferably lie with a single institution having control over suitable tools. If this is not the central bank, then these policies should be closely co-ordinated with the monetary authorities.

Box 1.5. The impact of government bond yield increases on banks

Until the recent sell-off, government bond yields in many OECD countries had been at historical lows for over two years. Since then, yields have risen significantly in some countries, and they may eventually increase further with the expected normalisation of monetary policy and dissipation of safe haven effects. Future changes may be quite abrupt given the nature of swings in investors' sentiment, as experienced for instance in 1994 or more recently. Against this backdrop, this box provides an illustrative analysis of the consequences of rising government bond yields for banks in selected OECD countries.

A rise in government bond yields has *a priori* ambiguous effects on commercial bank balance sheets. On the negative side, falling bond prices would inflict losses if bonds are sold or lead to an accumulation of unrealised losses which could flow through to capital.¹ Net interest income may also deteriorate initially if returns on assets are fixed for longer than interest paid on liabilities, implying a slow adjustment of long-term bond portfolios, and thus affect capital via potentially lower retained earnings.² In addition, if the interest rate increases are driven by negative shocks, such as higher uncertainty about monetary and fiscal policies, the inflation outlook or spillovers from abroad, banks could be negatively affected by falling equity prices and business activity.³ In contrast, if the interest rate increases reflect improvements in economic prospects, banks could benefit from higher stock prices and more business activity. Thus, to fully analyse the impact of higher bond yields on banks it is necessary to account for the size, structure and maturity of total bank balance sheets and the extent of hedging in a specific macroeconomic scenario. This box, however, reports a limited and illustrative analysis by looking only at the direct impact of a fall in government bond prices.

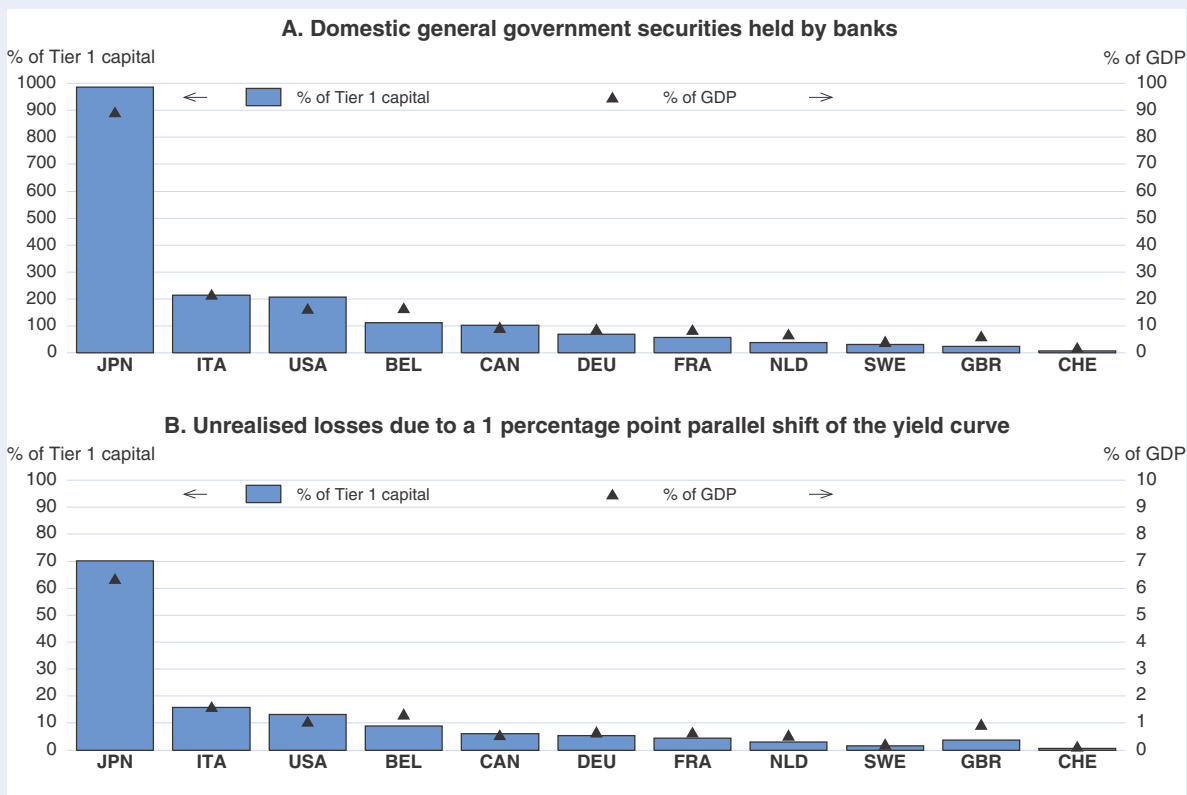
Unrealised losses of banks due to an increase in government bond yields will increase with the amount of bonds held in the trading book and their maturity. To illustrate the potential scope for such losses, stylised calculations for aggregated banking systems in selected OECD countries are made. They use data on the total banking sector holdings of domestic general government securities, which vary significantly across the analysed countries and are particularly high in Japan – almost 1000% of Tier 1 capital (see figure below). It is assumed that all these bonds are in the trading book – and therefore marked to market – and that the maturity structure is the same as that of outstanding central government debt, and that bond yields increase by 1 percentage point across the yield curve. In practice, not all bonds would be marked to market and banks could keep bonds with shorter maturities, but loss estimates based on these assumptions give an upper limit and can be a useful benchmark. Assuming a smaller share of bonds in the trading account and lower average maturity would result in proportionally smaller losses. Similarly, losses would be smaller if the yield curve steepened with the increase in bond yields at the longer end limited to 1 percentage point. Steepening of the yield curve is likely when central banks start to reduce the scale of their asset purchase programmes.

The results suggest that, for most of the countries covered, the capital losses due to a 1-percentage point parallel upward shift of the yield curve are small (see figure below). Japan appears a notable exception, with Japanese banks incurring losses corresponding to 70% of Tier 1 capital, but this is likely to be an overestimation given the simplifying assumptions. For example, the Bank of Japan (2013) estimates – based on disaggregated data – that with the same shock, Japanese banks would incur unrealised losses of 6 trillion yen, i.e. only one-fifth of the above estimate.⁴ This may be partly due to the fact that the average maturity of bonds held by large and regional banks in Japan are around 2.5 and 4 years, respectively, while the average maturity of the Japanese central government's outstanding ordinary bonds is 7.3 years,⁵ and that not all bond holdings are marked to market.

However, banks could be hit harder if increases in bond yields are larger and take place in the context of subdued economic growth and declines in corporate bond prices. In addition, it cannot be excluded that some individual banks could be severely affected, given the heterogeneity in exposure to sovereign bonds among banks.


Box 1.5. The impact of government bond yield increases on banks (cont.)

The impact of government bond yield increases on banks' balance sheets



Note: The lower figure is based on stylised calculations assuming that all government bonds are marked to market and that the maturity structure of banks' bond holdings is identical to that of outstanding central government debt. As discussed in the text, banks in Japan hold government bonds with a shorter maturity than the average for outstanding bonds, which significantly reduces the impact of interest rate increases.

Source: Bank of Canada; Bank of Japan; Bloomberg; European Central Bank; Federal Reserve Board; IMF; Swiss National Bank; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888932947808>

1. Bonds classified as ready for sale are subject to mark-to-market accounting. Thus, bond yield increases generate unrealised losses, which under the Basel III regulation lower common equity Tier 1 capital. Not all banks are currently subject to this accounting requirement. Bonds held to maturity (recorded in the banking book) are not marked to market.
2. The implications may vary, however, with the pass-through of market interest rates to interest earned on assets and to the cost of funding and with the structure of assets and liabilities. For instance, if deposits, which are often less responsive to changes in market interest rates, are the primary source of bank funding and most assets are at floating interest rates, then net interest income could improve with rising interest rates.
3. The impact on banks' balance sheets will be affected by the degree of their off-balance sheet activities to hedge, or also to take, interest rate risk via derivatives, including with counterparties outside the banking sector.
4. Even with a parallel upward shift of the yield curve by 3 percentage points, unrealised losses would be 15.3 trillion yen, i.e. around 35% of Tier I capital of large and regional banks.
5. Assuming the average maturity of bonds to be 4 years, unrealised losses in the stylised calculations would almost halve.

pursuing their mandate. This may complicate the eventual exit from the ultra-accommodative monetary policy stance. If the monetary authorities are worried about sharp market reactions to the scaling down of support, they may be inclined to delay the normalisation of monetary policy, even if tighter policy would be appropriate for stabilisation purposes and in line

with previous conditional announcements. This would come at the cost of higher inflation of goods, services and assets prices, and necessitate a subsequent more rapid increase in policy interest rates.

Fiscal policy

The overall pace of fiscal consolidation is slowing gradually

The overall pace of fiscal consolidation in the OECD is slowing gradually. After consolidation of a little over 1% of GDP in 2013, the area-wide OECD underlying primary deficit is expected to fall by a bit more than $\frac{3}{4}$ per cent of GDP in both 2014 and 2015 (Table 1.5). The rise in public indebtedness that had accelerated with the financial and economic crisis will come to a stop by the end of the projection period. On current plans, by end-2014, fiscal positions in a large group of OECD countries will have improved to such an extent that an additional tightening of only 1% of GDP or less will be needed to reduce public debt to 60% of GDP by 2030, though much bigger consolidation will be required in some of the larger countries and some euro area programme countries (OECD, 2013b).

Table 1.5. **Fiscal positions will continue to improve**
Per cent of GDP / Potential GDP


	2011	2012	2013	2014	2015
United States					
Actual balance	-10.7	-9.3	-6.5	-5.8	-4.6
Underlying balance	-9.0	-8.1	-5.5	-5.0	-4.1
Underlying primary balance	-6.0	-5.1	-3.1	-2.1	-1.1
Gross financial liabilities	98.8	102.1	104.1	106.3	106.5
Euro area					
Actual balance	-4.1	-3.7	-2.9	-2.5	-1.8
Underlying balance	-3.5	-2.1	-1.1	-0.6	-0.1
Underlying primary balance	-0.9	0.4	1.4	1.9	2.4
Gross financial liabilities	95.8	104.3	106.4	107.1	106.8
Japan					
Actual balance	-8.9	-9.5	-10.0	-8.5	-6.8
Underlying balance	-7.8	-8.6	-9.4	-8.2	-6.5
Underlying primary balance	-7.0	-7.8	-8.4	-6.8	-4.7
Gross financial liabilities	210.6	218.8	227.2	231.9	235.4
OECD¹					
Actual balance ¹	-6.6	-5.9	-4.8	-4.0	-3.2
Underlying balance ²	-6.0	-5.3	-4.0	-3.5	-2.7
Underlying primary balance ²	-3.8	-3.1	-2.1	-1.3	-0.5
Gross financial liabilities ²	102.5	107.4	110.3	111.8	112.0

Note: Actual balances and liabilities are in per cent of nominal GDP. Underlying balances are in per cent of potential GDP and they refer to fiscal balances adjusted for the cycle and for one-offs. Underlying primary balance is the underlying balance excluding net debt interest payments.

1. Excludes Chile and Mexico.

2. Excludes Chile, Mexico and Turkey.

Source: OECD Economic Outlook 94 database.

StatLink  <http://dx.doi.org/10.1787/888932949138>

In the United States, fiscal consolidation should be at a moderate pace

In the United States, a substantial turnaround in the short-run budget situation has occurred, attributable to higher taxes on the wealthy and on payrolls enacted in January, sweeping spending cuts, dividends from the

public housing finance corporations and the steady, though still moderate, economic recovery delivering more revenue to the government. The long-run budget situation has also improved, largely on account of health spending rising more slowly than previously expected, but it remains of concern. The gridlocked political situation has been unable to deliver reforms that would adequately cut the long-term cost of big social safety net programmes such as Medicare and Social Security, as well as secure the additional revenues that a long-term fiscal solution should include. Indeed, the improvement in the budget position may have reduced the immediate pressure to tackle the solvency of entitlement programmes. The projections assume that the 2014 draft budget is implemented. With spending sequestration biting in full, as well as some tax increases, fiscal tightening is estimated at around 1% of GDP in both 2014 and 2015. This slowdown in the pace of fiscal tightening – from an estimated 2% of GDP in 2013²¹ – is appropriate. A medium-term roadmap is needed to restore long-run fiscal sustainability and give policy makers greater flexibility in adjusting near-term consolidation (notably that due to sequestration) to better suit the needs of the economy without risking adverse consequences in financial markets. Consideration should also be given to legal reforms that would reduce the occurrence of brinkmanship over government borrowing, preferably by dropping the nominal debt ceiling entirely.

Japan is embarking on a rapid fiscal consolidation path next year

In Japan, the underlying primary deficit will fall by about 1½ per cent in 2014 and 2% of GDP in 2015, but public debt remains on an unsustainable path. Hence, the announced increase in the consumption tax rate to 8% in April 2014 is just the first step toward achieving fiscal sustainability and should be followed by the second increase, to 10%, in 2015. A fiscal package, expected to amount to around 1% of GDP, will accompany the 2014 tax change to offset its immediate negative impact on activity. Around one-third of this will comprise tax cuts and the rest additional spending. The government plans to finance the package without new bond issuance. To bring maximum benefits, the stimulus package should be focused on one-time measures with high fiscal multiplier effects, while avoiding permanent measures that would limit progress on fiscal consolidation. In addition to the fiscal package, Japan will cut taxes by 1 trillion yen. The government approved a new medium-term fiscal plan in August, which confirmed that it aims to halve the primary budget deficit (relative to GDP) of central and local governments from an estimated 6.6% in FY 2010 to 3.3% in FY 2015 and achieve balance by FY 2020, and thereafter steadily reduce the public debt ratio. With some 3½ percentage points of GDP in consolidation over the next two years, the 2015 objective can be met only if fiscal tightening has a small adverse effect on activity. This is far from granted given the large estimated fiscal multipliers for permanent consolidation measures in Japan (Barrell et

21. This estimate is not adjusted for the impact of the shifting of income into 2012 in anticipation of tax rate changes that occurred at the beginning of 2013. This may have increased government revenue in 2013 (when the taxes due were paid), as well as the change in the underlying primary balance used to assess fiscal tightening, by approximately 0.4% of GDP.

al., 2012). A more detailed roadmap is essential to underpin the credibility of the plan to achieve the 2020 objective and sustain confidence in Japan's public finances. Such a roadmap should include social security reforms to limit spending increases, particularly in the areas of health and long-term care, as well as revenue increases.

In the euro area, the pace of fiscal consolidation will slow markedly

In the euro area, after structural fiscal consolidation of 1% of GDP in 2013, the pace of fiscal tightening is set to slow. With a neutral fiscal stance in Germany, and with Italy, France and Spain all planning to slow the pace of efforts in 2014 and 2015 relative to this year, area-wide consolidation is expected to amount to ½ percentage point of GDP in 2014 and the same in 2015. Greece, Portugal and Ireland are likewise projected to gradually relax their budget consolidation efforts. Given the progress already made and the still-weak economy, a slowdown in the pace of fiscal adjustment is appropriate. The automatic stabilisers should be allowed to operate fully around the slower structural consolidation paths, but euro area governments should also avoid relaxing fiscal adjustment efforts relative to the structural commitments they have made if there are positive growth surprises or reduced financial market pressure. These commitments and the various EU fiscal rules will require sustained consolidation efforts even beyond the projection horizon in many euro area countries (Box 1.6). Further debt relief may also need to be considered where public debt proves to be on an unsustainable path.

Box 1.6. Fiscal consolidation needed after 2015 under the EU fiscal rules

Despite considerable progress on needed fiscal consolidation over the past few years in EU countries, and additional fiscal tightening over 2014 and 2015 of around 1% of GDP in the euro area, the existing set of EU fiscal rules will require additional budgetary efforts beyond the short-term projection horizon that ends in 2015. This box updates estimates, first presented in the May 2012 *OECD Economic Outlook* and detailed in Barnes et al. (2012), of the amount of fiscal consolidation that EU fiscal rules introduced by recent reforms strengthening the Stability and Growth Pact (the “six-pack” and the “two pack”) and the Treaty on Stability Coordination and Governance (the “fiscal compact”) imply beyond 2015. The update uses the current set of short-term projections which are then extended into the medium-term following the usual methodology for long-term scenarios presented in Johansson et al. (2013).¹ For the short-term projection horizon up to 2015, fiscal projections are based on current budget and medium-term plans (see Box 1.2). Beyond 2015, the required amount of fiscal consolidation is computed for various fiscal rules. The most restrictive rule (i.e., the one requiring the largest fiscal consolidation) is considered to be binding in that year and the overall amount of fiscal consolidation required over the medium term is then computed from the resulting “most restrictive” path. After 2015, a country's short term interest rate is assumed to continue normalising towards a neutral rate that depends on the country's or area's potential growth rate and inflation target, as well as the country's external debt and fiscal positions.

1. See also Box 4.1 of OECD (2013b).

Box 1.6. Fiscal consolidation needed after 2015 under the EU fiscal rules (cont.)

Three fiscal rules are considered for the period 2016 to 2023:

- *The Excessive Deficit Procedure (EDP)*. It stipulates that the headline deficit should be reduced to below 3% of GDP. Because the exact amount of fiscal consolidation under the EDP is not specified, it is assumed that if the deficit is above the 3% threshold, the structural budget balance in the following year is reduced by ½ per cent of potential GDP.
- *The debt convergence rule*. It requires a debt-to-GDP ratio (Maastricht definition) exceeding 60% of GDP to be reduced over three years at an average rate of 1/20th of the excess over 60% of GDP. The required debt reduction is calculated using the European Commission guidelines. For countries that are currently in the EDP, the rule will start applying after a transition period of three years after closure of the EDP. During this transition period, the debt ratio has to decline at a sufficient pace, approximated here by a constant adjustment of the underlying balance with maximum structural adjustment of ¾ per cent of GDP per year, over the three years.
- *The Medium-term Objective (MTO)* for the structural balance agreed for each country in the context of the Stability and Convergence Programme (SCP). Unless the MTO is already met, countries are assumed to move towards it by consolidating at the annual rate of ½ per cent of potential GDP. MTOs are set at levels agreed in 2013 the SCPs and they are assumed not to vary over the simulation period.

Some important caveats apply and the simulation results should only be treated as indicative. The simulation assumes that countries follow the rules exactly. This may be too mechanistic an assumption given the past experience of over- or under-performance. The results are also sensitive to the interest rate and GDP growth projections and to the assumption that these are independent of fiscal policy. It is assumed that the MTOs remain unchanged throughout the simulation, but they could be revised and imply faster fiscal consolidation. Finally, due to differences in output gap estimates, automatic stabilisers and one-offs, the assessment of structural balances may differ from the official EU estimates.

Keeping these caveats in mind, the following conclusions can be drawn as to which of the EU fiscal rules are likely to be binding in OECD-EU countries² (see Table):

- Current EDP procedures are projected to be closed on time with the exception of Ireland, Spain and Portugal where deadlines for EDP correction will likely have to be extended by one year, and Poland, where it will likely have to be extended by a few years, the large 2014 fiscal surplus related to a one-off transfer of pension assets notwithstanding.
- In France, Greece, the Netherlands, Portugal and Slovenia, the debt rule, or its transition version, is expected to be binding after EDP procedures are closed, but in some cases (the Netherlands, France and Slovenia) only over a short period due to the fact that the structural balances consistent with these rules are very close to those implied by the countries' MTOs.
- The debt rule is also binding in Italy before the MTO is reached in 2018. Despite a high debt level, the primary balance is projected to reach 3½ per cent of GDP in 2015, sufficient to put the debt ratio on a fairly steep downward trajectory.
- In Finland, between 2018 and 2023, maintaining the structural balance as required by the MTO rule results in breaching the 60% gross debt ceiling and activation of the debt rule.

One way to assess the fiscal effort that EU fiscal rules will demand is to look the amount of fiscal consolidation necessary to meet them. In 11 out of the 20 OECD economies covered by EU fiscal rules, the required improvement in the underlying primary balance between 2014 and 2023 is less than 1% of potential GDP, with some even afforded a slight fiscal loosening. For the euro zone countries, the aggregate required improvement is 0.7% of potential GDP. However, Spain, Portugal, Ireland and Greece would have to strengthen their underlying fiscal position by up to 4% of GDP (see Figure, panel A).


2. By virtue of Protocol 15 on certain provisions relating to the United Kingdom annexed to the Treaty on the Functioning of the European Union (TFEU), numerical fiscal rules and the EDP reference values on the deficit and the debt do not apply to the United Kingdom.

Box 1.6. **Fiscal consolidation needed after 2015 under the EU fiscal rules (cont.)****Binding fiscal rules over the medium term**

	Current deadline for EDP correction	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Austria	2013	..	..	..	..	..	debt	=	=	=	=	=	=	=
Belgium	2013	3%	3%	..	..	..	=	=	=	=	=	=	=	=
Estonia	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Finland	..	..	..	..	..	..	debt	=	debt	debt	debt	debt	debt	debt
France	2015	3%	3%	3%	3%	..	trans.	=	=	=	=	=	=	=
Germany	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Greece	2016	3%	3%	..	..	..	trans.	debt	debt	=	=	=	=	=
Ireland	2015	3%	3%	3%	3%	3%	3%	=	=	=	=	=	=	=
Italy	..	3%	..	..	..	..	debt	debt	=	=	=	=	=	=
Luxembourg	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Netherlands	2014	3%	3%	3%	3%	..	trans.	trans.	=	=	=	=	=	=
Portugal	2015	3%	3%	3%	3%	3%	3%	trans.	trans.	trans.	debt	debt	=	=
Slovak Rep.	2013	3%	3%	..	..	..	->MTO	->MTO	=	=	=	=	=	=
Slovenia	2015	3%	3%	3%	3%	..	trans.	trans.	=	=	=	=	=	=
Spain	2016	3%	3%	3%	3%	3%	3%	3%	=	=	=	=	=	=
Czech Rep.	2013	3%	3%	..	..	..	->MTO	->MTO	=	=	=	=	=	=
Denmark	2013	..	3%	..	..	..	->MTO	=	=	=	=	=	=	=
Hungary	..	..	..	..	..	..	debt	=	=	=	=	=	=	=
Poland	2014	3%	3%	3%	3%	3%	3%	debt	=	=	=	=	=	=
Sweden	..	..	..	..	..	..	=	=	=	=	=	=	=	=

Notes: "3%" is the 3% deficit ceiling rule under the current EDP; "trans." is the transition rule; "debt" is the debt convergence rule; "->MTO" stands for the transition to MTO; "=" denotes that the MTO is reached and maintained. Calculations start in 2016, following the end of the short-term projection horizon.

Source: OECD calculations.

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Although the medium-term fiscal headwinds post-2013 appear moderate, mainly a result of the very large fiscal consolidation effort already accomplished, the difficulties of maintaining high structural primary balances over an extended period should not be under-estimated. In Greece, Portugal and Italy for instance, partly because of high debt levels, the fiscal rules imply maintaining an average underlying primary surplus of more than 5% of GDP between 2014 and 2023. Ireland, Spain, Belgium, Hungary, Slovenia and France could all need to have an average underlying primary surplus of 2% of GDP or more during this period. Except for Belgium and Ireland, the other countries have never had such high underlying primary surpluses in any 5-year period between 1987 and 2009 (see Figure, panel B). The difference between the highest underlying primary balance sustained in the recent past and that required by the EU fiscal rules is also large in the Czech Republic.

Box 1.6. Fiscal consolidation needed after 2015 under the EU fiscal rules (cont.)

Fiscal policy stance under the EU fiscal rules

In per cent of potential GDP



1. Past effort refers to biggest one or multi-year consolidation between 1987 and 2009 (depending on data availability).

2. Past level refers to the country-specific 5-year period between 1987 and 2009 (again, depending on data availability) with the highest average underlying budget balance.

Source: OECD Economic Outlook 94 database; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888932947827>

The United Kingdom must continue on the path of deficit reduction

The United Kingdom is planning about 1¼ per cent of GDP in structural budget consolidation over the next two years, which is appropriate given the still-large fiscal deficit (nearly 7% of GDP in 2013) and the need to retain market confidence. The announced reprioritisation of spending towards public investment is also welcome, as cuts in infrastructure and other public capital spending can weaken longer-term growth prospects. The recently established government “Help to Buy” property programme needs to be carefully monitored, as planned, and swiftly adjusted if it risks triggering sharp increases in house prices as a result of supply rigidities.

China may have exhausted room for significant fiscal stimulus

In China, after the economy slowed markedly at the turn of the year, the government shifted its focus to supporting activity to meet its 7.5% growth objective for this year. In July, the State Council announced a small fiscal stimulus package,²² which is consistent with the stated objective of developing the role of the market and improving the supply side of the economy. The combined deficit of the national government and social security is set to narrow somewhat from 0.9% to about 0.6% of GDP in 2014, though it would be higher if it included local governments and, as in the case of public-sector liabilities, much higher if it included various off-budget vehicles. Taking into account various off-budget forms of debt, the latest *OECD Economic Survey of China* (OECD, 2013c) placed total public debt at 57% of GDP at the end of 2010, still relatively low, but the concern is less about the level than the recent rate of increase. A broad accounting of the public sector’s fiscal position thus suggests that much of the scope for countercyclical fiscal policy may have been used already. It also raises concerns in view of the potential fiscal cost of any eventual credit crisis. The government’s fiscal position, as well as its ability to boost social spending and hence consumption, could be strengthened by not allowing funds from profitable state-owned enterprises to subsidise loss-making companies but instead transferring increased dividends to the general budget.

Fiscal policy in other EMEs must contend with portfolio capital outflows

Fiscal policy requirements differ across other EMEs. The appropriate fiscal policy response in countries faced with portfolio capital outflows depends on policy credibility and initial fiscal positions, which vary across economies:

India needs more progress on budgetary consolidation...

- India’s central government has a fiscal consolidation roadmap but the economic slowdown, the higher cost of oil subsidies following the rupee depreciation and newly adopted costly measures mean that progress recently has been limited. Given the large fiscal deficit (about 7% of GDP this year for general government), and the need to strengthen confidence in economic management in view of the sharp depreciation

22. The measures suspend taxes on small businesses, reduce fees and administrative burdens for exporters, and promote new funding sources for railway construction. The announcement did not stipulate the additional amounts to be spent.

of the currency, more rapid progress on the fiscal consolidation roadmap may be necessary, even as monetary policy is also tightened.

... Brazil should scale back fiscal stimulus...

- With economic activity in Brazil unexpectedly weak, fiscal policy has been providing support via automatic stabilisers and also discretionary measures, including tax exemptions and credit provision by public-sector banks. Moreover, the use of substantial quasi-fiscal operations suggests that the actual fiscal stance may be looser than suggested by the primary surplus alone. The stimulus measures should be scaled back as the economy recovers and the clarity of fiscal accounts should be preserved by avoiding exemptions from the primary surplus definition and quasi-fiscal operations involving public enterprises.

... and Russia does not need further fiscal stimulus

- In Russia, the government approved a stimulus package in July, using money from the National Welfare Fund (now worth 4.3% of GDP) for investment in infrastructure projects and support to bank lending programmes for small businesses. No additional stimulus is warranted. Rather, fiscal policy should be tightened gradually in line with the fiscal rule, while the prioritisation and the efficiency of public spending should be improved.

The policy mix in Indonesia leaves the fiscal stance mildly expansionary

- In Indonesia, savings from the reduction in government fuel subsidies are being offset by the compensation package to low-income earners and recent stimulus measures, leaving the fiscal policy stance mildly expansionary at present. Despite low and sustainable public debt, further loosening next year is not warranted, given high inflation and the sizeable external deficit.

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ANNEX 1.1

Indicators of potential financial vulnerabilities

The following table and set of diamond charts show the position of OECD and non-OECD countries on a number of indicators that could reveal potential exposure to financial turbulence. The main focus of the table is on domestic vulnerabilities of OECD and BRIICS countries, that of the diamonds on financial account vulnerabilities of OECD and non-OECD G20 countries.

The **table** presents indicators typically associated with financial vulnerabilities (*e.g.* International Monetary Fund, 2012; European Commission, 2012) arising primarily from the domestic economy in four broad categories: the real economy, the non-financial sector, the financial sector and the public finances. Possible weaknesses to the real economy are captured by the difference between the potential and the actual GDP growth rate, the difference between the actual unemployment rate and the natural rate of unemployment (or NAIRU), the current account deficit and the evolution of relative unit labour costs. Indicators of financial market excesses related to the non-financial sector are household debt, non-financial corporations' debt and house price growth. Non-performing loans, financial corporations' debt and core Tier-1 capital additions required to reach 5% (without any normative implications) of total assets in each of the country's selected banks are included to account for the direct risk exposure of the financial sector. The calculations of the core Tier-1 capital additions are based on over 1200 commercial banks, including 915 in the United States, 197 in the OECD euro area countries, 23 in the United Kingdom, 11 in Canada and 7 in Japan. Vulnerabilities stemming from the public sector are quantified along three dimensions: government net borrowing, gross government debt and the difference between 10-year sovereign bond yields in real terms and the potential GDP growth rate.

The four OECD countries with the weakest scores are labelled in dark grey, the four OECD countries with the next weakest scores in light grey. Higher values generally indicate a larger vulnerability. The table also includes the current sovereign credit ratings issued by Standard and Poor's.

The **diamond charts** (an updated version of Ahrend and Valdivia, 2012) display financial-accounts-related risk factors to financial stability based on previous OECD empirical analysis (Ahrend and Goujard, 2012a, 2012b) covering OECD and emerging market economies over the past three decades. This shows that a bias in gross external liabilities towards debt, in particular bank debt, substantially increases the risk of financial crises (bank debt being defined as debt to a foreign bank). In contrast, a larger share of FDI in gross external liabilities decreases such risk. Shorter banking debt maturities have also been found to increase crisis risk, mainly by increasing exposure to financial contagion. The size of reserve holdings appears to reduce the probability of crises, whereas neither external assets (excluding reserves) nor liabilities as a share of GDP are found to influence crisis risk, except when they are exceptionally large.

The diamonds show: i) the position of each country in the first quarter of 2013 (or the latest available) along various dimensions of its financial account structure relative to the OECD median, and ii) the country-specific change, from 2007 to the beginning of 2013, on each dimension relative to the 2007 OECD

median (for simplicity and without any normative implications). Indicators are measured in multiples of the standard deviation across countries for the variable in question. Larger values indicate a financial account structure that presents a larger risk to financial stability compared with the OECD median.

The main highlights emerging from the analysis include:

- Countries with a large financial sector – as, for example, proxied by the size of financial corporations' gross debt relative to GDP in the table – tend to exhibit the largest financial-accounts-related risk factors to financial stability (in the diamonds). These include Denmark, Luxembourg, the Netherlands, Switzerland and the United Kingdom.
- The euro area programme countries tend to perform weakly across a broad range of indicators in both the table and the diamonds. Based on the table (which mainly focuses on domestic indicators), the least vulnerable OECD countries include Austria, Estonia, Finland, Germany, Israel and the Slovak Republic.
- According to the table, countries which are generally perceived as vulnerable score weakly on some indicators, *e.g.* Italy (low growth, non-performing loans, public debt, bond yields), Slovenia (low growth, non-performing loans, bond yields), Spain (high unemployment, government net borrowing, bond yields). Although Italy, Slovenia and Spain do not stand out particularly in the diamonds, their external liabilities exhibit a systematic debt bias (above the OECD median).
- There are indications that some OECD countries (Australia, Canada, New Zealand, Norway and Sweden) which have suffered relatively little from the global financial and euro area crises are exposed to vulnerabilities stemming from the non-financial sector (most or all from household debt, house prices and relative unit labour costs). On the other hand, their financial sector does not appear to exhibit significant external vulnerability, as evidenced by the diamonds.
- Overall, the diamonds suggest only modest increases in external financial stability risks for non-OECD G20 countries since 2007. The general exception to this pattern is a relatively short maturity of their external bank debt which has become more pronounced since 2007, possibly related to increased inflows of foreign capital, raising the risk of rapid outflows.

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Table A1a. Indicators of potential financial vulnerabilities

	Real economy				Non-financial sector		
	Potential GDP growth rate-actual GDP growth rate differential	Actual unemployment rate-NAIRU differential	Current account deficit ¹	Relative unit labour cost	Household gross debt ^{2,3}	Non-financial corporation gross debt ^{1,3}	Real house prices
	2012	2013 Q2 ⁵	2012	% change 2000Q1-13Q2	2012 ⁶	2012 ⁶	% change 2000Q1-13Q2
United States	-0.8	1.4	2.7	-25.9	111.0	106.6	11.9
Japan	-1.2	-0.3	-1.1	-46.2	134.6	164.7	-30.2
Germany	0.3	-1.1	-7.1	-14.6	93.2	72.7	-5.1
France	1.2	1.3	2.2	5.2	107.8	106.2	76.5
Italy	2.2	2.6	0.6	14.2	81.6	94.5	19.5
United Kingdom	0.8	0.9	3.8	-20.4	151.5	91.5	57.2
Canada	0.2	-0.1	3.4	48.0	168.8	140.4	86.5
Australia	-0.6	0.4	3.7	54.1	184.9	77.5	79.4
Austria	1.1	0.4	-1.6	-1.9	92.8	101.1	19.2
Belgium	1.5	0.7	2.0	10.5	98.2	99.0	63.4
Chile	-0.8	-2.7	3.5	25.6	73.2	131.4	..
Czech Republic	2.2	0.8	2.4	42.2	66.6	64.8	..
Denmark	1.0	1.1	-5.9	13.1	321.1	112.3	23.4
Estonia	-1.6	-2.0	1.8	33.4	91.5	103.9	..
Finland	1.8	0.8	1.9	3.7	122.8	101.7	31.9
Greece	5.3	12.1	3.4	-6.8	109.7	73.8	-1.5
Hungary	1.7	0.2	-0.9	29.8	62.6	112.1	..
Iceland	-0.6	0.5	5.5	-21.1	98.7	357.2	..
Ireland	1.1	3.2	-4.4	13.6	230.4	248.6	-10.4
Israel	0.7	-0.6	-0.1	-18.0	..	74.3	25.2
Korea	1.7	-0.2	-3.8	-4.5	163.8	163.7	25.1
Luxembourg	2.2	1.3	-6.6	29.0	153.3	318.9	..
Mexico	-0.8	0.3	1.2	3.5	..	..	..
Netherlands	2.0	2.7	-9.4	6.5	311.5	107.4	-2.8
New Zealand	-1.3	0.0	4.7	51.6	..	..	87.6
Norway ⁹	-1.1	0.1	-14.2	58.8	212.9	104.5	85.7
Poland	1.0	0.6	3.7	-8.7	58.9	53.7	..
Portugal	3.1	5.0	1.5	0.5	146.3	157.6	-10.3
Slovak Republic	1.7	-0.2	-2.3	28.3	54.9	77.7	..
Slovenia	2.8	2.8	-3.3	0.4	57.8	105.8	..
Spain	2.2	5.0	1.1	2.4	141.1	124.6	23.3
Sweden	0.9	1.0	-6.0	-5.7	172.0	151.5	77.9
Switzerland	0.8	0.5	-11.1	25.4	200.8	..	42.2
Turkey	3.0	-0.1	6.0	-17.1	..	3.1	..
Brazil	2.4	..	2.4	30.6	..	..	..
China	0.7	..	-2.4	92.0	..	..	..
India	2.5	..	5.0	-39.9	..	..	..
Indonesia	-0.2	..	2.8	2.6	..	..	..
Russian Federation	-0.3	..	-3.6	204.4	..	..	..
South Africa	0.8	..	6.3	-13.7	..	..	..

1. In per cent of GDP.

2. In per cent of gross household disposable income.

3. Consolidated for most countries and not consolidated otherwise; and defined as liabilities less financial derivatives and shares and other equity.

4. Long-term foreign currency rating.

5. Economic Outlook 94 estimates for Mexico and Turkey.

6. Or latest available.

7. Economic Outlook 94 estimates for Japan, Israel, Korea, Mexico, New Zealand, Japan, Indonesia and Russian Federation.

8. Economic Outlook 94 estimates for Japan, Korea, Japan and Switzerland.

9. Mainland (potential) GDP is used instead of total (potential) GDP where applicable.

■ Labels the 4 OECD countries with the weakest scores.

■ Labels the 4 OECD countries with the next weakest scores.

Source: OECD Economic Outlook 94 database; OECD National Accounts database; IMF Financial Soundness Indicators database; European Central Bank; European Commission; OECD Housing Prices database; OECD calculations; and Standard & Poor's.

Table A1b. Indicators of potential financial vulnerabilities (cont'd)

Financial sector			Public finance			Sovereign credit rating S&P ⁴	Country
Core Tier-1 capital required to reach 5% of assets in selected banks ¹	Non-performing loans to total loans	Financial corporation gross debt ^{1,3}	Headline government budget deficit ¹	Gross government debt ¹	Real 10-year sovereign bond yield-potential GDP growth rate differential		
Latest available	Latest available	2012 ⁶	2012 ⁷	2012 ⁸	2013Q3 ⁶	Latest	
0.6	3.2	328.2	9.3	102.1	-1.1	AA+	United States
0.3	2.3	553.5	9.5	218.8	0.9	AA-	Japan
3.9	3.0	331.1	-0.1	88.3	-1.2	AAA	Germany
7.1	4.3	286.1	4.8	109.3	-0.4	AA	France
0.3	12.9	214.3	2.9	142.2	3.2	BBB	Italy
4.6	3.7	714.7	6.2	102.4	-0.4	AAA	United Kingdom
3.2	0.6	328.9	3.4	96.1	-1.5	AAA	Canada
..	1.6	318.7	3.5	32.4	-0.1	AAA	Australia
0.3	2.8	248.5	2.5	85.6	-1.4	AA+	Austria
1.9	3.5	314.4	4.1	104.0	-0.4	AA	Belgium
..	2.2	195.8	..	..	-1.7	AA-	Chile
..	5.2	127.1	4.4	55.7	0.2	AA-	Czech Republic
0.5	4.7	461.0	3.9	59.3	-0.4	AAA	Denmark
..	2.1	119.0	0.2	13.6	..	AA-	Estonia
4.7	..	250.2	2.2	64.0	-1.5	AAA	Finland
1.1	27.9	212.7	9.0	167.3	11.6	B-	Greece
..	16.8	106.3	2.1	90.1	2.8	BB	Hungary
..	..	1 024.7	3.8	129.6	1.2	BBB-	Iceland
1.9	21.7	1 010.3	8.1	127.5	1.9	BBB+	Ireland
..	2.6	211.4	4.9	68.2	-2.8	A+	Israel
..	0.7	383.1	-1.7	35.5	-1.8	A+	Korea
..	0.3	5 152.5	0.6	30.2	-3.4	AAA	Luxembourg
..	2.6	..	-0.1	..	-0.6	BBB	Mexico
4.5	3.0	703.3	4.0	82.7	0.1	AAA	Netherlands
..	..	..	3.9	42.6	1.0	AA	New Zealand
..	1.5	208.3	-13.8	34.4	-3.5	AAA	Norway ⁹
..	5.2	100.6	3.9	62.4	-0.8	A-	Poland
0.0	10.4	276.8	6.5	134.5	6.8	BB	Portugal
..	5.3	119.7	4.5	56.9	-1.2	A	Slovak Republic
..	17.4	144.0	3.8	61.6	5.7	A-	Slovenia
1.8	7.6	244.6	10.6	92.8	3.4	BBB-	Spain
0.5	0.7	283.8	0.4	48.8	-0.9	AAA	Sweden
..	0.8	..	0.2	42.4	-1.2	AAA	Switzerland
..	2.6	99.7	..	..	-3.0	BB+	Turkey
..	3.2	..	2.5	..	1.0	BBB	Brazil
..	1.0	..	0.3	..	-7.4	AA-	China
..	3.6	..	7.6	..	-5.5	BBB-	India
..	1.8	..	2.0	..	-5.4	BB+	Indonesia
..	6.3	..	-0.4	..	-5.8	BBB	Russian Federation
..	3.9	..	6.2	..	-1.6	BBB	South Africa

1. In per cent of GDP.

2. In per cent of gross household disposable income.

3. Consolidated for most countries and not consolidated otherwise; and defined as liabilities less financial derivatives and shares and other equity.

4. Long-term foreign currency rating.

5. Economic Outlook 94 estimates for Mexico and Turkey.

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7. Economic Outlook 94 estimates for Japan, Israel, Korea, Mexico, New Zealand, Japan, Indonesia and Russian Federation.

8. Economic Outlook 94 estimates for Japan, Korea, Japan and Switzerland.

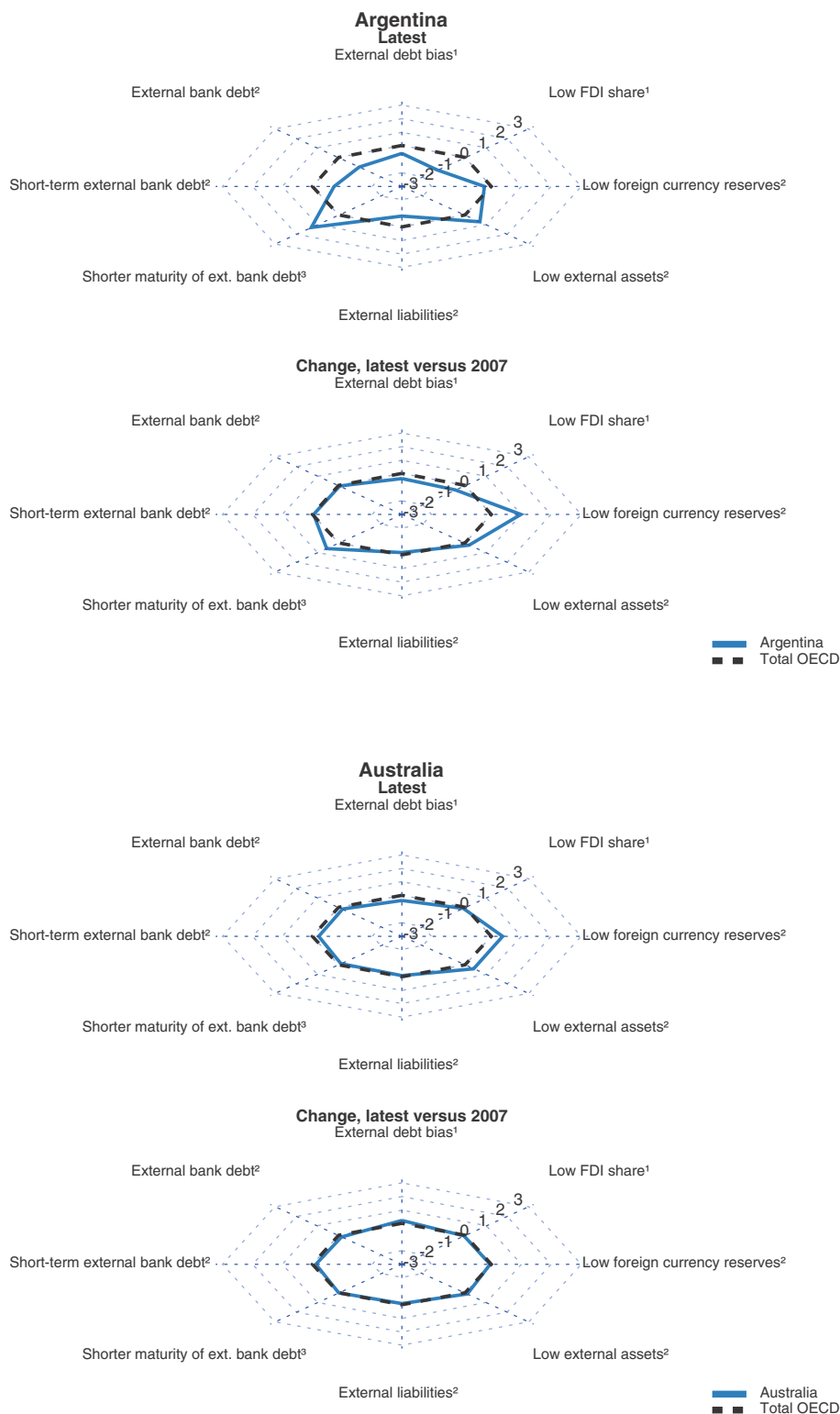
9. Mainland (potential) GDP is used instead of total (potential) GDP where applicable.

■ Labels the 4 OECD countries with the weakest scores.

■ Labels the 4 OECD countries with the next weakest scores.

Source: OECD Economic Outlook 94 database; OECD National Accounts database; IMF Financial Soundness Indicators database; European Central Bank; European Commission; OECD Housing Prices database; OECD calculations; and Standard & Poor's.


Financial-accounts-related risk factors to financial stability

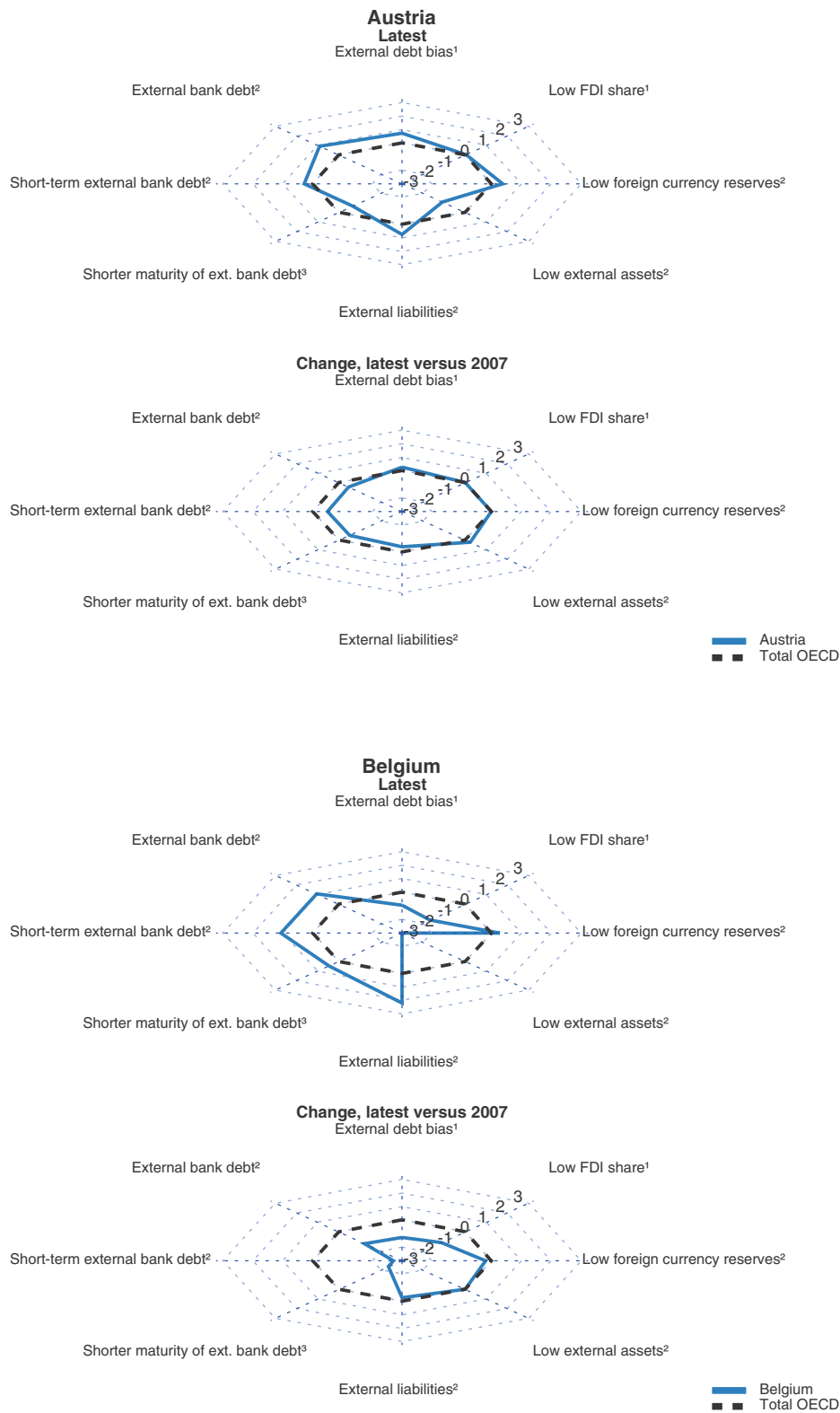


Note: The diamond charts are explained in the introduction to the annex.

(1) As a per cent of external liabilities. (2) As a per cent of GDP. (3) As a per cent of external bank debt.

Source: OECD calculations.

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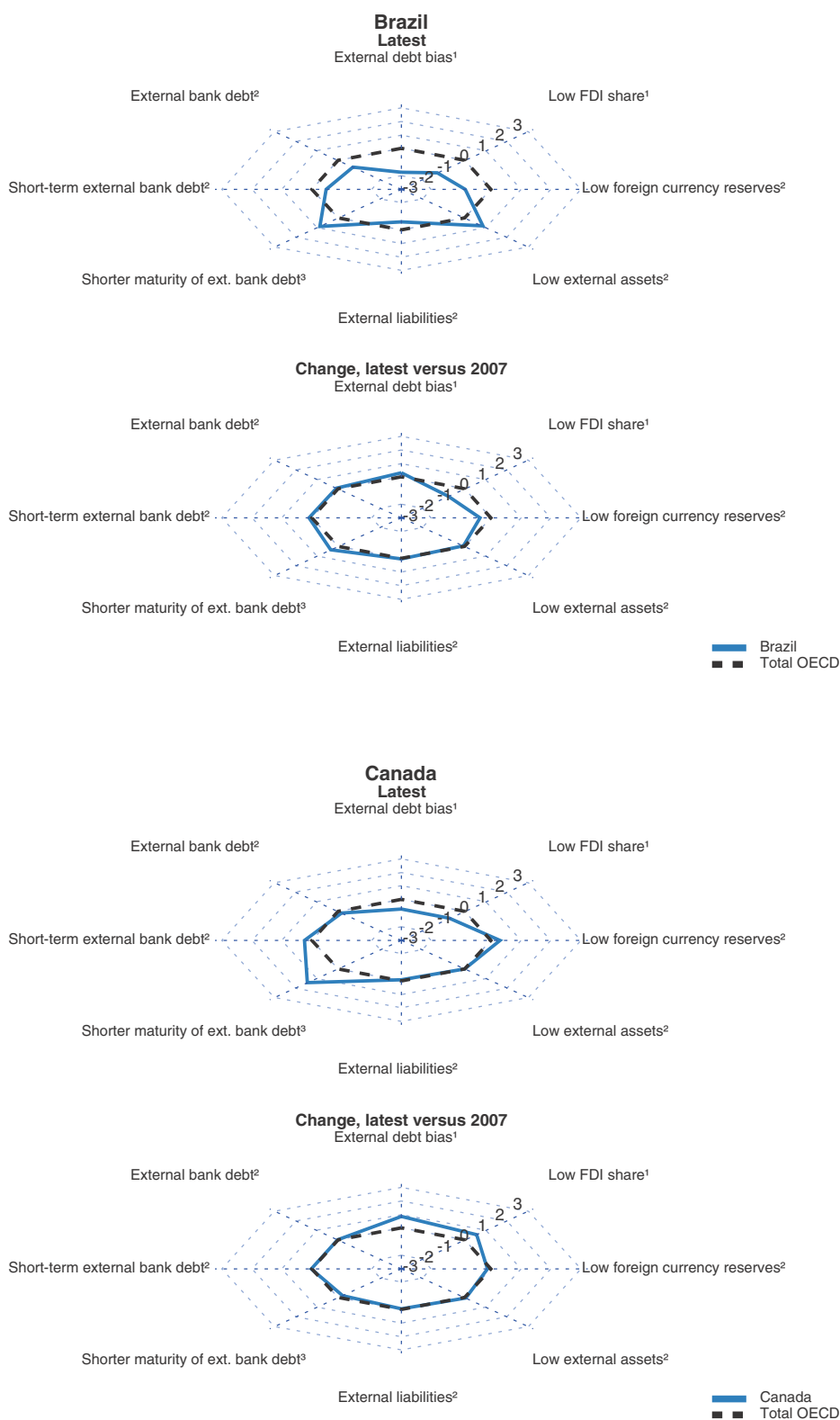


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(1) As a per cent of external liabilities. (2) As a per cent of GDP. (3) As a per cent of external bank debt.

Source: OECD calculations.

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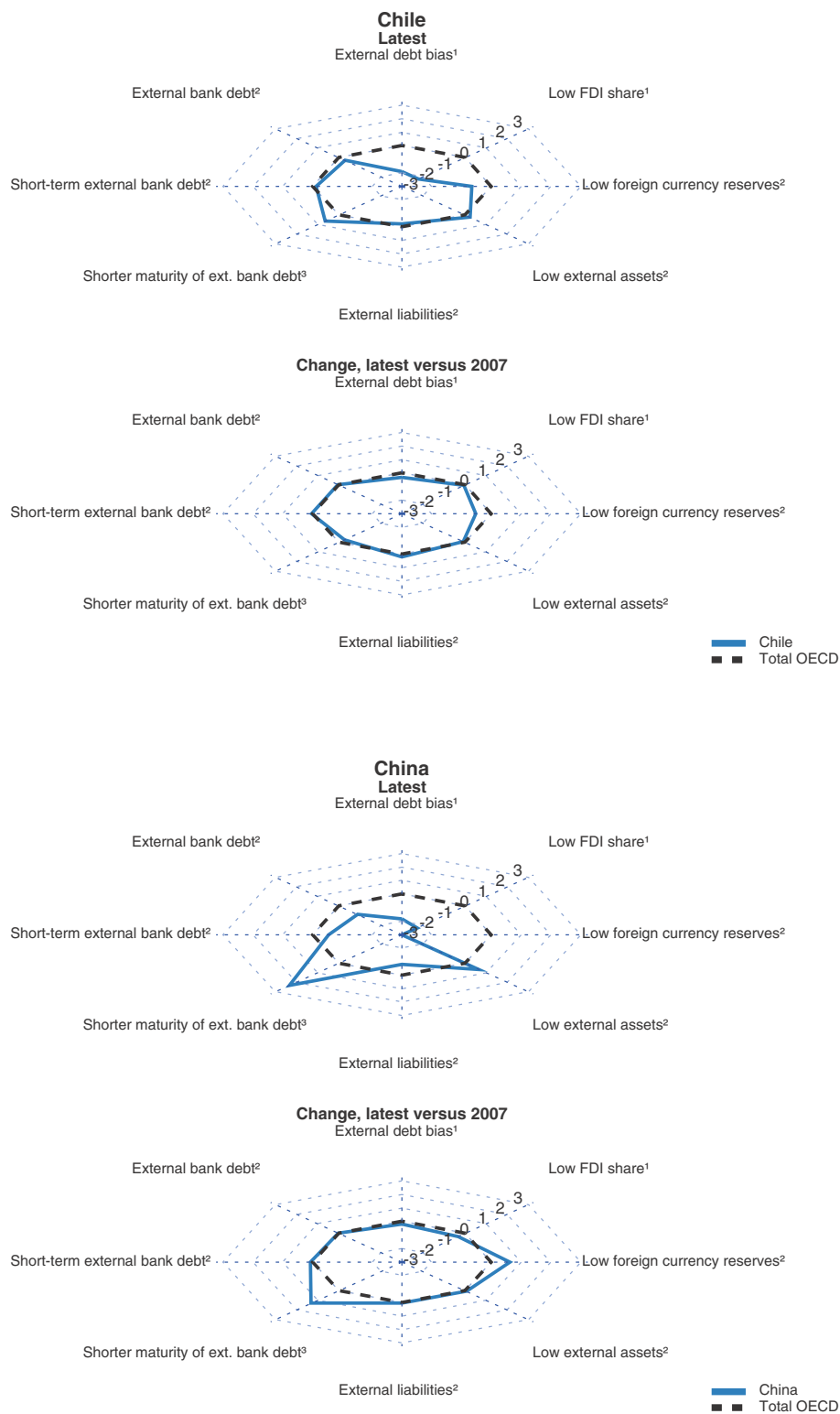


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Source: OECD calculations.

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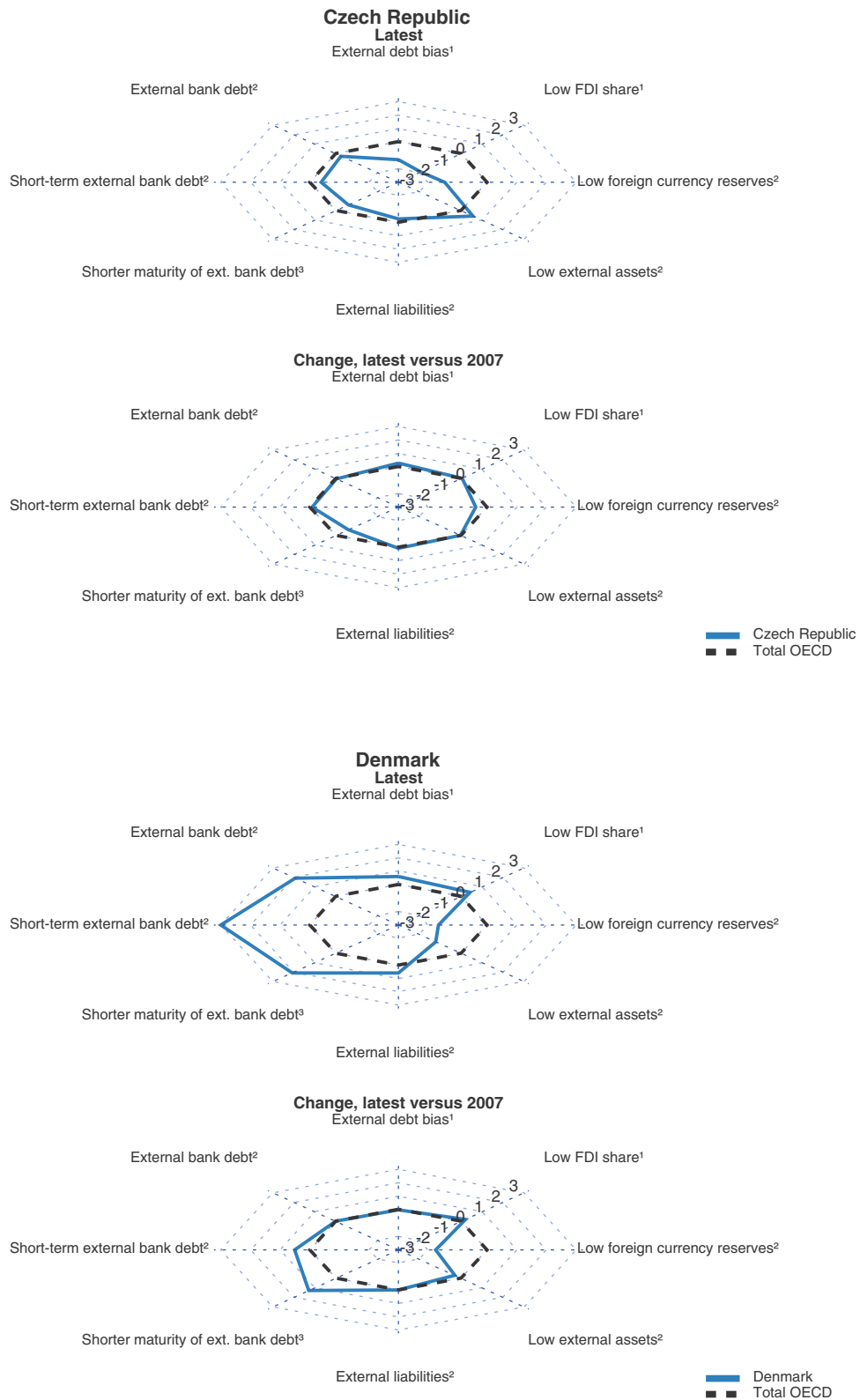


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Source: OECD calculations.

StatLink <http://dx.doi.org/10.1787/888932958866>

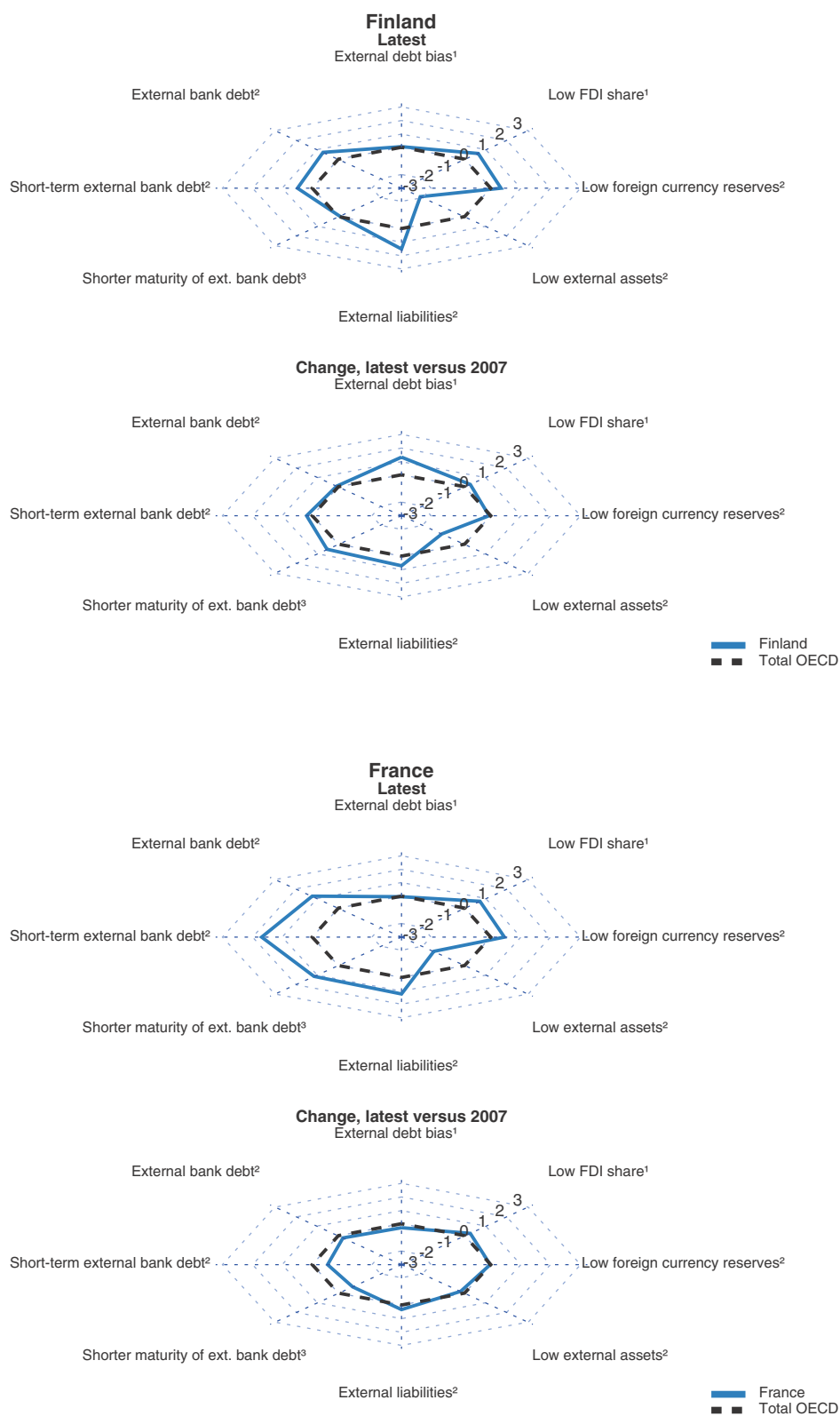


Note: The diamond charts are explained in the introduction to the annex.

(1) As a per cent of external liabilities. (2) As a per cent of GDP. (3) As a per cent of external bank debt.

Source: OECD calculations.

StatLink <http://dx.doi.org/10.1787/888932958866>

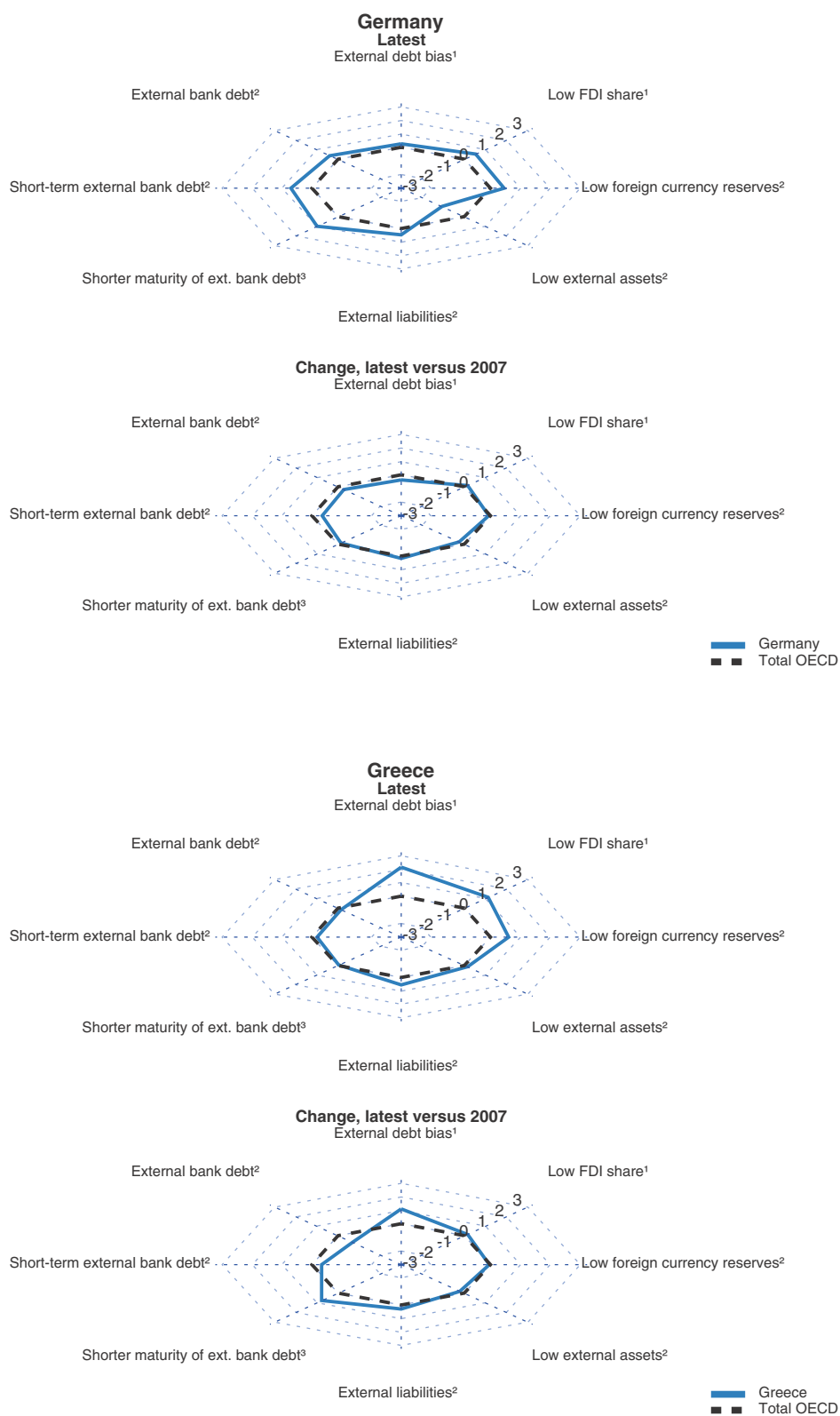


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Source: OECD calculations.

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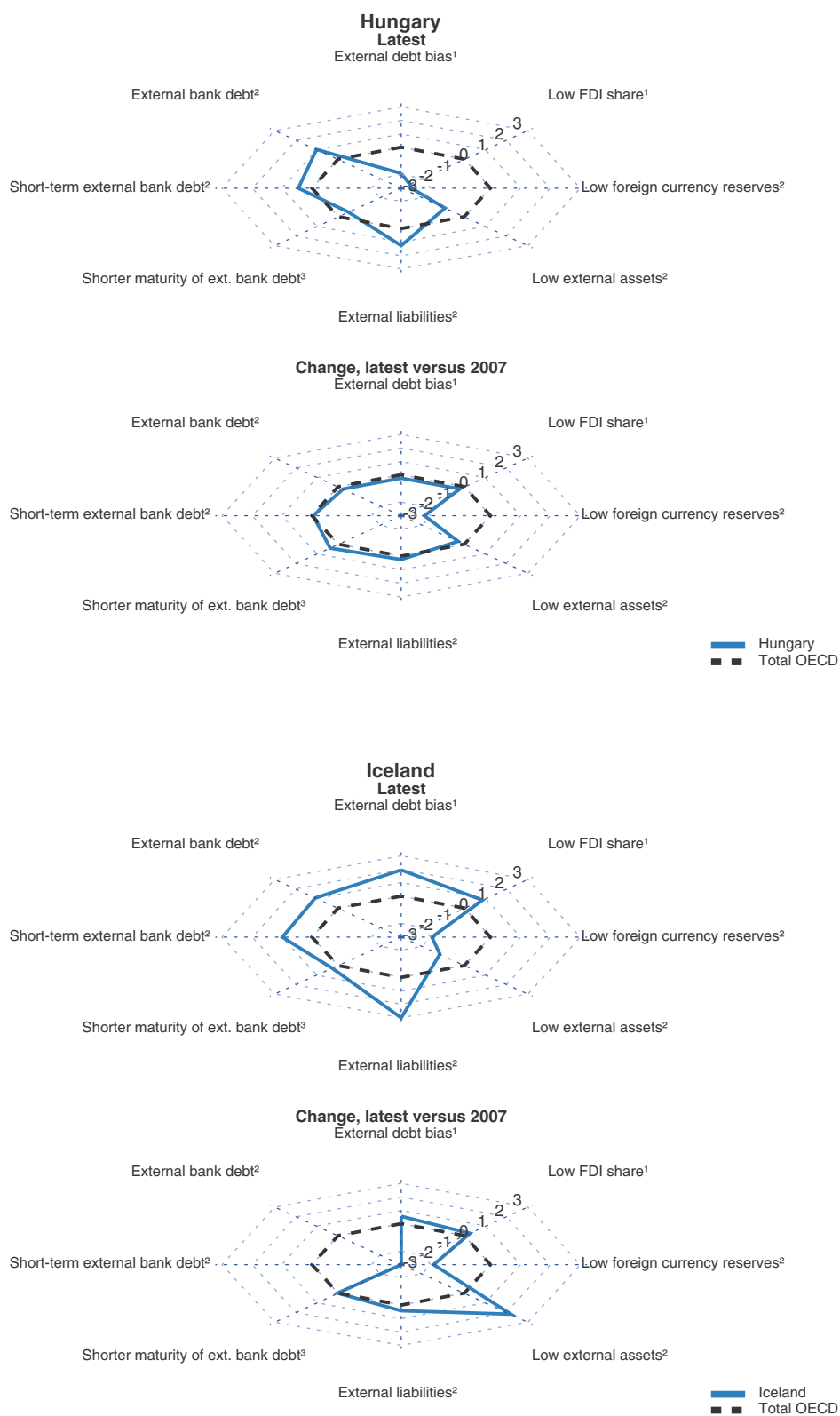


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Source: OECD calculations.

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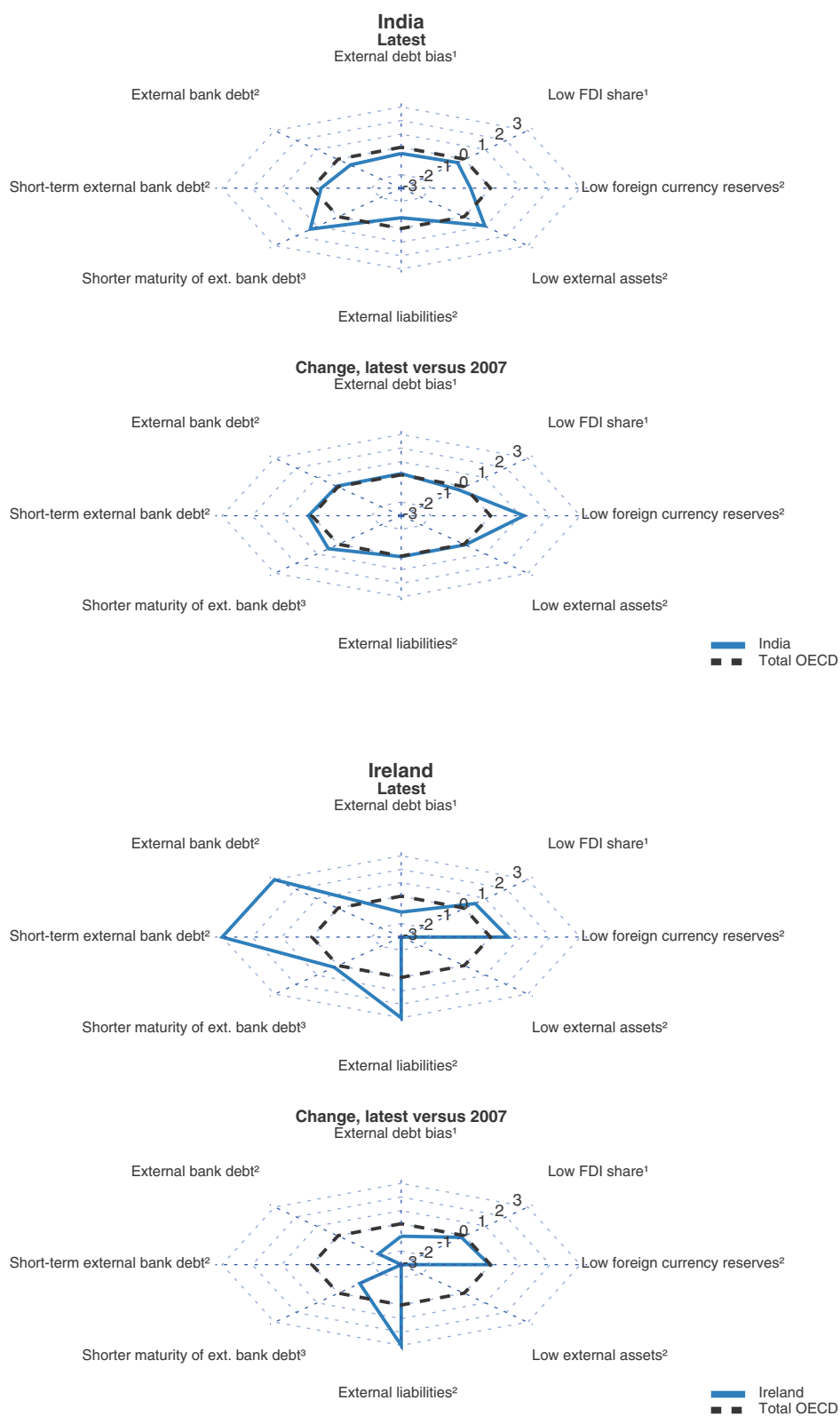


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Source: OECD calculations.

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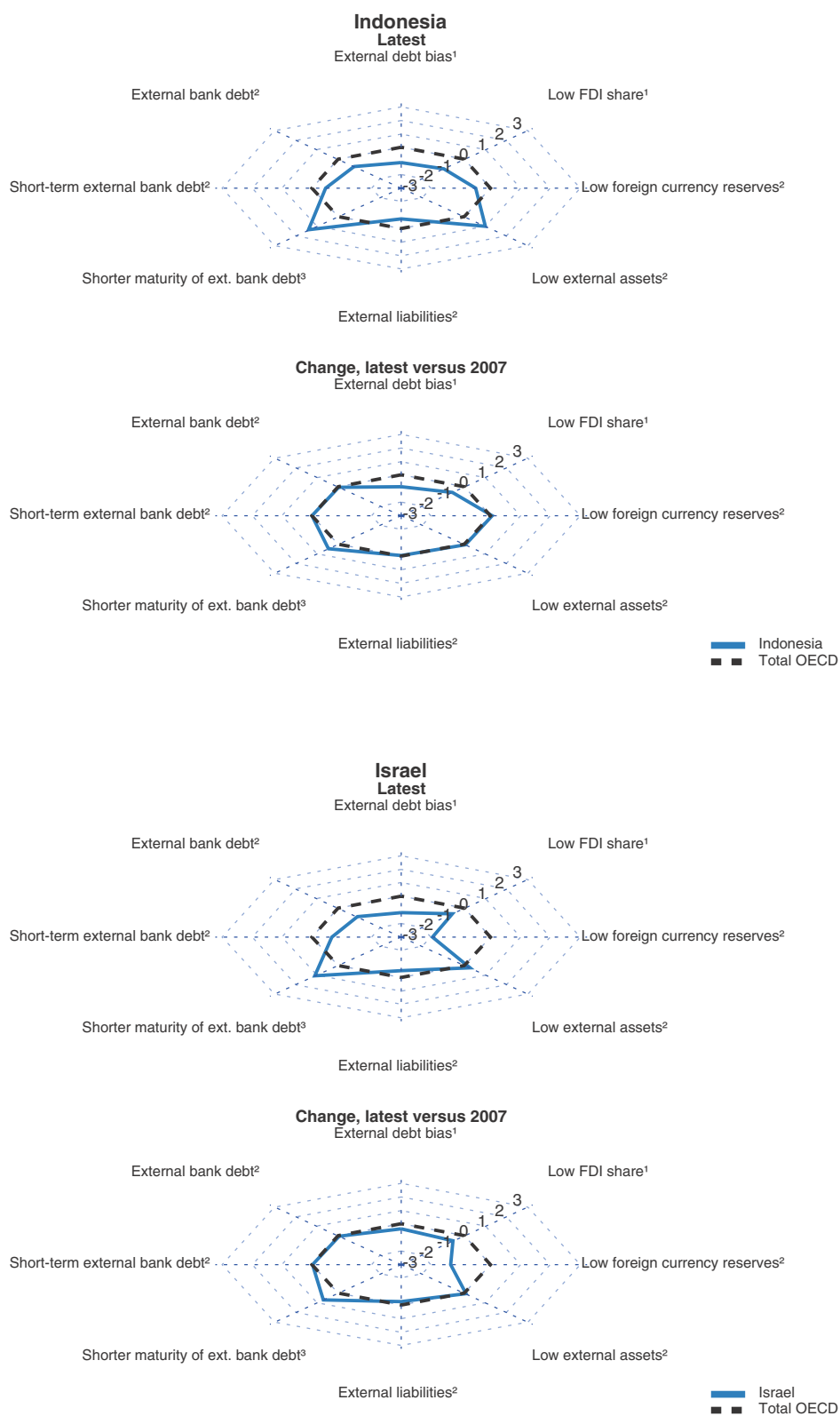


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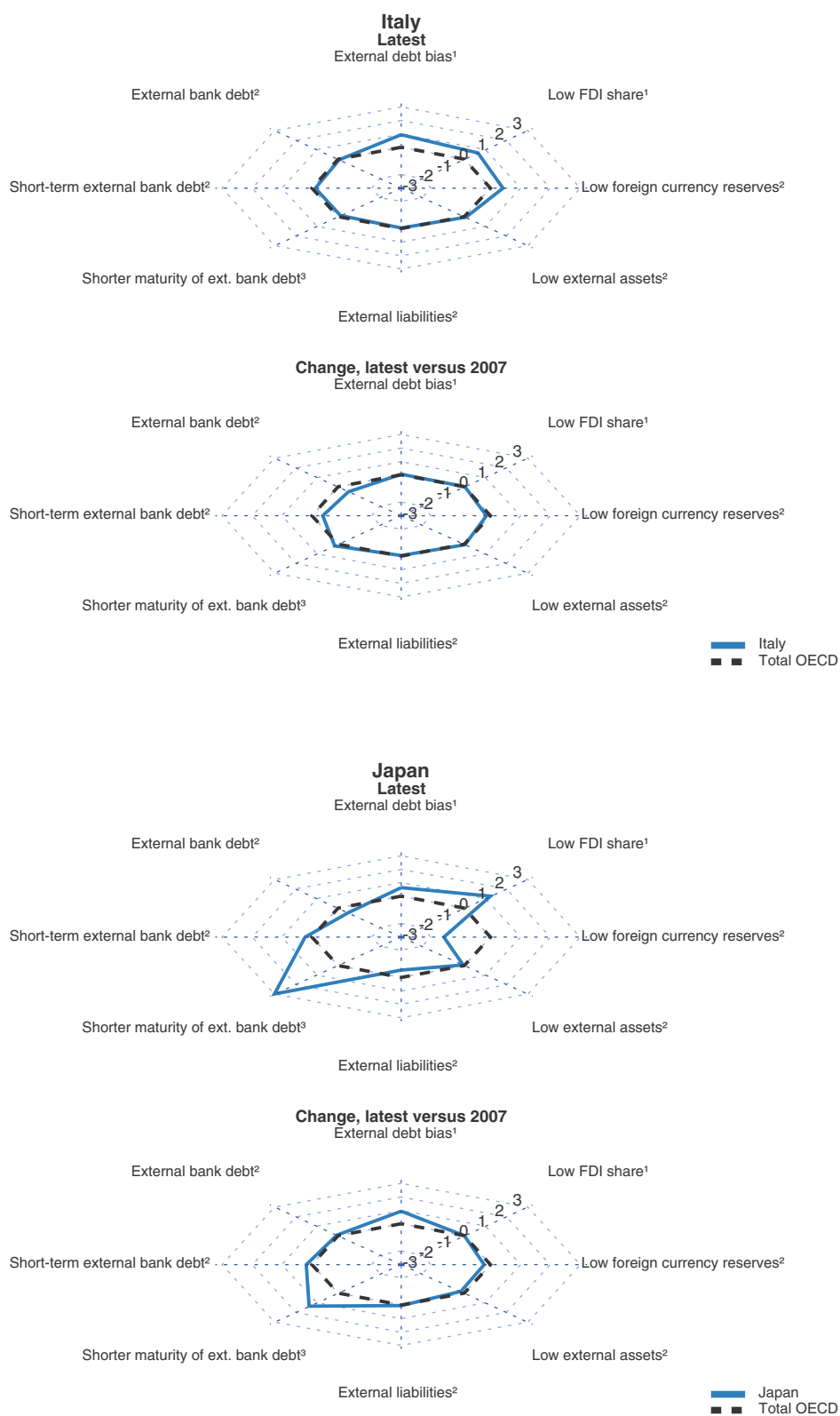


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Source: OECD calculations.

StatLink <http://dx.doi.org/10.1787/888932958866>

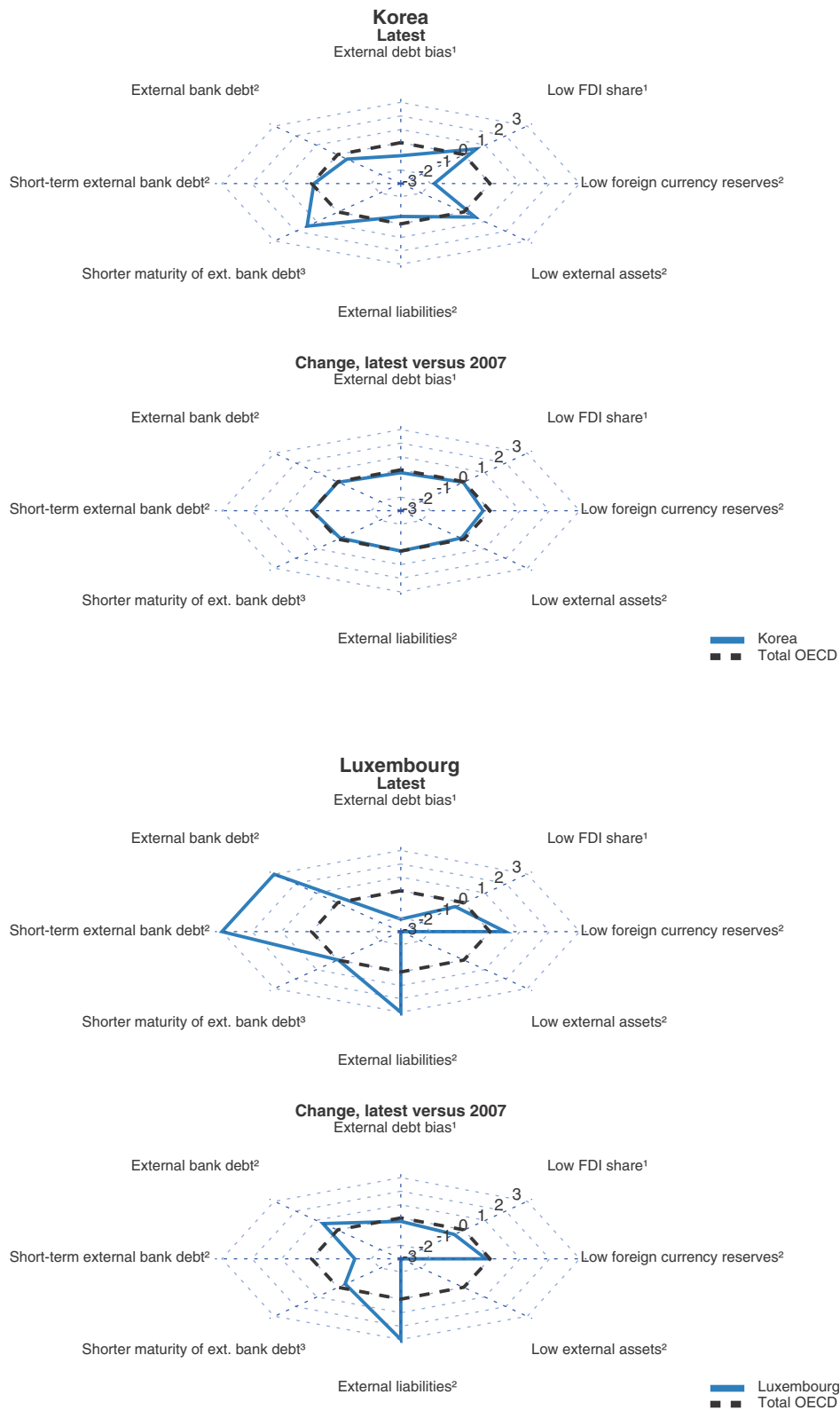


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Source: OECD calculations.

StatLink <http://dx.doi.org/10.1787/888932958866>

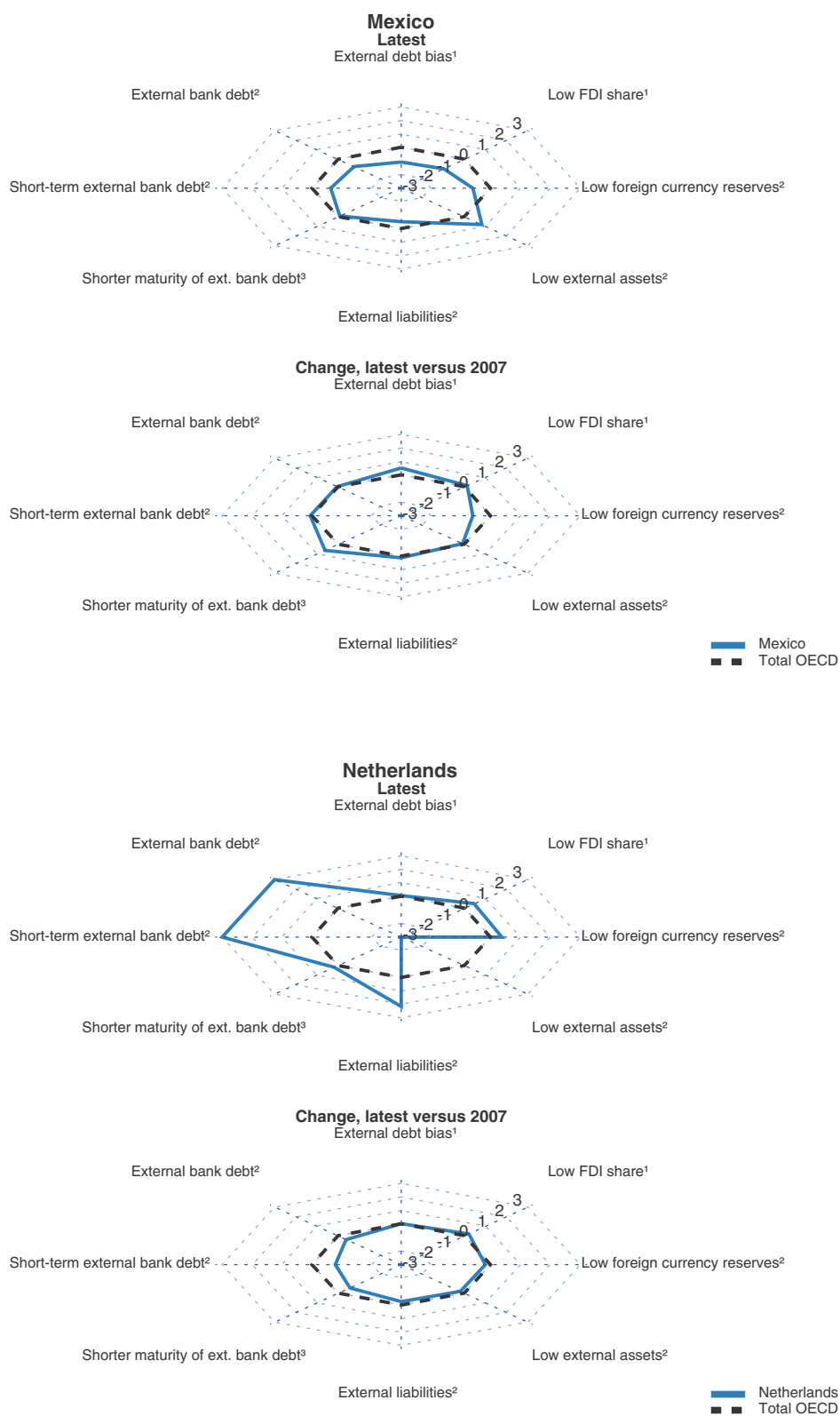


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Source: OECD calculations.

StatLink <http://dx.doi.org/10.1787/888932958866>

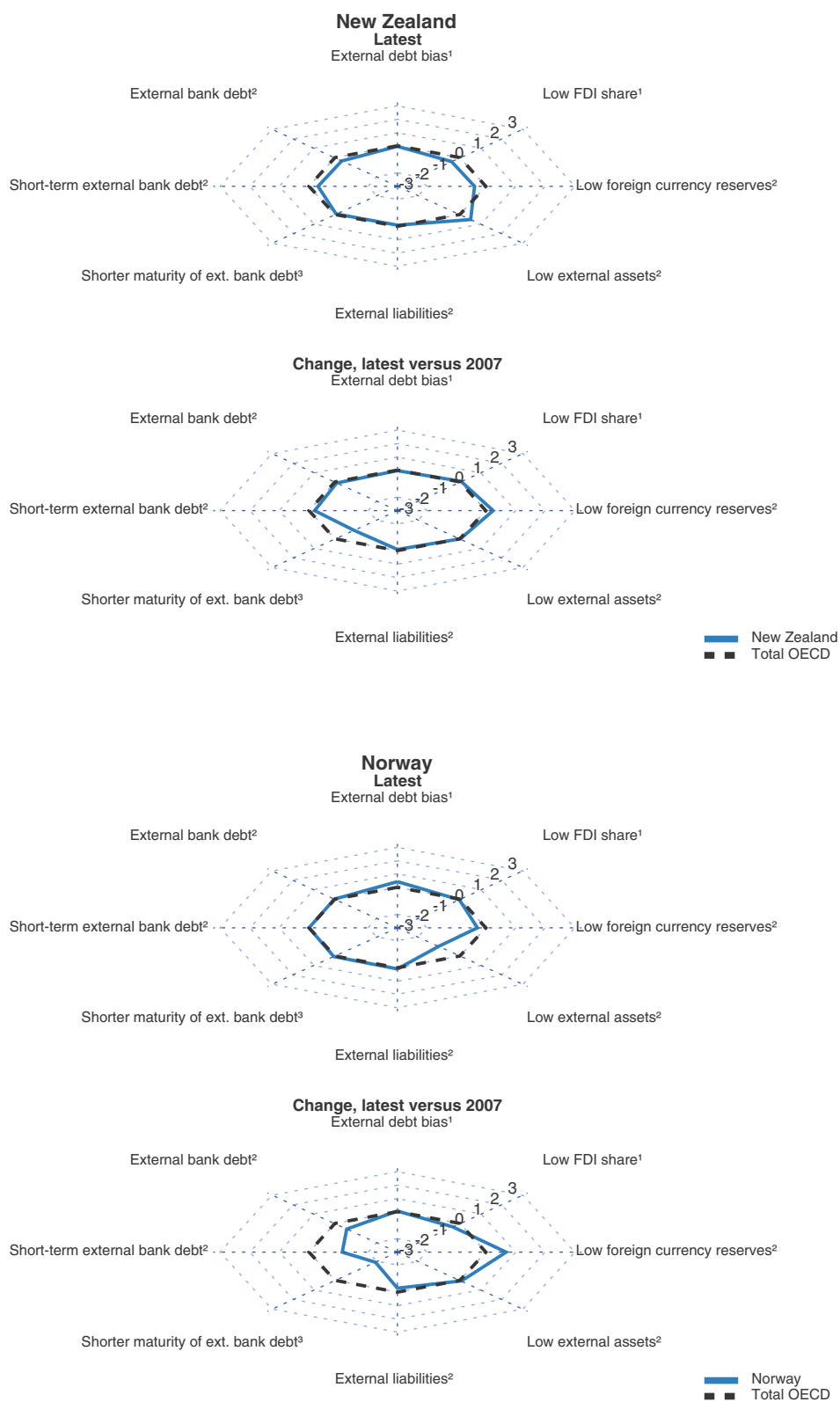


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Source: OECD calculations.

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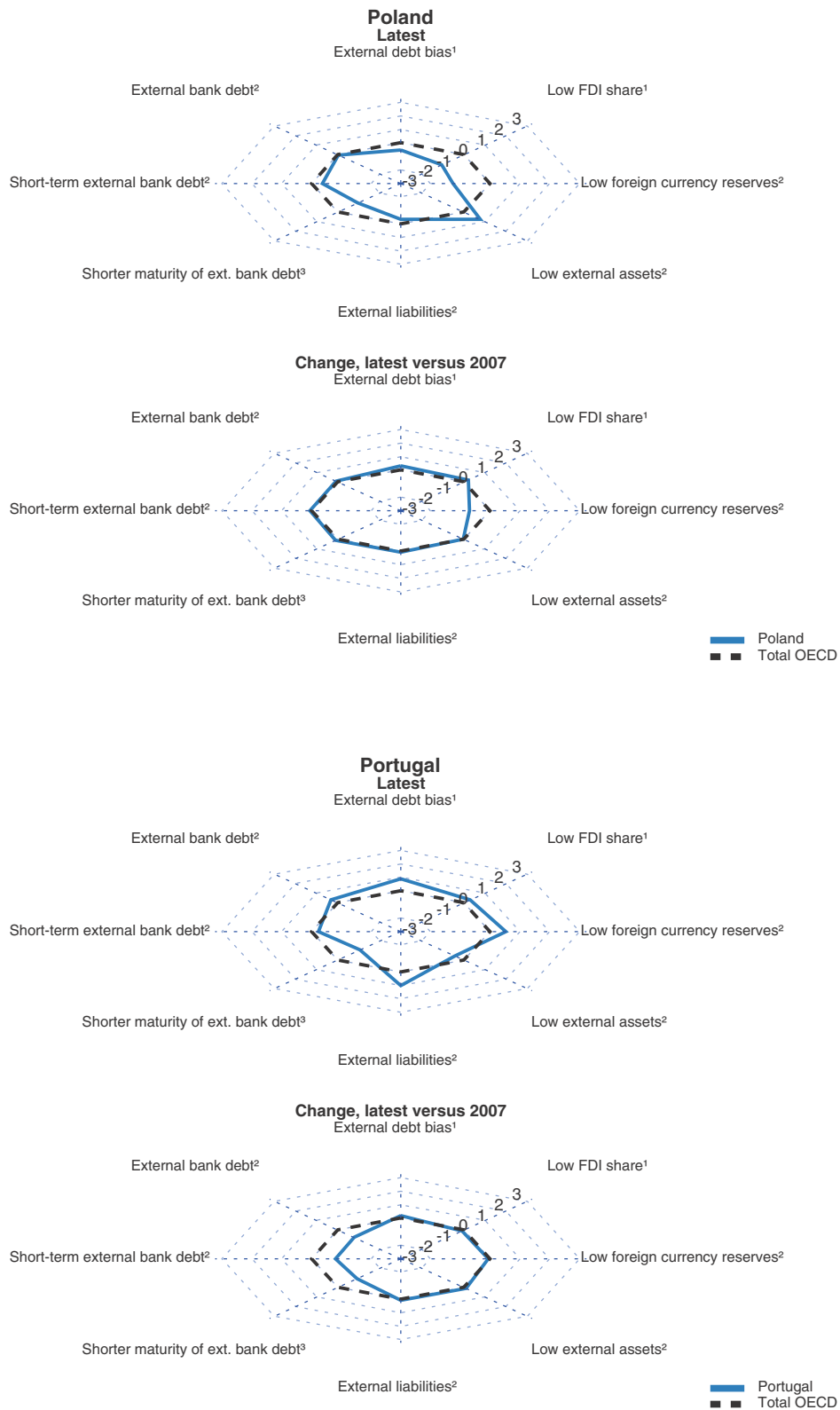


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Source: OECD calculations.

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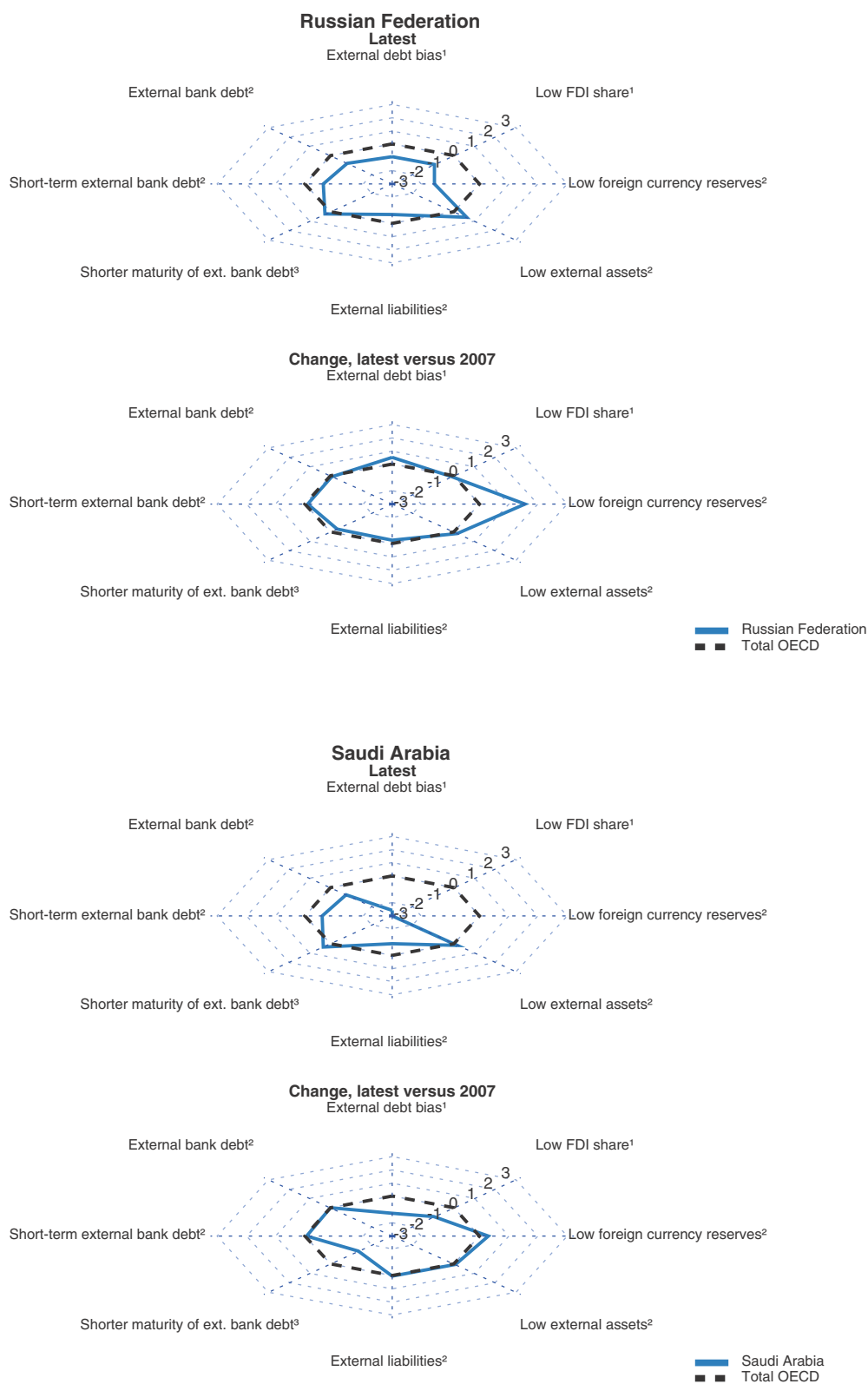


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Source: OECD calculations.

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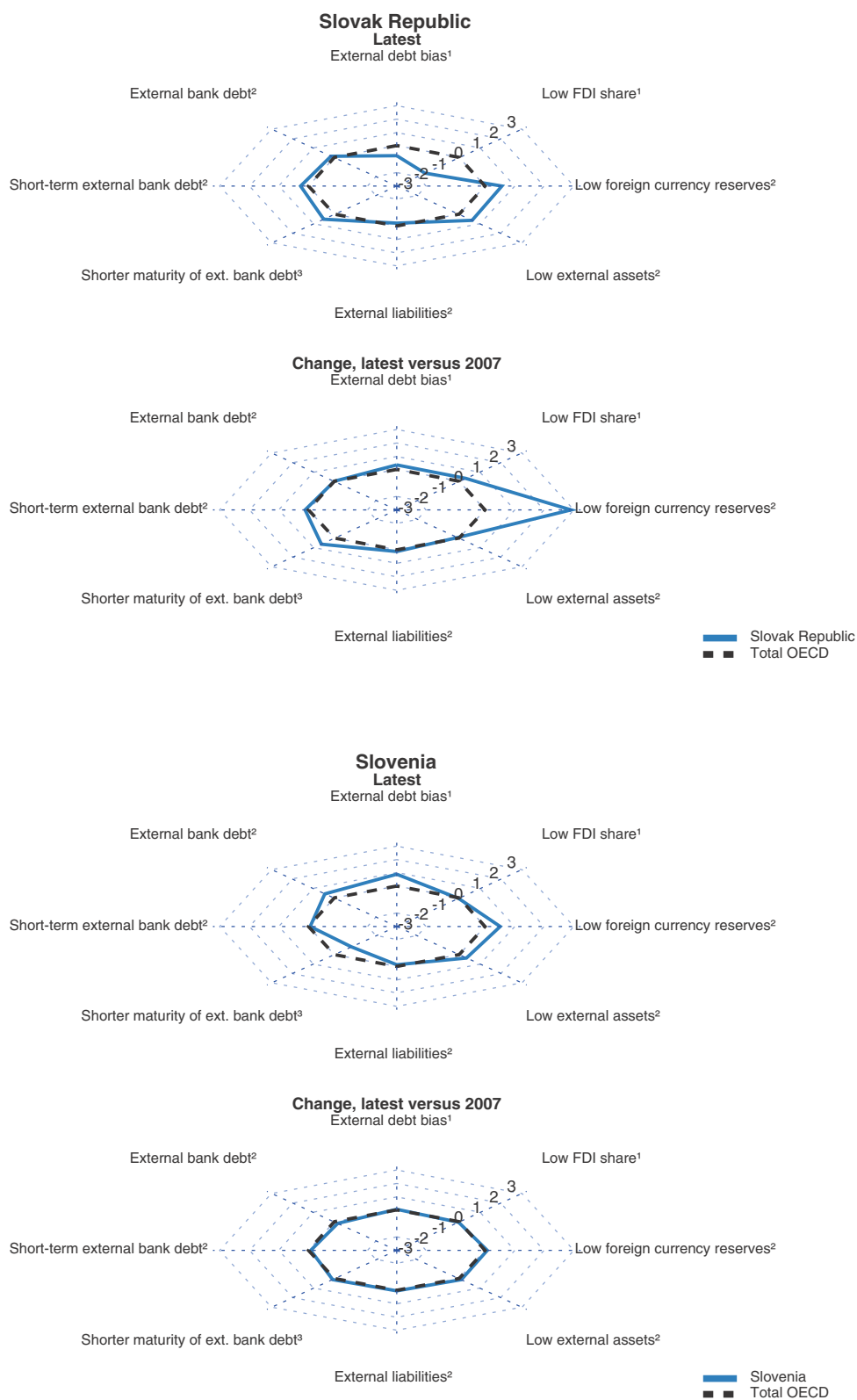


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Source: OECD calculations.

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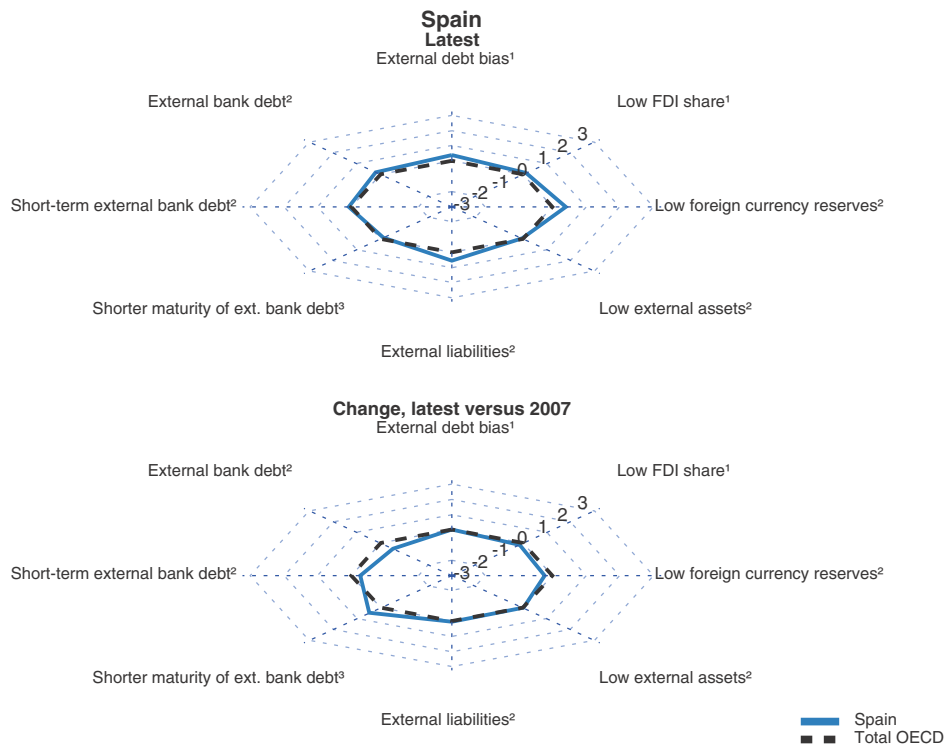


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Source: OECD calculations.

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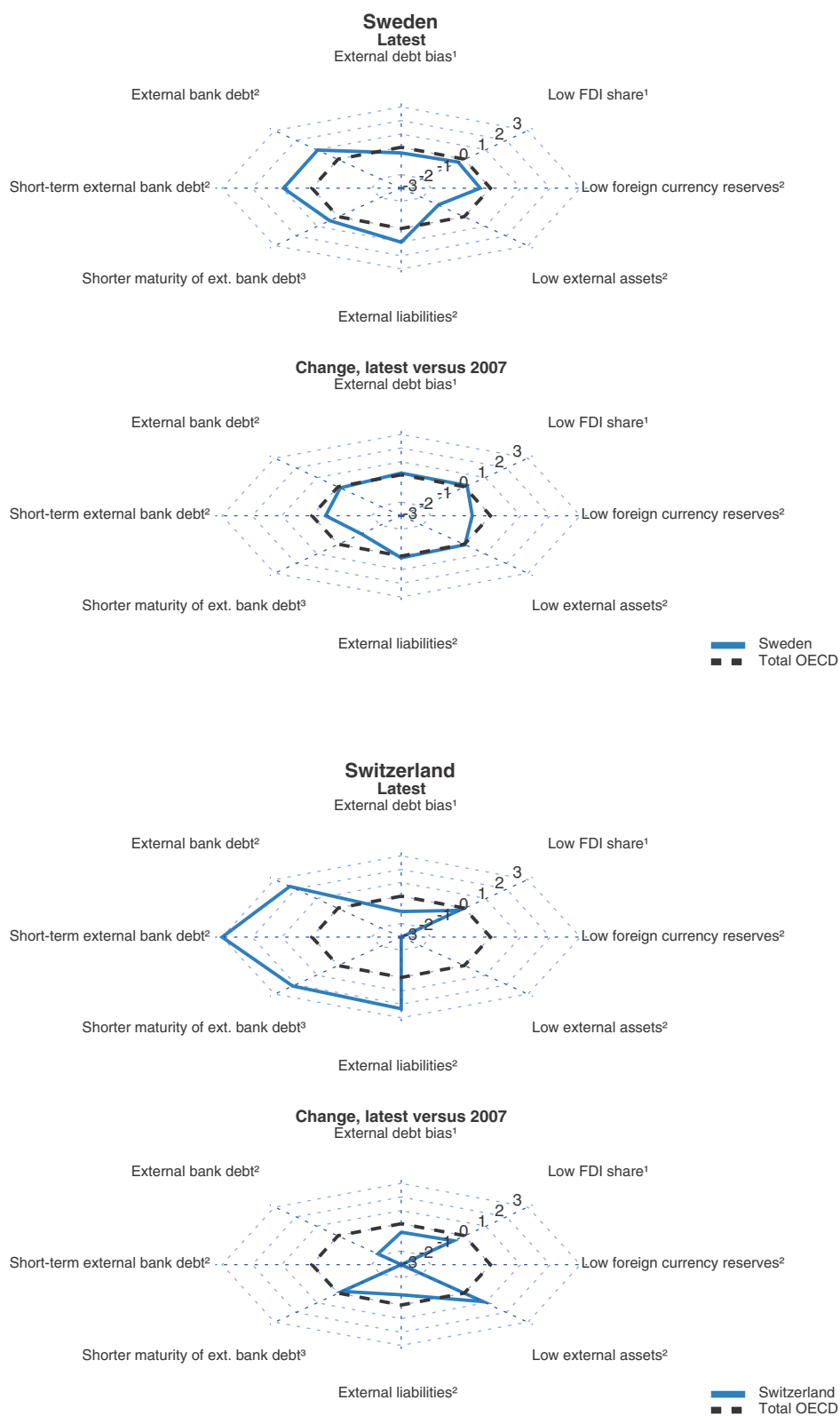


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Source: OECD calculations.

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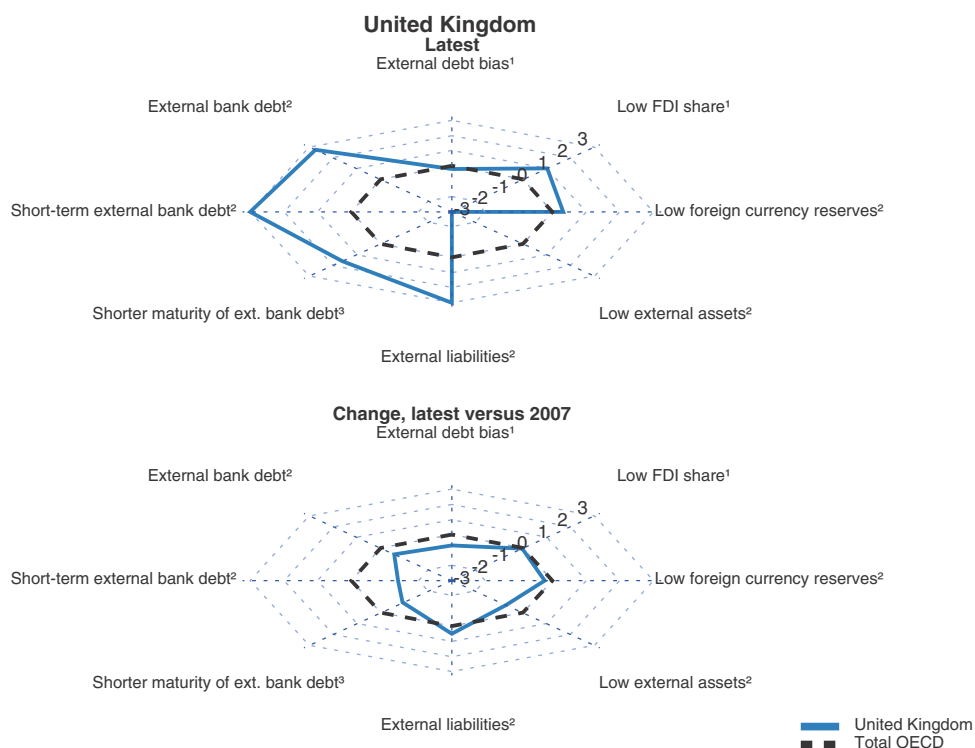
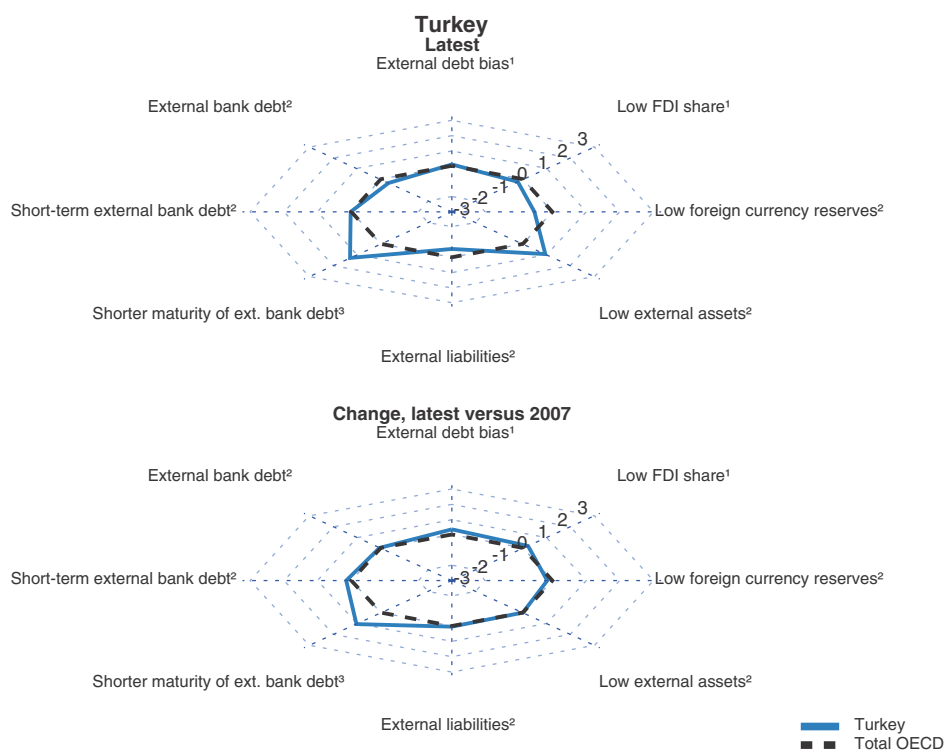


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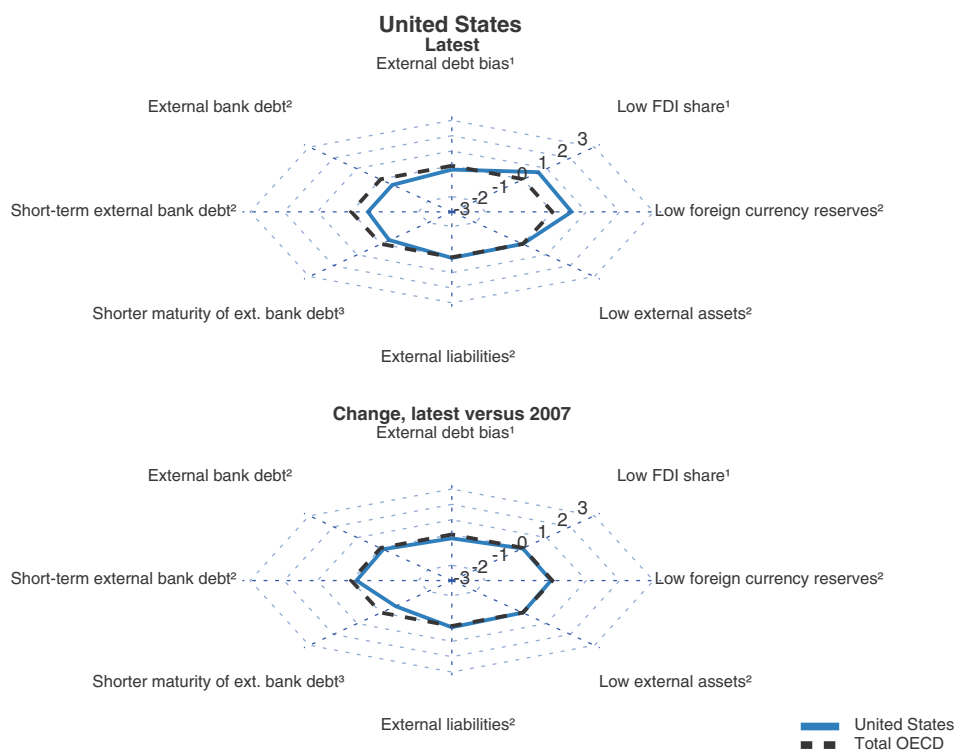


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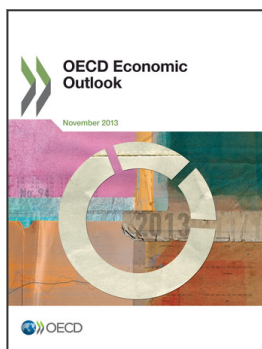


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