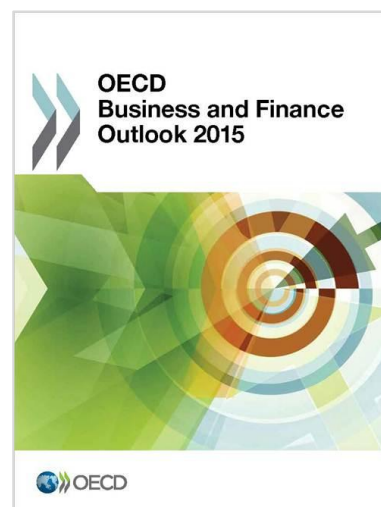


The OECD's Business and Finance Outlook looks at the Greatest Puzzle of Today

Adrian Blundell-Wignall gives a preview of what's in the OECD Business and Finance Outlook scheduled for release on 24 June 2015

The greatest puzzle today is that since the global crisis financial markets see so little risk, with asset prices rising everywhere in response to zero interest rates and quantitative easing, while companies that invest in the real economy appear to see so much more risk. What can be happening? The puzzle is even more perplexing when we see policy makers lamenting the lack of investment in advanced countries at a time when the world economy shows all of the characteristics of excess capacity: low inflation and falling general price levels in some advanced countries for the first time since the gold standard and despite six years of the easiest global monetary policy stance in history.

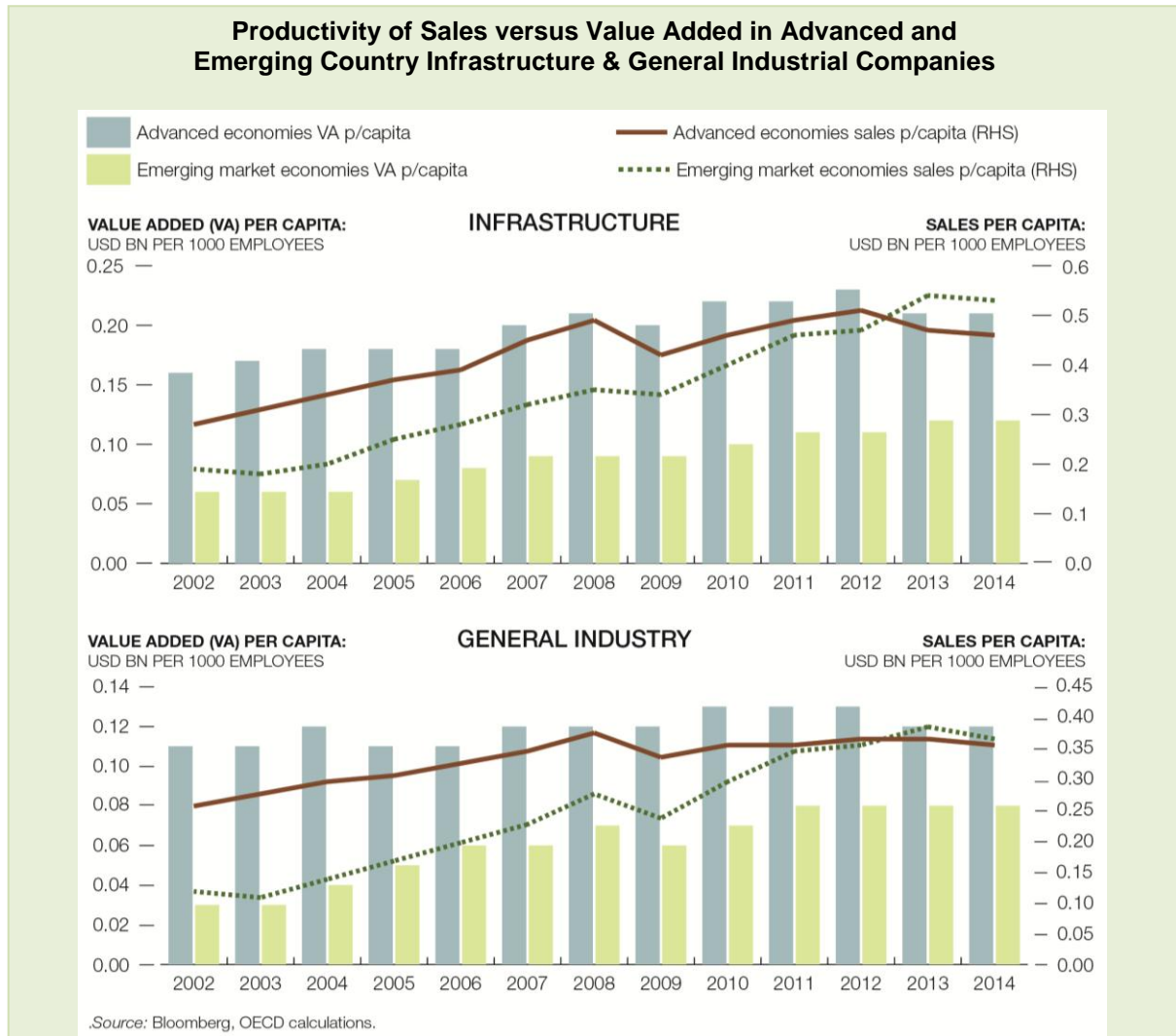


Will financial markets be proved wrong so that asset prices will soon collapse? Or, alternatively, will business investment take off and carry growth and employment to more acceptable levels validating the market optimism? The forthcoming *OECD Business and Finance Outlook* presents a reconciliation of these apparent contradictions based on the bringing together of new evidence about what is happening in some 10,000 of the world's biggest listed companies as they participate in global value chains across 75 countries and which represent a third of world GDP. The salient points are these:

- There is plenty of investment globally but from an advanced country perspective it is happening in the wrong places, as global value chains have broken down the links between policies conducted by governments inside their own borders and what their large global companies actually do. Short-termism too is apparent, where investors prefer companies that carry out more buybacks and dividends compared to those that embark on long-term investment strategies. Advanced country companies appear to prefer outsourcing investment risk to emerging market countries in global value chains when they can.
- From a developing country point of view financial repression and exchange rate targeting are legitimate development strategies. Investment is enormous (running at double the rate per unit of sales in general industrial companies compared to those of advanced countries), but it is not well based on market signals and efficient value creation strategies. Instead, it is fostered by cross-border controls, the heavy presence of state-owned banks that intermediate the “bottled-up” savings into investment, local content requirements and pervasive regulations and controls. Over-investment—characterised as a falling return on equity in relation to the high cost of equity that opens a negative value creation gap—is a feature of many emerging market companies which, at the same time, are borrowing too heavily.
- Concern about employment and growth in advanced countries has seen central banks vainly trying to stimulate investment at home: for six years they have kept close to zero interest rates and successive attempts at quantitative easing have been launched in the US, the UK, Japan and Europe. These actions are pushing up the value of risk assets in the search for yield, as pension funds and insurance companies face very real insolvency possibilities (with liabilities rising and maturing bonds being replaced by low-returning securities). The competition to buy high-yield bonds is seeing covenant protections falling, and less liquid alternative products hedged with derivatives are once more on the rise.
- Many of these new products are evolving in what has come to be known as the “shadow banking sector”: as banks themselves have become subject to greater regulatory controls financial innovation and structural changes in business models are once again adjusting to shake off the efforts of regulators. Broker-dealers intermediate between cash-rich money funds on the one hand, which need to borrow higher-risk securities to do better than a “zero” return, and cash-poor institutional

investors on the other, that need cash to meet margin and collateral management calls that the new-generation higher-yield alternative products demand. Shadow banking is focused on the reuse of assets and collateral. With this comes a new set of risks for financial market policy makers to worry about: leverage, liquidity, maturity transformation, re-investment and other risks outside of traditional banking system.

The OECD *Business and Finance Outlook* provides evidence on some of these trends.



The global value chains that facilitate the shift in the centre of gravity of world economic activity towards emerging markets are not serving economic development in the manner that might be expected.

Sales-per-employee, shown by the lines in the graph, illustrate an astounding “catch-up” of emerging countries over the past decade. However, when company “value added” per employee is calculated (shown in the bars), there is much less sign of any emerging market catch-up to advanced country productivity levels, in either infrastructure or general industrial companies.

Worse still, the “value added” productivity growth apparent in the rising columns prior to the crisis has not continued in subsequent years. This is no way in which to foster promises for ageing baby boomers, nor for the stable growth of employment for younger generations. The international financial and production systems will have to be reformed towards greater competition and openness if the world economy is to be put onto a more stable path.